INTEREST DEDUCTIBILITY—*PUBLIC TRUSTEE V CIR*

This interpretation statement expresses the Commissioner's view of the principles relating to interest deductibility from the Court of Appeal decision in *Public Trustee v CIR* [1938] NZLR 436.

The analysis in this statement considers the application of *Public Trustee* in *Williams v CIR* (1988) 10 NZTC 5,078 and the more recent case of *Borlase & Anor v Commissioner of Inland Revenue* (2001) 20 NZTC 17,261. The cases of *Pacific Rendezvous v CIR* (1986) 8 NZTC 5,146 and *Commissioner of Inland Revenue v Brierley* (1990) 12 NZTC 7,184 are also discussed.

There are four main parts to this statement. Part 1 is a summary of the Commissioner's view of when interest is deductible when applying *Public Trustee*. Part 2 is an expanded analysis section discussing the Commissioner's view. Some background and specific comments on alternative approaches not accepted by the Commissioner are covered in Part 3. Part 4 contains the conclusions.

> The position outlined in this statement replaces the Commissioner's interpretation of *Public Trustee* in a statement in *Tax Information Bulletin* Vol 3, No 9 (June 1992). That statement in the TIB, to the extent that it relates to the interpretation and application of *Public Trustee*, is hereby withdrawn.
>
> This statement originates from issues paper IRRUIP 5: *Interest deductibility in certain arrangements*, which was issued for public consultation in March 2001. (IRRUIP 5 had superseded an earlier issues paper, IRRUIP 3.) IRRUIP 5 should not be relied upon as stating the Commissioner's current view on matters of interest deductibility.
>
> Other issues discussed in IRRUIP 5 may be covered in future statements

PART 1 – SUMMARY

1. The interest deductibility test is satisfied if there is a sufficient connection between interest and assessable income. In *Public Trustee*, the borrowed funds were not used to acquire income earning assets, but were used to retain income earning assets.

2. When borrowings are used to acquire assets, the connection with assessable income is different in nature from any connection made when borrowings retain assets. The case of *Pacific Rendezvous* has held that if the borrowed funds are used to acquire income earning assets, that would in itself be sufficient to establish the connection between interest incurred on the borrowed funds and the derivation of assessable income. Where funds are

instead used to retain income earning assets, the interest is not necessarily deductible. It may be deductible if, in the circumstances, a sufficient connection with assessable income exists.

3. Following *Public Trustee*, the Commissioner considers that interest on borrowings will be deductible when the borrowed funds retain income earning assets, if the taxpayer can establish that:

- the liability that the borrowed funds were used to discharge was involuntary; and
- the taxpayer definitely would have realised particular income earning assets, if the taxpayer had not borrowed; and
- the liability that the borrowed funds were used to discharge arose in connection with the income earning assets retained.

The factors in the second and third bullet points may entail apportionment.

4. When the three factors are all present, taxpayers have certainty about how the Commissioner will apply the law. The Commissioner accepts that it may be possible for taxpayers to establish that interest is deductible when borrowings are made in order to retain assets, even though the three factors are not present. Interest may be deductible in such circumstances if the nexus is similar in strength to the nexus established when the three factors are present. In considering these situations, a guiding principle will be whether, on the particular facts, the borrowing prevented a realisation of income earning assets. All the circumstances will be relevant in considering whether there is a sufficient connection with income.

5. *Pacific Rendezvous* and *Public Trustee* also establish that where there is a sufficient connection with assessable income, whether through income earning assets being acquired or retained, the fact that the borrowed funds concurrently serve another use, unrelated to income, will not break that sufficient connection.

PART 2 – ANALYSIS OF THE COMMISSIONER'S VIEW

BACKGROUND

Legislation

Income Tax Act 2004

Part D — Deductions

Subpart DA — General rules

DA 1 General permission
DA 1(1) Nexus with income

A person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation loss) to the extent to which the expenditure or loss is—

(a) incurred by them in deriving—
  (i) their assessable income; or
  (ii) their excluded income; or
  (iii) a combination of their assessable income and excluded income; or

(b) incurred by them in the course of carrying on a business for the purpose of deriving—
  (i) their assessable income; or
  (ii) their excluded income; or
  (iii) a combination of their assessable income and excluded income.

DA 1(2) General permission
Subsection (1) is called the **general permission**.
Defined in this Act: amount, assessable income, business, deduction, depreciation loss, excluded income, general permission, loss

DA 2 General limitations
DA 2(1) Capital limitation
A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.
DA 2(2) Private limitation
A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the **private limitation**.
DA 2(3) Exempt income limitation
A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income. This rule is called the **exempt income limitation**.
…
DA 2(7) Relationship of general limitations to general permission
Each of the general limitations in this section overrides the general permission.
Defined in this Act: amount, capital limitation, deduction, employment limitation, exempt income, exempt income limitation, general limitation, general permission, income from employment, loss, non-residents' foreign-sourced income, non-residents' foreign-sourced income limitation, private limitation, schedular income subject to final withholding, withholding tax limitation

DA 3 Effect of specific rules on general rules
DA 3(1) Supplements to general permission
A provision in any of subparts DB to DZ may supplement the general permission. In that case, a person to whom the provision applies does not have to satisfy the general permission to be allowed a deduction.
DA 3(2) Express reference needed to supplement
A provision in any of subparts DB to DZ takes effect to supplement the general permission only if it expressly states that it supplements the general permission.
DA 3(3) Relationship of general limitations to supplements to general permission
Each of the general limitations overrides a supplement to the general permission in any of subparts DB to DZ, unless the provision creating the supplement expressly states otherwise.
DA 3(4) Relationship between other specific provisions and general permission or general limitations
A provision in any of subparts DB to DZ may override any 1 or more of the general permission and the general limitations.
DA 3(5) Express reference needed to override
A provision in any of subparts DB to DZ takes effect to override the general permission or a general limitation only if it expressly states—

(a) that it overrides the general permission or the relevant limitation; or
(b) that the general permission or the relevant limitation does not apply.

…

DB 1 Taxes, other than GST, and penalties
DB 1(1) No deduction
A person is denied a deduction for the following:
(a) income tax:
(b) a civil penalty under Part 9 of the Tax Administration Act 1994:
(c) a tax, a penalty, or interest on unpaid tax that is—
  (i) payable under the laws of a country or territory outside New Zealand; and
  (ii) substantially the same as a civil penalty as defined in section 3(1) of the Tax Administration Act 1994, or a criminal penalty under Part 9 of the Act, or interest imposed under Part 7 of the Act.

…

DB 6 Interest: not capital expenditure
DB 6(1) Deduction
A person is allowed a deduction for interest incurred.
DB 6(2) Exclusion
Subsection (1) does not apply to interest for which a person is denied a deduction under section DB 1.
DB 6(3) Link with subpart DA
This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.
Defined in this Act: capital limitation, deduction, general limitation, general permission, interest

DB 7 Interest: most companies need no nexus with income
DB 7(1) Deduction
A company is allowed a deduction for interest incurred.
DB 7(2) Exclusion: qualifying company
Subsection (1) does not apply to a qualifying company.
DB 7(3) Exclusion: exempt income
If a company **(company A)** derives exempt income or another company **(company B)** in the same wholly-owned group of companies derives exempt income, subsection (1) applies to company A only if all the exempt income is 1 or more of the following:
(a) dividends; or
(b) income exempted under section CW 46 (Disposal of companies' own shares); or
(c) income exempted under section CW 48 (Stake money) and ancillary to the company's business of breeding.
DB 7(4) Exclusion: non-resident company
If a company is a non-resident company, subsection (1) applies only to the extent to which the company incurs interest in the course of carrying on a business through a fixed establishment in New Zealand.
DB 7(5) Exclusion: interest related to tax
Subsection (1) does not apply to interest for which a person is denied a deduction under section DB 1.
DB 7(6) Link with subpart DA
This section supplements the general permission and overrides the capital limitation, the exempt income limitation, and the withholding tax limitation. The other general limitations still apply.
Defined in this Act: business, capital limitation, company, deduction, dividend, exempt income, exempt income limitation, fixed establishment, general limitation, general permission, income, interest, New Zealand, non-resident company, qualifying company, supplement, wholly-owned group of companies, withholding tax limitation

***Public Trustee** principle not relevant to section DB 7 deductions*

6. The interest deductibility legislation distinguishes between companies and other taxpayers. Interest incurred by companies is automatically deductible—that is, there is no requirement to satisfy a nexus test—except for certain exceptions. The impact of this is that the interest deductibility principle derived from *Public Trustee* will have limited application. *Public Trustee* will apply in relation to the deductibility of interest expense incurred by individuals, partners, trusts and qualifying companies, and to other companies unable to obtain a deduction under section DB 7.

7. Interest incurred by companies is deductible, subject to certain exceptions. Under section DB 7, interest incurred by a company is deductible, provided the statutory exceptions in subsections DB 7(2) – (5) do not apply. The exceptions are:

    - qualifying companies;
    - companies deriving exempt income except if that exempt income is dividends, exempt income arising from a disposal of a company's own shares or exempt income related to stake money and a breeding business;
    - non-resident companies to the extent to which interest is not incurred in the course of carrying on a business through a fixed establishment in New Zealand; and
    - interest on unpaid taxes payable to another country and substantially the same as civil or criminal penalties as defined under certain laws in New Zealand.

8. The effect of section DB 7 is discussed in *Tax Information Bulletin* Vol 13, No 11 (November 2001).

How the sections of the Act, other than section DB 7, apply in relation to interest deductibility

9. Section DB 6(1) provides that:

    > A person is allowed a deduction for interest incurred.

10. Section DB 6(3) states that

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

11. Therefore, a person seeking to deduct interest is subject to the general permission, which states:

    > **DA 1 General permission**
    > **DA 1(1) Nexus with income**
    > A person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation loss) to the extent to which the expenditure or loss is—

(a) incurred by them in deriving—
  (i) their assessable income; or
  (ii) their excluded income; or
  (iii) a combination of their assessable income and excluded income; or
(b) incurred by them in the course of carrying on a business for the purpose of deriving—
  (i) their assessable income; or
  (ii) their excluded income; or
  (iii) a combination of their assessable income and excluded income.

DA 1(2) General permission
Subsection (1) is called the **general permission**.

12. So in applying the Act to interest, a person must satisfy the test under the general permission that the expenditure (interest in this case) is incurred in deriving assessable income (or excluded income) or incurred in carrying on a business for the purpose of deriving assessable (or excluded income). This test is the same in all relevant respects to the test under the 1994 Act.

13. The concept of "excluded income" requires some comment. "Excluded income" is defined and specified to include, for example, GST, fringe benefits, certain life insurance premiums or claims derived by persons carrying on the business of life insurance, and other specific classes of income (see sections OB 1, BD 1(3) and subpart CX). The addition of the reference to "excluded income" in the general permission does not alter the principles applying to the deductibility of interest. Because the concept of "excluded income" is a statutory mechanism used to deal with certain types of income, and does not affect the principles of interest deductibility, "excluded income" is not referred to further in this statement.

14. The general permission is subject to the general limitations, pursuant to section DA 2(7). The general limitations include the private limitation and the capital limitation:

DA 2 General limitations
DA 2(1) Capital limitation
A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.
DA 2(2) Private limitation
A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the **private limitation**.
…
DA 2(7) Relationship of general limitations to general permission

15. The private limitation applies to interest expense, pursuant to sections DA 2(2). The capital limitation, on the other hand, does not apply. This result is achieved in the Act by the capital limitation being expressly overridden. Sections DA 3(4) and DA 3(5) state the general rule that a limitation (such as that applying to capital expenditure) does not apply if it is expressly overridden:

DA 3(4) Relationship between other specific provisions and general permission or general limitations
A provision in any of subparts DB to DZ may override any 1 or more of the general permission and the general limitations.
DA 3(5) Express reference needed to override

> A provision in any of subparts DB to DZ takes effect to override the general permission or a general limitation only if it expressly states—
> (a) that it overrides the general permission or the relevant limitation; or
> (b) that the general permission or the relevant limitation does not apply.
> **…**

16. The capital limitation is expressly overridden by section DB 6(3) (subsections DB 6(1) is reproduced to give context):

> **DB 6 Interest: not capital expenditure**
> **DB 6(1) Deduction**
> A person is allowed a deduction for interest incurred.
> **…**
> **DB 6(3) Link with subpart DA**
> This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.
> **Defined in this Act:** capital limitation, deduction, general limitation, general permission, interest

Summary of the legislation relating to interest deductions

17. In summary, the legislation provides the following general rules relating to interest deductibility:

- Interest incurred by companies is usually automatically deductible;
- For other taxpayers, interest is deductible if it is incurred in deriving assessable income or incurred in carrying on a business for the purpose of deriving assessable income;
- Interest is not deductible if it is private or domestic in nature;
- Being capital in nature will not, on its own, mean that interest is non-deductible.

Case law on the deductibility of interest

18. Before *Public Trustee* is discussed, general principles relating to interest deductibility will be outlined.

Pacific Rendezvous

19. In *Pacific Rendezvous*, the Court of Appeal held that the test for interest deductibility was whether borrowed funds on which the interest is incurred have been used in deriving income or in a business carried on to derive income. Richardson J said:

> It is both necessary and sufficient that the capital was employed in the production of assessable income. "Employed" bears its plain ordinary meaning and is synonymous with "used". The difficulty lies in determining whether or not the statutory nexus is satisfied in the particular case.

20. The borrowed funds had all been put into additions and improvements. Although the company in that case had another dominant purpose of increasing the capital value of the property, and even received capital amounts, that was not relevant. The sole question was whether the capital was employed in the production of the assessable income, and the Court held that it was.

21. At that time the interest deductibility provision referred to capital "employed" in the production of income. The Court in *Pacific Rendezvous* said that there was no difference between "employed" and "used". It can be assumed therefore that in the context of interest deductibility the meaning of "employed" is the same as the meaning of "used". For the purposes of this statement, the word "used" will generally be used instead of "employed".

The old and the new interest deductibility tests— is the "use" of the funds still the test?

22. Richardson J commented in *Pacific Rendezvous* on the similarities between the interest deductibility test the Court was considering and the general deductibility test. The comments are of particular interest because the interest deductibility test was amended after *Pacific Rendezvous* to mirror the general deductibility test. Under the test the Court was considering in *Pacific Rendezvous*, interest was deductible if it was payable on capital employed in the production of assessable income. The general deductibility provision was satisfied if the expenditure was incurred in the gaining or producing of assessable income or necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income.

23. Richardson J said that the considerations under both provisions will ordinarily be the same. Therefore, an examination of the use of borrowed funds remained relevant under the reworded interest deductibility provision. The legislation was amended again in the rewritten Income Tax Act 2004, to provide that expenditure (including interest) is deductible if it is incurred in deriving assessable income. In the Commissioner's opinion, this latest change has not affected the test. If a sufficient connection exists through the use of borrowed funds, the interest will be deductible.

24. The courts have continued to examine the use of the funds and continued to regard *Pacific Rendezvous* as the leading authority on interest deductions, despite the change in wording. For example, in *Borlase*, a 2001 decision, the High Court applied a "use" test. Since *Pacific Rendezvous*, Taxation Review Authority decisions concerned with interest deductions all examine the use of funds, for example, *Case L76* (1989) 11 NZTC 1,441, *Case L81* (1989) 11 NZTC 1,648, *Case R8* (1994) 16 NZTC 6,049 and *Case S17* (1995) 17 NZTC 7,127. A reason for the continued reliance on an examination of the borrowed funds is that usually the interest itself is not connected with the income earning activity. The interest is the cost of the funds and is not itself used in deriving income. Rather, it is the borrowed funds that are invested in an income earning activity or business, and so it is the borrowed funds that may have a connection with income (*Ure v FC of T* 81 ATC).

The relevance of other factors, including purpose

25. Although the use of funds remains the primary test, the courts have indicated that in some situations other factors may be relevant. Interest arising under financial arrangements is deductible if a sufficient connection is established, though there is no principal amount. *Roberts and Smith* can be argued to be authority that interest may be deductible if borrowing replaces funds used in an income earning activity, without the necessity of tracing the payment of the borrowings to the funds replaced. Following *Roberts and Smith*, arguably the deduction can be obtained if the funds are paid elsewhere (in that case to partners) and in effect replace capital in the partnership.

26. Another factor that may sometimes be relevant is a taxpayer's purpose. In *Pacific Rendezvous*, Richardson J said a taxpayer's purpose may be relevant, but only in considering whether capital has been employed in the production of assessable income.

Brierley

27. *Pacific Rendezvous* was followed in *Brierley*. In *Brierley*, the taxpayer had borrowed money to take up annual cash issues made by the public company. A number of different types of returns, including non-assessable amounts, were received by the taxpayer.

28. The Commissioner argued that there were several uses to which the borrowed moneys were put, and only one was a use connected with income. Like *Pacific Rendezvous*, the taxpayer's purpose included deriving capital gain amounts and other non-assessable amounts. The Commissioner considered that the interest should be apportioned not just on the basis of the taxpayer's purposes, but on the basis of the actual amounts the taxpayer received.

29. The Court concluded:

> It is the standard case of an investment which may provide both an income and a capital return. It was in that same situation that the Court in *Pacific Rendezvous* held that the moneys borrowed were fully employed in the production of assessable income even though they were also used for a purpose other than the production of assessable income, and even though capital profits were actually realised during the relevant income years. In short, it was not considered appropriate to dissect and apportion in such a case where separate uses in respect of different parts of the assets involved or for different periods of time could not be identified.

THE PUBLIC TRUSTEE CASE

30. *Public Trustee* concerned an estate that did not have sufficient cash to pay death duties. The death duties constituted a charge on all of the assets of the estate. The trustee of the estate borrowed to pay the death duties. In a majority judgment, the Court held that the interest was deductible.

31. The leading judgment was given by Myers CJ. At p. 452, Myers CJ said:

> For the determination of this question the substance of the transaction must be regarded. 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.
>
> …
>
> 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.

32. He then went on to say (at p. 453):

> 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.

33. Myers CJ considered that there was a sufficient connection between the interest and the Public Trust's income earning assets. Myers CJ considered that the borrowing "left the money so borrowed or its equivalent in capital assets".

34. Myers CJ says in this passage that the situation he was dealing with was equivalent to the situation where an 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. His Honour viewed the situation as one where it was necessary to borrow, and not one where the taxpayer had a choice of methods to meet liabilities. His Honour referred again to this element of necessity in distinguishing *Ward and Co., Ltd. v Commissioner of Taxes* [1923] A.C. 145 and *Federal Commissioner of Taxation v Munro* (1926) 38 C.L.R. 153. Myers CJ said that unlike the facts of *Ward*, the death duties were not a voluntary debt. After discussing the *Munro* case, Myers CJ said at p. 454:

> 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 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. [in *Munro*], 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.

35. The involuntary element in *Public Trustee* will be discussed later in this statement.

What is meant by the "use" of borrowed funds

36. Two of the most recent Court of Appeal judgments on the deductibility of interest, *Pacific Rendezvous* and *Brierley*, have held that the statutory provision is concerned with how the capital was used during the period in which the interest in question was incurred. The next issue is to understand what is meant by "use" in the context of interest deductibility.

37. In *Public Trustee* the borrowed funds were applied in payment of the death duties. The actual payment made with the funds was to the Crown in satisfaction of a death duties liability. It was argued that the funds were used to retain assets. The dissenting judge in *Public Trustee*, Northcroft J, had the following view about how the borrowed funds were used:

> … if money be borrowed to discharge a debt of the owner of the business which debt is otherwise unconnected with the business and if the alternative be a sale of business assets with a consequent diminution of profits, then, in my opinion, this would be capital employed in the payment of the debt and not in the production of income. The result would be the maintenance of income, but nevertheless, the employment of the capital would not be in the production of income but in the payment of the debt.

38. Northcroft J's view was not shared by the majority. The majority held that the capital was used in the payment of the debt and to retain assets. Callan J held that borrowed capital used in retaining assets is employed in the production of assessable income, just as capital used in acquiring assets is employed in the production of assessable income. Therefore, the case is authority that in identifying how borrowed funds are used as required by the statutory test, the use of funds will not only be the actual application, but will include the outcome of the application. This interpretation is consistent with the meaning of "use" in the *Concise Oxford Dictionary* (11th ed, Oxford University Press, 2004):

> **use** take, hold, or deploy as a means of achieving something.

39. This definition involves two aspects: deployment (i.e. application) and outcome. In the Commissioner's view, the majority in *Public Trustee* considered that "use" includes these dual aspects in the interest context. In *Public Trustee*, the funds were applied to pay death duties, but were held to be used in two ways—to pay the death duties and to retain assets forming part of the income earning activity.

40. A similar conclusion was reached in *Pacific Rendezvous*. In *Pacific Rendezvous*, the actual application of the funds was presumably payment to builders and other contractors for the construction of the assets. The use of the funds was held to be in acquiring assets for the motel business and in augmenting the company's capital.

41. Although there were differences in the facts in *Public Trustee* and *Pacific Rendezvous*, in that in one assets were retained and in the other assets were acquired, Richardson J in *Pacific Rendezvous* referred to funds being used in the production of assessable income in *Public Trustee*. The Court in *Pacific*

Rendezvous considered that in both cases, the borrowed funds were used to derive assessable income.

42. In *Williams*, another case concerned with interest deductibility and retention of income earning assets, Barker J also stated this view, saying that payments made to retain assets are no different in principle to payments made to acquire assets.

Establishing the sufficient connection in *Public Trustee*

43. With this understanding of the meaning of "use" or "employment" in the context of interest deductibility (the outcome achieved by the application of the borrowed funds), the degree of the connection with income in *Public Trustee* will now be considered.

44. The statutory test requires a connection between the deriving of assessable income and the relevant interest. The courts have held that this connection must be of a sufficient strength (*Pacific Rendezvous*). When borrowings are used to fund income earning assets, the test is to consider whether there is a sufficient connection between assessable income derived from those assets and the interest incurred.

45. In the *Pacific Rendezvous* situation, it is true to say that, generally, application of funds to acquire assets which form part of the income earning activity or business means that the funds are used in that income earning activity or business. In most cases it will necessarily follow that the application of the borrowed funds connects those funds with the assessable income derived from the assets forming part of the income earning activity or business. Borrowed funds used directly on consumable items that contribute to the derivation of assessable income also have a direct connection with income. It is difficult to conceive of a stronger connection between borrowed funds and income earning assets than exists in these two situations.

46. In contrast, where a taxpayer argues that borrowed funds retain income earning assets, the sufficient connection required is not so easily established. The connection with assessable income, through retention of the assets, does not arise as a matter of necessity from the application of the borrowed funds. In the two New Zealand cases, *Public Trustee* and *Williams*, where the Courts have accepted that interest is deductible when borrowings retain income earning assets, certain factors were present which the Commissioner considers established the sufficient connection with assessable income in those cases. These factors are that:

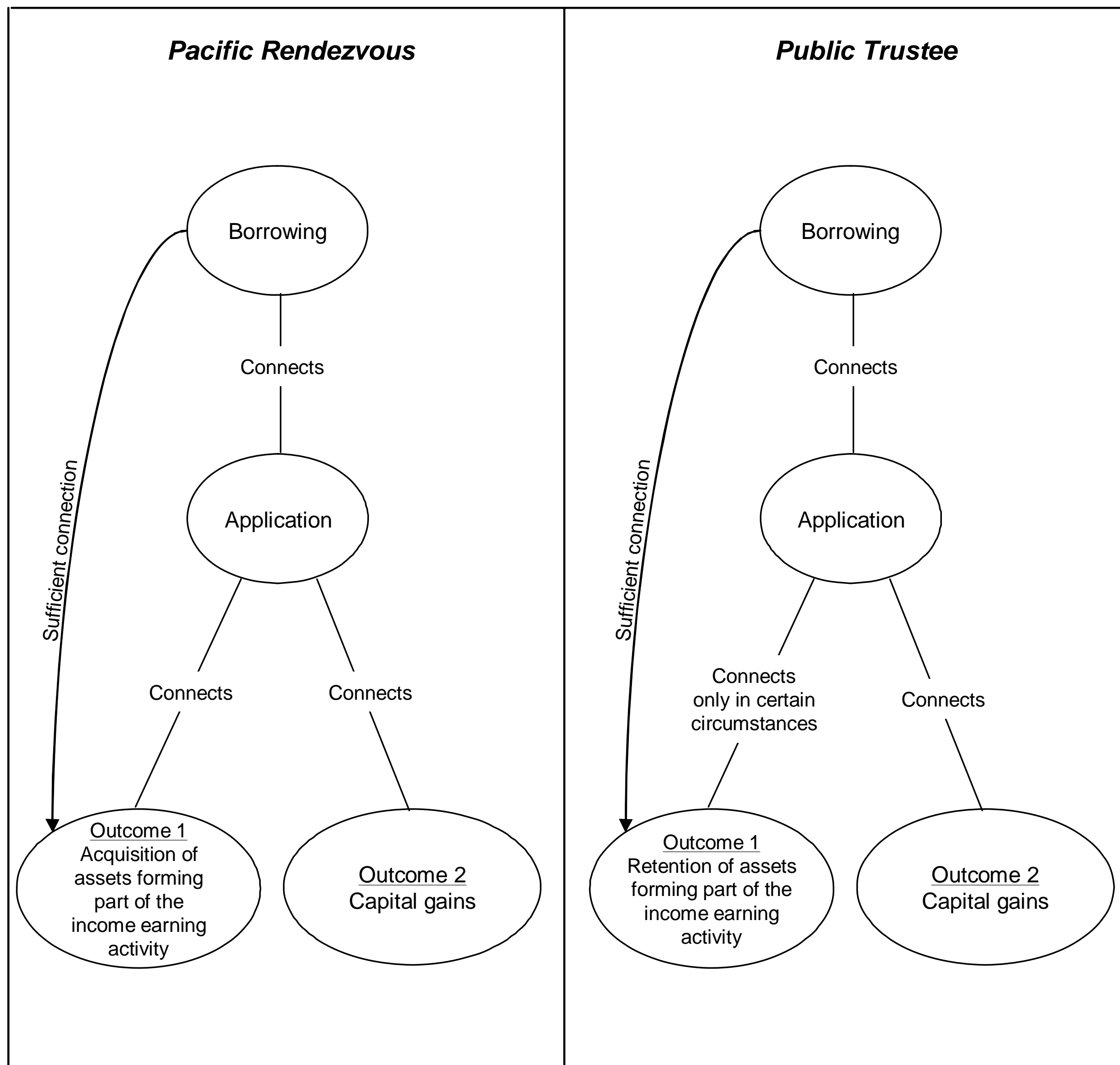
- the liability that the borrowed funds were used to discharge was involuntary; and
- the taxpayer definitely would have realised particular income earning assets, had the taxpayer not borrowed; and
- the liability that the borrowed funds were used to discharge arose in connection with the income earning assets retained.

47. The Commissioner considers that where these factors are present, the borrowing retains particular income earning assets, and the sufficient connection between the interest and assessable income is established. If the last two factors are established only to a certain extent, an apportionment or adjustment will be required. Each of these factors, and also apportionment and adjustments, are discussed further below.

Concurrent uses of borrowed funds

48. *Pacific Rendezvous* established that if borrowed funds are used in deriving assessable income, and the sufficient connection is established, it does not matter that the funds are also used to achieve a non-taxable outcome. In the Commissioner's opinion, this same reasoning applies to the *Public Trustee* situation. If the sufficient connection is established through the use of the borrowed funds, that connection is not lost if there is a second, non-income-related outcome. In *Public Trustee*, the two outcomes were the payment of death duties, and the retention of income earning assets.

49. *Pacific Rendezvous* and *Public Trustee* are compared in the following diagram. The degree of connection in each case, and the concurrent outcomes can be seen.



Application of *Public Trustee* by the High Court

50. The decision in *Public Trustee* has been applied in two High Court cases in relation to whether interest is deductible.

Williams v CIR

51. In *Williams v CIR* the facts were that the taxpayer and his wife, who had been farming during their married life, had separated. The former wife registered a notice of claim under section 42 of the Matrimonial Property Act 1976 against the taxpayer's title to the farm. Eventually the parties entered into an agreement under section 21 of the Matrimonial Property Act. Section 21 enables spouses to contract out of the Matrimonial Property Act. The agreement in *Williams* was stated to be entered into in settlement of the litigation and provided for the division of matrimonial and separate property.

The taxpayer was required to pay his ex-wife a lump sum, some of that within six weeks and the remainder after five years. The taxpayer borrowed to comply with the terms of the agreement.

52. Barker J held that the interest was deductible, on the grounds that the borrowing retained the income earning assets. In the Commissioner's opinion, the connection was sufficient because the liability was involuntary, the taxpayer would have sold the farm if he had not borrowed, and the liability arose in connection with the farming assets retained. The concurrent use of the money to meet the matrimonial claim did not affect this conclusion.

Borlase v CIR

53. *Public Trustee* was also applied in the High Court decision in *Borlase & Anor v Commissioner of Inland Revenue*. In that case, the husband and wife taxpayers moved from one city to another on account of the husband's work. They retained their former home, which was subject to a mortgage of $23,326, and let it. They bought a home in which to live in the second city for $185,000. They borrowed $208,000 to buy the home and to refinance the mortgage on their old home. The mortgage was secured over both properties. The taxpayers sought to deduct interest relating to both properties, arguing that by borrowing they retained their rental property.

54. Pankhurst J held that the funds were used to purchase a private dwelling. *Public Trustee* did not apply because, unlike *Public Trustee* and *Williams*, the requirement to pay and the amount of the payment were not involuntary because they were not external to and beyond the control of the taxpayer. Further, in the Commissioner's opinion, another factor contributing to the fact that the connection was not established was that the liability had not arisen in connection with income earning assets.

THE THREE FACTORS FROM *PUBLIC TRUSTEE*

55. When taxpayers argue that borrowings are made in order to retain income earning assets, the Commissioner's opinion is that a sufficient connection will be established and the interest on those borrowed funds will be deductible when:

- the liability that the borrowed funds were used to discharge was involuntary; and
- the taxpayer definitely would have realised income earning assets, if the taxpayer had not borrowed; and
- the liability arose in connection with the income earning assets retained.

Each of these three factors will now be discussed.

The first factor—the liability that the borrowed funds were used to discharge was involuntary

56. In *Public Trustee* the borrowed funds were used to pay death duties. Myers CJ said in *Public Trustee* that the circumstances he was dealing with were equivalent to those where an estate had had the necessary money available in cash, paid the duties with that cash, and then found it necessary to borrow. His Honour viewed the situation he was considering as one where it was necessary to borrow, and not one where the taxpayer had a choice of methods to meet liabilities. His Honour also referred to the involuntariness of the liability in distinguishing *Ward* and *Munro*.

57. In *Munro*, 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 concluded in *Munro* (p.197):

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

58. In *Public Trustee* Myers CJ quoted *Munro*, including the above statement of Isaacs J (*Public Trustee* at p 454), and italicised the quote as follows:

> 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.

59. 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.

60. Myers CJ made the point that a crucial factor which differentiated the facts of *Public Trustee* from *Munro* was that the liability was involuntary. Unlike the taxpayer in *Munro*, the taxpayer in *Public Trustee* did not have any discretion over the fact of the liability arising and the amount of the liability. The fact that the debt was involuntary was a factor in concluding that but for the borrowing, the assets really would have been sold. In *Munro*, arguably the

taxpayer could have arranged matters so that he was not faced with the choice of borrowing or selling, and further, 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.

61. Myers CJ also relied on the involuntary nature of the liability to distinguish the Privy Council decision in *Ward*. The fact that the liability was involuntary therefore formed part of Myers CJ's reasoning. Glazebrook and James[1] have argued that the reference to involuntariness was unnecessary, because the case was distinguishable on the basis that the expenditure was not incurred for the direct purpose of producing profits, so was not deductible under the general deductibility test that, at the time, required expenses to be exclusively incurred in deriving income. They say that the reference to involuntariness was merely a convenient means of distinguishing *Ward*. In the Commissioner's opinion, it was relevant in *Ward* that the expense was incurred voluntarily, because if it was, in the circumstances it was harder to say that it was exclusively incurred in deriving assessable income. The fact that the involuntary nature of the expense was relevant to the judgment in *Ward* made it relevant therefore in distinguishing *Ward* in *Public Trustee*. Myers CJ did in fact note the point from Callan J's judgment that the wording of the legislative test was different, and also that the nature of the expense in *Ward* was different than in *Public Trustee*, but despite these differences, his Honour still made a point of distinguishing *Ward*. *Ward* was concerned with expenditure aimed at preventing the destruction of the profit making thing—and so was *Public Trustee*. *Ward* was therefore relevant law.

62. The involuntary nature of the liability was seen as crucial by Pankhurst J in *Borlase* to the application of *Public Trustee*:

> [26] The case [*Public Trustee*] is now of course of long-standing [sic]. But in my view it is also well-settled that the involuntary nature of the expenditure (payment of death duties) is pivotal to the outcome. Significantly there have been very few cases since in which it has been accepted that some form of private expenditure was involuntary, such that income [sic] on borrowings against an income-producing asset were deductible in whole or in part. One such case is *Williams v C of IR* (1988) 10 NZTC 5,078 in which the taxpayer borrowed against the security of his farm (an income-producing asset) in order to settle his wife's matrimonial property claim. Given the involuntary nature of the payment, it was accepted that the funds were used to retain an income-producing asset, and hence the interest expense was deductible.

63. Keane DJ held in *Case L76* that *Public Trustee* did not apply, because the lack of discretion present in *Public Trustee* did not arise. The taxpayer in that case financed the purchase of a home with borrowings rather than break her short-term interest earning investments.

64. In the Australian case *Begg v FC of T* (1937) 4 ATD 257 the facts were similar to *Public Trustee* and it was also decided in the taxpayer's favour. It could be argued that involuntariness was not a decisive factor in this decision, but, on the other hand, the judge did find that the liability arose in a manner that was

[1] "*Taxation Implications of Company Law Reform*" by Susan Glazebrook and Jan James, New Zealand Journal of Taxation Law and Policy, Volume 1, pages 152 to 158.

outside the taxpayer's control. The issue in *Begg* was whether interest paid on moneys borrowed by an executor to pay succession and estate duties and other outgoings for the general administration of the estate was deductible. Reed AJ said that the borrowing preserved the assets, and that there was a relation between the payment of the interest and the production of the assessable income. In coming to this conclusion, his Honour said that "the very circumstances under which [the executors] acquired the estate imposed a liability, the satisfaction of which would necessarily reduce that income". So because of this fact, the executors had no choice whether to incur the liability, or, in other words, it was involuntary. Also, it is notable that this case has been criticised and not applied in the later decisions of *Roberts and Smith* and *Hayden v FCT* (1996) 33 ATR 352.

65. In conclusion, although Myers CJ did not explicitly state involuntariness to be a factor in ensuring deductibility in the circumstances he was considering, his Honour relied on the fact that the expense was involuntary to distinguish *Ward* and *Munro* and spoke of borrowings that were necessary. The involuntariness of the liability was seen as a crucial factor in *Borlase* and *Case L76*, and was arguably present in *Begg*.

The Commissioner's opinion

66. In the Commissioner's view, the presence of the involuntary factor (along with the other two factors) means that the statutory test for deductibility is satisfied, because the connection with assessable income is stronger when the liability met is incurred involuntarily. The connection is strengthened because it is more likely that income earning assets would have been sold when there was no choice but to meet the liability. Therefore, in the circumstances, the borrowing retains income earning assets and prevents them from having to be sold.

What is meant by "involuntary"

67. Pankhurst J in *Borlase* discussed what was meant by an "involuntary" liability. His Honour held that the expenditure on a domestic house was discretionary, rather than voluntary. His Honour said:

> In both *Public Trustee* and *Williams* the requirement to pay, and the quantum of the payment at issue was truly external to and beyond the control of the taxpayer. The same cannot be said of the expenditure in this case.

68. Therefore, a liability will be involuntary if the taxpayer has no control over the circumstances of the liability arising and the quantum of the payment.

69. It might be argued that there was some possibility in *Williams* of the taxpayer being able to influence the amount of the settlement, and similarly in *Public Trustee* to mitigate the amount of the death duties. However, the extent of the taxpayer's control over the liability in both cases was limited. Pankhurst J in *Borlase* considered that the quantum of the liability in *Williams* was outside the control of the taxpayer. Any ability to negotiate the amount was not mentioned in *Williams* as a feature of the liability. Barker J describes the settlement process which involved competing claims from both parties

following separation, negotiations through counsel and a settlement agreement made under section 21 of the Matrimonial Property Act. Given the statutory overlay and the formal nature of the settlement, the taxpayer had little scope to alter the amount of his liability. In *Public Trustee*, as the amount of the liability was based on the amount of the estate's assets at the time of death, a time before the taxpayer Trustee had control over the assets, any ability to alter the amount of the liability must be seen as limited. Pankhurst J considered the liability in *Public Trustee* to be involuntary and did not refer to any ability of the taxpayer to alter the amount. Therefore, the Commissioner considers that a liability will be involuntary in this context where the taxpayer has no control over the amount of the liability, or only very limited scope to negotiate the final amount of a liability, which has arisen involuntarily.

70. It may be that a future court would accept that a liability, though not involuntary to the degree just discussed, was still sufficiently involuntarily incurred so as to establish a sufficient connection with assessable income. A court may go further and hold that even in the absence of an involuntary liability, other circumstances establish that the borrowing prevents income earning assets from being sold so that the nexus with assessable income is established. The Commissioner will consider such situations on a case-by-case basis.

The second factor—the taxpayer definitely would have otherwise realised income earning assets

Case law

71. In *Public Trustee* Myers CJ found on the facts that the borrowing left the money in the estate and enabled the Trustee to maintain the income from the assets. In other words, if it had not borrowed it could not have maintained the income because it would have sold income earning assets. Callan J found on the facts that:

> … the payment of the duties with the borrowed money saved from sale an ascertainable portion of the tangible assets by the use of which the assessable income was produced.

72. Similarly in *Williams*, if the taxpayer had not borrowed he would have had to have sold income earning assets. Barker J in *Williams* stated the facts as follows, referring to the taxpayer's subjective intention:

> The objector was then faced with the necessity of raising money to comply with the terms of the agreement. He had no major asset, other than the farm; he did not want to sacrifice the farm at a giveaway price. In order to remain in farming, he eventually borrowed from a trust …

73. In these two cases, the facts were such that the Court could conclude that but for the borrowing, the taxpayer definitely would have realised income earning assets. The focus is on what the taxpayer actually would have done if the taxpayer had not borrowed.

The Commissioner's opinion

74. In the Commissioner's opinion, this factor is central to establishing a nexus when it is argued that borrowings are made in order to retain assets. When it is clear from the facts that the taxpayer definitely would have sold income earning assets if it had not borrowed, the Commissioner will treat the interest as deductible (assuming the other two factors are present i.e. the liability is involuntary and the liability arose in connection with the income earning assets retained). When it is less clear what the taxpayer would have done if it had not borrowed, the Commissioner may still form the view that interest is deductible, but will still need to be satisfied that the borrowings in fact had the effect of preventing income earning assets from being sold.

When can it be concluded that the taxpayer would have otherwise sold?

75. Establishing whether the taxpayer really would have realised the income earning assets involves considering the taxpayer's state of mind before the borrowing. This involves a consideration of a hypothetical situation based on the taxpayer's intentions – what would this particular taxpayer have done if the funds had not been borrowed? Certain factual features will help to answer this question.

76. If the circumstances suggest that it was necessary or inevitable that the taxpayer would have otherwise realised income earning assets, for example, if the taxpayer only had income earning assets, it might be argued that an intention to have otherwise realised income earning assets is not necessary. However, the Commissioner's view is that in no situation is it certain from the objective facts alone that a taxpayer would have otherwise realised assets, because there is always the possibility that the taxpayer would have chosen not to pay the liability, or managed to obtain funds in some other way, had the taxpayer not borrowed.

77. It will be relevant to consider whether the taxpayer had actually formed a definite intention to realise income earning assets, had the funds not been borrowed. In some situations, a taxpayer may not have clearly formed a view of what would have been done if the borrowing had not taken place. There may have been some plan to realise income earning assets, but the taxpayer may not have put any thought into which option the taxpayer really would have taken if the funds had not been borrowed. If these are the facts, the taxpayer may not necessarily be able to satisfy the Commissioner that the requisite intention had been present to realise assets if the amount had not been borrowed.

78. It may be difficult from a practical perspective for a taxpayer to establish what the taxpayer had in mind immediately before the funds were borrowed. The practicality of testing a subjective intention was considered in *Grieve v C of IR* (1984) 6 NZTC 61,682. Although the context was different, it is considered that the same difficulty applied, so the Court's approach is relevant. Richardson J said in *Grieve*: "Now the existence of a bona fide intention is often tested or assessed having regard to objective factors such as the conduct of the person concerned." Therefore, in order to prove to the Commissioner's

satisfaction that a taxpayer would have realised income earning assets, it will be appropriate to consider objective evidence to support a conclusion regarding the taxpayer's state of mind. Proof that the intention to realise income earning assets had been formed might be supported by documentation, and a past history of realising the type of income earning assets owned at the time of borrowing.

79. If a taxpayer had some income earning assets and some other assets (non-income earning assets or assets earning exempt income) at the time of borrowing, the taxpayer would have had several choices apart from realising income earning assets or borrowing. In that situation it may often be difficult for the taxpayer to provide objective evidence supportive of an intention to have otherwise realised income earning assets, particularly if cash is one of the non-income earning assets. In contrast, it might be easier for a taxpayer with only income earning assets at the time of borrowing to prove that the intention was to have otherwise realised income earning assets.

80. This element of *Public Trustee*—that the taxpayer definitely would have otherwise realised income earning assets if the taxpayer had not borrowed—may entail apportionment. Apportionment will be appropriate when:

- a taxpayer can satisfy the onus of proof only to a certain extent, that is, the taxpayer can prove only that some income earning assets definitely would have been realised if not for the borrowing, but cannot prove to the required standard that other income earning assets would have been realised; and
- a taxpayer borrows to retain both income earning and non-income earning assets; and
- a taxpayer would have otherwise realised income earning assets, but the amount realised would have been a lesser amount than the amount borrowed.

Apportionment is discussed further below.

Could the taxpayer in* Public Trustee *have realised non-income producing assets?

81. In *Public Trustee* the estate consisted partly of assets producing assessable income but principally of assets producing non-assessable income (p 445). The taxpayer had borrowed money to pay death duties that related not only to assets producing assessable income, but also to assets producing non-assessable income. The Commissioner and the taxpayer agreed that, if the Court found for the taxpayer, deductible interest would equal:

total interest x (assets producing assessable income/total assets)

82. The formula arrived at between the parties assumed that the taxpayer would have realised both income producing and non-income producing assets on a pro rata basis, and that interest would have been deductible on the basis of the

proportion of income producing assets. On the basis of the formula, the Court assumed that some income earning assets definitely would have been realised, and the interest was deductible to the extent it related to those assets. Therefore, the Court did not need to consider which assets would be realised.

83. This formula was agreed to between the parties and was not sanctioned by the Court. The Commissioner now considers that the taxpayer must show that particular income earning assets definitely would have otherwise been realised, and would no longer simply agree to a pro rata approach.

No assets to realise

84. *Public Trustee* applies when borrowings retain income earning assets and a sufficient connection with income derivation is established. In some instances, a taxpayer may not have sufficient value in income earning assets that could be retained through borrowing to meet a liability. The interest would not be deductible to the extent that the amount borrowed exceeded the value of the particular income earning assets retained. An example would be a business consultant whose only business assets comprise a computer, telephone, facsimile and furniture, who could not realise sufficient funds from the realisation of those items to meet a liability.

The third factor—the liability arose in connection with the income earning assets retained

85. The third factor that needs to be present is a liability that arises in connection with the income earning assets retained. In *Public Trustee*, Myers CJ noted that the liability was charged over the income earning assets (p 452):

> The question then is whether the money which was borrowed by the estate from the Public Trustee under special statutory authority and which was charged over the whole estate – i.e. the assets producing both assessable and non-assessable income alike – was employed "in the production of income". For the determination of this question the substance of the transaction must be regarded. The death duties were a charge on the whole estate.

86. Also, Myers CJ in *Public Trustee* distinguished *Munro* (where interest was held not to be deductible) on the basis that in *Munro* the liability was in no way referable to the income earning assets.

87. In *Williams*, the only other New Zealand case where a court has held that interest incurred in retaining income earning assets is deductible, the liability also arose in connection with the income earning assets. The liability represented the taxpayer's ex-wife's interest in the farm assets and was calculated with reference to the value of those assets.

88. Support for this view can also be found in *Begg*. *Begg*, discussed above, was the Australian case decided in the taxpayer's favour. In considering whether interest was deductible, the Court found that the liability arose in connection with the assets forming part of an estate. Reed AJ said:

> … the very circumstances under which [the executors] acquired the estate imposed a liability, the satisfaction of which would necessarily reduce that income.

The Commissioner's opinion

89. When the liability has arisen in connection with the income earning assets retained, the connection with assessable income is strengthened, because there is another link between the interest and the liability. This aspect of the connection is not as strong as it is in the *Pacific Rendezvous* situation, where the borrowings were applied directly to a liability that was the acquisition of income earning assets themselves. On the other hand, the connection is not as remote as it is in the situation where the liability does not relate at all to the income earning assets retained. There is no authority that the sufficient connection can be established in this latter scenario.

Apportionment relating to the third factor

90. Apportionment will be required when the factors that have been discussed are present only to a certain extent. Apportionments relating to the second factor were outlined above. An apportionment will be required in relation to the third factor if the liability met by the borrowed funds arose in connection with both income earning assets and non-income earning assets. This adjustment involves calculation of a ceiling, being the maximum deduction available.

How are assets valued?

91. The essence of the *Public Trustee* case is that interest on borrowings may be deductible if, in the circumstances, the borrowings retain income earning assets. To put it another way, the assets would have otherwise been realised but for the borrowing and the amount realised would have been used to meet the liability. The relevant value of the assets in considering the extent to which borrowed funds retain income earning assets is therefore the realisable value, less the costs of realisation, or in other words, the net realisable value.

Examples showing apportionment

92. The circumstances of a taxpayer's mix of assets and the valuation of the liability will affect the calculation of apportionment when applying the Commissioner's interpretation of *Public Trustee*, as the following examples illustrate.

Example 1—a mix of income and non-income earning assets

93. In this example, taxpayer A has both income earning and non-income earning assets. The income earning assets have a net realisable value of $60 and the non-income earning assets have a net realisable value of $40. Taxpayer A borrows to fund an involuntary liability of $10. If Taxpayer A can prove that he would have otherwise realised only income earning assets to the required extent, the $10 liability would have been met out of the $60 obtained from the realisation of those assets, so all of the interest would be deductible.

94. If, instead, it can be established that he would have realised the non-income earning assets first, then the $10 liability would have been met out of the $40

obtained from non-income earning assets, and so none of the interest would be deductible.

95. If, on the facts, he would have realised some income earning and some non-income earning assets, then the interest deduction will be calculated according to those proportions.

96. If there is no convincing evidence that Taxpayer A definitely would have otherwise sold income earning assets, none of the interest will be deductible.

Example 2—how to calculate the deduction when the liability is only partially related to income earning assets and the taxpayer has a mix of income earning and non-income earning assets

97. In Example 1, it has been assumed that the liability arose in connection with the income earning assets. In some situations, the liability may be only partially related to income earning assets. If so, the deduction will be available only to the extent to which the liability arose in connection with the income earning assets. A taxpayer in this situation may have a mix of non-income earning and income earning assets. Two adjustments would be needed for such a taxpayer to calculate the deductible portion of the interest.

98. In Example 2, Taxpayer B faces a liability which is related to only 20% of her income earning assets. The interest will only be deductible to the extent that the liability arose in connection with income earning assets. The maximum deduction here would be 20%, as that portion is the extent to which the liability arose in connection with the income earning assets. Taxpayer B has income earning assets with a net realisable value of $60 and non-income earning assets with a net realisable value of $40.

99. As in Example 1, if Taxpayer B can prove she would have realised only income earning assets, the $10 liability would have otherwise been met out of the $60 received from the realisation of income earning assets, had Taxpayer B not borrowed. However, although 100% of the retained assets are income earning assets, only 20% of the interest would be deductible because it relates to income earning assets only to that extent.

100. If, instead, Taxpayer B would have realised the non-income earning assets first, none of the interest would be deductible, and, if Taxpayer B would have realised some income earning and some non-income earning assets, then the interest deduction will be calculated according to those proportions, but to a maximum of 20%.

101. If there is no convincing evidence that Taxpayer B definitely would have otherwise sold income earning assets, none of the interest will be deductible.

SITUATIONS FALLING OUTSIDE THE THREE FACTORS

102. The general test is that interest will be deductible when there is a sufficient connection between the interest and assessable income. When it has been argued that interest is deductible where borrowings retain income earning

assets, the Courts have so far decided that interest is deductible when the three factors have been present (*Public Trustee* and *Williams*) and have held that it is not deductible when the factors are not present (see for example *Borlase* and *Case S87* (1995) 17 NZTC 7,545). When the three factors are present, the Commissioner considers interest is deductible, and so taxpayers can have certainty about how Inland Revenue will apply the law.

103. However, it is acknowledged that there may be situations where the sufficient connection is met where not all of the three factors are present. Inland Revenue will consider deductibility in situations falling outside the three factors on a case-by-case basis. In considering these situations, Inland Revenue will be asking whether the nexus between earning assessable income and the application of the borrowed funds is sufficient. That is, whether the degree of connection between interest and assessable income approaches the degree present in the facts of *Public Trustee* and *Williams*, or whether the degree of connection is closer to the facts in, for example, *Borlase*, *Case L76* or *Case S87*. In asking this question, a guiding principle will be whether the borrowing does in fact have the effect of preventing income earning assets from being sold. In the Commissioner's opinion, this consideration reflects the broad principle underlying the approaches of the Courts that have accepted interest is deductible when borrowings retain assets. It will also be relevant to consider other elements that establish a connection with assessable income. An example of another element that may contribute to a connection with assessable income is a connection between the liability met by the borrowed funds and the income earning assets.

PART 3 – FURTHER BACKGROUND AND OTHER APPROACHES CONSIDERED

The floodgates argument

104. The Commissioner's approach to interpreting the cases in this area is not governed by a concern that a wide interpretation would "open the floodgates" and therefore mean that, in the Commissioner's eyes, too much interest would be deductible. This suggestion had previously been made about an earlier view expressed in the area of interest deductibility. Rather, the Commissioner's view is based on applying the statutory words as they have been interpreted by the Courts. Interest is only deductible if a sufficient connection can be established, and the use of the words "to the extent that" in the statutory provision indicates that it was assumed that certain interest would not meet this test and apportionment of non-deductible interest would be appropriate in some circumstances.

Difficulties in satisfying the test

105. This statement has outlined the factors that need to be present if the taxpayer is to be certain that the Commissioner will agree that interest is deductible when applying the *Public Trustee* case. In some circumstances it may be difficult for practical reasons for taxpayers to satisfy the Commissioner that these

factors are present. It could also be said that the situations where the three factors are present may be limited. However, in the Commissioner's view, the Courts have only accepted that interest is deductible when *Public Trustee* is argued if these factors have been present. Further, as has been pointed out, the Commissioner may agree that interest is deductible when the three factors are not present, if the taxpayer can establish that there is a sufficient connection between interest and the taxpayer's assessable income.

106. The compliance problems are not relevant to all taxpayers. This area of case law will generally not apply to company taxpayers because interest incurred by companies is in most cases deductible without the necessity of satisfying the nexus test. The rules applying to companies are discussed earlier in this statement and in *Tax Information Bulletin* Vol 13, No 11 (November 2001).

107. Finally, it should be noted that any practical considerations relate to what is only a secondary test of deductibility. If interest has a connection with assessable income through the borrowed funds being used to acquire income earning assets or otherwise through a direct use in an income earning activity or business, there is no need to rely on *Public Trustee* and any practical considerations relating to that case do not arise.

More restrictive approach in other jurisdictions

108. The Commissioner's approach discussed in this statement permits greater deductibility than would apply in some other comparative jurisdictions. The judicial trend overseas has been to deny deductions when retention of assets is argued. In the Australian Full Federal Court decision in *Roberts* and *Smith*, Hill J referred to *Begg* as a "difficult case" and said:

> 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*.

109. Hill J's opinion was therefore that there was an insufficient nexus with assessable income in *Begg*.

110. In *Hayden v FCT* (1996) 33 ATR 352 the Federal Court did not apply *Begg* and did not consider that there was a principle that borrowing may retain income earning assets. 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 liability was therefore incurred involuntarily. 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.

111. 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 in the Federal Court rejected this argument, and held that the focus must be on the use to which the borrowed funds are put. 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*.

112. Canadian authorities have generally been decided on the basis that for interest to be deductible, borrowed funds must be directly used in producing income. In *The Queen v Phyllis Bronfman Trust* [1987] 1 CTC 117, a decision of the Supreme Court, the trustees borrowed to make distributions to the beneficiary of the trust rather than realise assets. The Chief Justice held that the courts could not ignore the direct use of the borrowed funds. The direct use of the funds was to make capital allocations to the beneficiaries, a use that earned the trust no income. The decision in *Bronfman* was followed in the Canadian Federal Court in *74712 Alberta Ltd v Minister of National Revenue* [1997] 2 C.T.C. 30. The taxpayer in *74712 Alberta* borrowed to pay a guarantee in respect of its parent companies' debt obligations. The Court applied *Bronfman Trust*, deciding that the interest was not incurred for the purpose of earning income and was not deductible.

113. The decisions in *Bronfman* and *Alberta* limited the application of the decision in *Trans-Prairie Pipelines Ltd. v MNR* [1920] CTC 537. In *Trans-Prairie* the taxpayer issued debentures and used the money to redeem preference shares. The Exchequer Court held that although the direct use of the money was to return amounts to preference shareholders, the interest was deductible because the money borrowed through the debentures had the effect of filling the hole left by the amount that was returned to the shareholders. Therefore, the borrowed funds were used for the purpose of earning income. In the Tax Court decision in *Chase Manhattan Bank of Canada v R* [1997] 2 CTC 3097, McArthur T.C.J. held that following the decisions in *Bronfman* and *74712 Alberta, Trans-Prairie* "has been confined to its own special circumstances".

114. The Canada Customs and Revenue Agency has a practice of allowing indirect interest deductions in a limited range of situations. These situations, such as money borrowed to redeem shares, are seen as a class of arrangements where borrowed money replaces funds in a business. The CCRA does not recognise retention of income earning assets as a principle of deductibility.

Use of money interest

115. This statement has its origins in two issues papers issued by the Public Rulings Unit on interest deductibility issues. The second of these issues papers, IRRUIP 5, discussed the issue of the deductibility of use-of-money interest. The issue of the deductibility of use-of-money interest is not considered in this statement. The Commissioner intends to consider whether to publish a view on the deductibility of use-of-money interest in a separate statement or statements.

Reasons for rejecting other analyses

116. In reaching the conclusions in this statement, the Commissioner has considered and rejected arguments for other analyses of the cases. These will now be briefly outlined.

Argument 1—Pacific Rendezvous and Public Trustee are distinguishable

117. In IRRUIP 5 the Commissioner expressed the view that the situation in *Public Trustee* is different in nature from that in *Pacific Rendezvous*, because in *Public Trustee* the connection with assessable income was indirect, and not direct as it was in *Pacific Rendezvous*. In *Pacific Rendezvous* there were two direct outcomes arising from the application of the borrowed funds—the receipt of assessable income and the receipt of capital gains. In contrast, in *Public Trustee* arguably only one outcome arose directly from the application of the funds, and that outcome was not related to assessable income. The other outcome, which was related to assessable income, arose only indirectly from the application of the funds. Therefore, it can be argued that the cases are precedents for two quite different principles.

118. Applying this analysis in IRRUIP 5, it was suggested that in the *Public Trustee* situation, certain factors will need to be present to make a sufficient connection with assessable income (which view the Commissioner also takes in this statement). The point of difference with this statement is the argument that as the two cases can be seen as standing for two distinct principles, the private prohibition applies differently to each. The argument was that under the *Public Trustee* principle, a deduction could never be taken for interest where the direct application of the funds is for private use. This was because under the statutory scheme, the prohibition against deductions for private expenditure applies even though the permissive provision in section DD 1 is satisfied. The principle from *Pacific Rendezvous* that a second non-income related use does not invalidate a connection with assessable income does not apply to this situation because that case is distinguishable. The result also could be argued to be consistent with the intention of the Act to tax income, and to prohibit deductions of a private nature.

119. The problem with this approach is that there is a strong argument that there is no conceptual difference between *Public Trustee* and *Pacific Rendezvous*. In both cases the funds were used in an income earning activity or business, and the second non-income producing use was achieved simultaneously with the use connected with income. Although the connection with assessable income in the *Public Trustee* scenario is indirect, once the sufficient connection is established, through the involuntariness of the liability, the fact that the taxpayer definitely would have otherwise realised income earning assets and the fact that the liability arose in connection with the assets, the situation would seem then to be analogous to *Pacific Rendezvous*. Any simultaneous use, although not related to assessable income, should not require an apportionment.

120. Further, the approach would seem to be inconsistent with the decision in *Williams*. In *Williams* a deduction was available even though one use of the funds—to fund a matrimonial claim—appeared to be private in nature.

Argument 2—*Pacific Rendezvous *and* Brierley *are wrong; other cases suggest apportionment

121. Another approach would be to apply the private prohibition in both the *Public Trustee* and *Pacific Rendezvous* situations, and to view the decisions in *Pacific Rendezvous* and *Brierley* as wrong or misunderstood on this point. Arguably, an apportionment should be made when borrowed funds are used to some extent for a use that is a prohibited deduction. *Ronpibon Tin NL v FC of T; Tongkah NL v FC of T* (1949) 78 CLR 47 at p 59), approved in *Banks* and *Buckley & Young*, arguably supports the proposition that apportionment is required not only when expenditure can be divided between a part related exclusively to income and a part related exclusively to something other than income (a "time and space apportionment"). The Court in *Ronpibon Tin* considered that apportionment is required not only when the expenditure can be divided on a time and space basis, but also when the expenditure serves two outcomes indifferently.

122. In *Pacific Rendezvous*, Richardson J appeared to consider the only issue was whether a time and space apportionment was appropriate. It could be argued that the question of whether an apportionment should be made for expenditure which serves both income earning and other purposes indifferently was not sufficiently appreciated in *Pacific Rendezvous*. Arguably it was open to the Court to apply the principle from *Ronpibon Tin* and require an apportionment. The expenditure in *Pacific Rendezvous* can be seen as expenditure which served both income earning and other purposes indifferently. In contrast to *Pacific Rendezvous*, in *Public Trustee*, the Court treated the expenditure as achieving both income-related and non-income related outcomes indifferently and the interest was apportioned.

123. However, the Commissioner's view is that despite possible contrary indications in *Ronpibon*, *Banks* and *Buckley & Young*, the law on interest deductibility in New Zealand seems settled on this point. In two authoritative cases—*Pacific Rendezvous* and *Brierley*—the Court of Appeal has given the view that an apportionment is not required when borrowed funds are all used in an income earning activity, despite co-existing advantages.

Argument 3—special nature of capital

124. A third possible approach also assumes that the private prohibition applies in both the *Pacific Rendezvous* and the *Public Trustee* situations. The argument is that the private prohibition would have applied in *Pacific Rendezvous* if the non-income use had been a private one. Similarly it could be argued that the private prohibition would have applied in *Public Trustee*, had it existed at that time. The private prohibition was introduced into the Land and Income Tax Act 1954 in 1968. The issue before the Court in *Public Trustee* was whether the deduction should be denied for a lack of connection with assessable income, not whether it was private in nature. Also, had the prohibition applied, on the facts of *Public Trustee*, it could have been argued that the payment of death duties by a trustee is not a private use of funds.

125. This argument is that it was the nature of the non-income use of borrowed funds in *Pacific Rendezvous*, and in *Brierley*, that meant that an apportionment was not required. This use of the borrowed funds in *Pacific Rendezvous* and *Brierley* was to achieve a capital gain. In *Brierley*, Richardson J recognised that it could be said that an asset is always employed in the production of both assessable income and prospective capital benefits. His Honour said that it would be contrary to the capital/revenue distinction and the scheme of the Act, to refuse a deduction for an assumed capital element of interest. Similarly, Cooke J said in *Pacific Rendezvous* that in applying funds, "often a taxpayer would not be prudent to have regard for income only; capital appreciation is commonly an important consideration". It could be argued that when funds are used for two uses, and one of those is private, such private use is not intrinsically linked with the use of the funds in the income earning activity as capital gains are, and therefore the interest should be apportioned.

126. However, Richardson J in *Pacific Rendezvous* stated a broader principle, and did not refer to the nature of the non-income outcome. His Honour said that interest is deductible if the borrowed capital was all used in the income earning activity. His Honour did not qualify this statement by adding that in contrast, the deduction would have been apportioned if the second use had instead been a use that was not a capital one. Richardson and Cooke JJ said that the test is simply to examine the use of the borrowed funds, and if all of the funds are used in an income earning activity, then the interest is deductible. Although Cooke J went on to explain this in terms of the intrinsic link between interest and capital, it is not clear that his Honour was intending to limit non-deductibility to joint income/capital outcomes. On balance, it is considered that the better view is that *Pacific Rendezvous* stands for this wider principle.

Argument 4—the deductibility test provides for a wide range of deductions

127. Another potential approach is to view the general permission in section DA 1 as broad enough to apply to interest incurred in respect of expenditure not directly connected with the income earning activity, without the need to apply *Public Trustee*. An example is interest incurred on money borrowed to pay tax. This argument was more obvious under a previous wording of the deductibility provision, which specifically provided for deductions necessarily incurred in carrying on a business for the purpose of deriving gross income. However, the cases have held that the "necessarily incurred in carrying on a business" test is, like the more general test, concerned with the relationship between an expense and the income earning activity. The connection with assessable income must be sufficient for expenditure, including interest, to be deductible.

128. In the example of borrowing to pay tax, a payment of tax might be a transaction typical of a business, but it is not part of the carrying on of the income earning activity or business. Interest incurred on money borrowed and used for such transactions is not sufficiently connected with assessable income merely on the basis that these are business transactions. Payment of tax is a payment made after income has been derived. In *Smiths' Potato Crisps (1929) Ltd v IR.* [1948] AC 508, Lord Normand said at pp 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."

Comparison with the Commissioner's previous statements

***Issues paper* - IRRUIP 5 (2001)**

129. IRRUIP 5 was published to replace IRRUIP 3. The conclusions in IRRUIP 5, and the reasons why the Commissioner has departed from that view, have already been outlined under the heading "Argument 1- *Pacific Rendezvous* and *Public Trustee* are distinguishable". In summary, the view put forward in IRRUIP 5 was that *Public Trustee* was fundamentally different from *Pacific Rendezvous*, and that the private prohibition in section BD 2 prevents a deduction of interest where the direct application of the funds is a private use. The Commissioner now considers that the two cases are analogous in this regard as in both cases the borrowed funds were used in relation to assessable income. The Commissioner considers that in the circumstances of both cases the private prohibition will not prevent a deduction if the borrowed funds are used to acquire or retain income earning assets. Another difference is the Commissioner's view of the circumstances in which the sufficient connection is met. The Commissioner's view is now that *Public Trustee* will apply if the liability met by the borrowed funds was involuntary, to the extent to which the taxpayer can prove that the taxpayer definitely would have otherwise realised particular income earning assets to meet the liability, and to the extent to which the liability arose in connection with the income earning assets. The Commissioner may take the view that interest is deductible in situations when these three factors are not present, if the nexus is sufficient. In considering whether the nexus is sufficient, the Commissioner will consider whether, in the circumstances, the borrowing has the effect of preventing a realisation of income earning assets.

130. IRRUIP 5 also dealt with deductibility issues arising from the decision in *Roberts and Smith*. The Commissioner's intention is that these issues will now be dealt with in a separate statement or statements. IRRUIP 5 should not be relied upon as stating the Commissioner's current view in relation to interest deductibility issues.

***Tax Information Bulletin* Vol 3, No 9 (June 1992)**

131. In TIB Vol 3, No 9 the Commissioner's view of the *Public Trustee* decision was stated to be as follows:

> Interest is deductible if a taxpayer establishes that the capital was borrowed to meet involuntary expenditure to retain assets used in producing assessable income. However, if the capital was borrowed for purposes quite alien from the income producing asset (such as meeting personal obligations), the interest will not be deductible.
>
> The onus is on the taxpayer to establish that the interest is deductible, and what portion of it is deductible.

132. The view in the TIB is that the liability must be involuntary, and that the liability met with the borrowed funds must not be "alien" from the income producing assets, or, in other words, must be connected in some way with the income earning assets. In these respects, the view in the TIB and the view in this statement are similar. This statement analyses in more depth when borrowing retains income earning assets, and concludes that for assets to be retained, the taxpayer must at least prove that the borrowing prevented a realisation of income earning assets. Also, the Commissioner has clarified that a private use of the funds will not on its own prevent a deduction of the interest, and, that in such a situation, interest may be deductible if there is another use of the borrowed funds that has a sufficient connection with assessable income to establish deductibility.

133. The item in TIB Vol 3, No 9, to the extent that it relates to *Public Trustee*, is replaced by this statement.

PART 4 – CONCLUSIONS

Establishing the sufficient connection – acquiring and retaining

134. The test of interest deductibility is whether there is a sufficient connection between the interest incurred and the income earning activity or business. This connection is established and interest will be deductible if the borrowed funds are used in an income earning activity or business. "Used" or "employed" refers to the outcomes achieved by the application of the borrowed funds.

135. Funds are used in an income earning activity or business if they are used to acquire assets or otherwise directly in that activity or business, or to retain assets which form part of that activity or business.

136. When funds are applied to acquire income earning assets, that acquisition has a direct link with the income derivation activity and the connection with the income earning activity or business is established. In contrast, when funds retain assets, the application of the funds—to pay death duties, to settle a matrimonial obligation, or to buy a private house, for example—does not necessarily contribute to the income earning activity business without further facts being present.

The Commissioner's opinion on when interest will be deductible when income earning assets are retained

137. The Commissioner will be satisfied that a sufficient nexus with assessable income is established where the borrowing retains income earning assets if the taxpayer can establish that:

- the liability that the borrowed funds were used to discharge was involuntary; and

- the taxpayer definitely would have realised particular income earning assets, if the taxpayer had not borrowed; and

- the liability that the borrowed funds were used to discharge arose in connection with the income earning assets retained.

138. This interpretation of *Public Trustee* is consistent with the High Court decisions in *Williams* and *Borlase*.

139. When the three factors are present, taxpayers have certainty about how the Commissioner will apply the law.

Situations falling outside the three factors

140. Inland Revenue will consider situations falling outside the three factors on a case-by-case basis. In each case Inland Revenue will be considering whether the nexus between interest and assessable income is sufficient. That is, whether the degree of connection between interest and assessable income approaches the degree present in the facts of *Public Trustee* and *Williams*, or whether the degree of connection is closer to the facts in, for example, *Borlase*, *Case L76* or *Case S87*. In asking this question, it will be relevant to consider:

- whether the borrowing does in fact have the effect of preventing income earning assets from being sold, and

- other elements that establish a connection with assessable income.

Concurrent non-income earning use

141. When borrowed funds are used to retain income earning assets, a concurrent non-income earning use of the funds will not on its own prevent a deduction of the interest (*Pacific Rendezvous*, *Borlase*, and *Williams*).

The involuntary factor

142. Myers CJ stated that the borrowing in *Public Trustee* had been necessary and relied on the fact that the liability was involuntary to distinguish *Ward* and *Munro*. Pankhurst J in *Borlase* stated that the involuntary nature of the liability is an essential element of the *Public Trustee* test. The fact of a liability being involuntary contributes to the formation of a sufficient connection with assessable income, and is therefore consistent with the statutory test.

143. A liability is involuntary if the requirement to pay, and the quantum, is external to and beyond the control of the taxpayer (*Borlase*).

Apportionment

144. Apportionment is appropriate when applying *Public Trustee* to reflect the extent to which:

- a taxpayer can satisfy the onus of proof;
- the borrowing retains non-income producing assets;
- the amount otherwise realised from the income earning assets would have been a lesser amount than the amount borrowed.

145. In addition, an adjustment may be required to reflect the extent to which the liability arose in connection with income earning assets.