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IRRUIP 3/IP3502 - Interest Deductibility

RULINGS UNIT ISSUES PAPER NO 3 — IP3502

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Deductions — Indirect test — Interest on money borrowed and used by company to repurchase shares, pay dividends, make a subvention payment; by partnership to return capital contributions, pay profits to partners; by any taxpayer to pay tax on income and use of money interest — Interest may be deductible under interest deductibility provisions, depending on taxpayer's circumstances — Income Tax Act 1994, s DD 1(b)(i), (ii).

1 Summary of this paper

1.1 This paper considers whether interest is deductible where a taxpayer borrows funds and the funds are not used directly in deriving the taxpayer's gross income or not used directly in the taxpayer's business which is carried on for the purpose of deriving the taxpayer's gross income.

1.2 In particular, the discussion is concerned with the six arrangements which are the subjects of draft public rulings. The arrangements are the deductibility of interest in relation to money borrowed and used:

- By a company to repurchase shares.
- By a company to pay dividends.
- By a partnership to return capital contributions.
- By a partnership to pay profits to partners.
- By any taxpayer to pay income tax and use of money interest.
- By a company to make a payment to share in a company's losses (a "subvention payment").

The draft rulings are included as appendices.

1.3 The conclusion reached in this paper is that, in the six arrangements, the interest may be deductible under the interest deductibility provisions in sections DD 1(b)(i) and DD 1(b)(ii) of the *Income Tax Act* 1994, depending on the taxpayer's circumstances. The conclusion is based primarily on the decision in *Public Trustee v CIR* [1938] NZLR 436, and is also consistent with the decision of the Full Federal Court of Australia in *FC of T v Roberts; FC of T v Smith* 92 ATC 4,380. These cases indicate that a strict tracing of the use of borrowed funds is not always necessary to establish deductibility of interest.

1.4 Although the interest deductibility test discussed in this paper is based on the statutory provision, *Public Trustee* and other cases, the scope and detail of the test are not found in any case. As the decided cases do not deal with the facts of the arrangements, an interest deductibility test is being proposed that is based on the available law but which uses a conceptual basis to deal with these other fact situations.

1.5 Under the approach proposed, interest will be deductible in the six arrangements to the extent that the borrowed funds can finance gross income earning assets or assets of a business carried on for the purposes of deriving gross income. This principle, and qualifications to it outlined in this paper, is referred to as the "indirect test".

1.6 Interest would not be deductible in reliance on this indirect test if a taxpayer's direct use of the borrowed funds is for the taxpayer's private use or for use in acquiring assets which produce exempt income.

1.7 Under the indirect test, a taxpayer would be permitted to deduct interest on borrowings not used directly in an income earning activity to the extent to which the total market values of income earning assets or assets of a business exceeds the total amount of liabilities of that activity or business. The indirect test must be satisfied throughout the whole period during which the interest is incurred. For the purposes of this calculation, assets included are assets that can be sold.

1.8 In addition, an interest deduction under the indirect test is limited if a taxpayer owns assets that are private, produce exempt income, or are held otherwise than for producing gross income. In these situations, only a portion of interest incurred on the funds indirectly used in the taxpayer's income earning activity or business would be deductible. The portion is calculated based on the ratio of the value of gross income earning assets less debt directly invested in the income earning activity, to the value of all assets less all debt other than indirect debt.

1.9 The Commissioner acknowledges that it is not possible to reconcile all the New Zealand and overseas case law in the area of interest deductibility. The courts have not developed any cohesive doctrine. The approach in the draft rulings and discussed in this paper is an attempt to develop a logical and internally consistent approach that accords as far as possible with the decided cases.

1.10 The indirect test would allow interest deductions to be available in a broader range of situations than have been accepted by Australian or Canadian courts. Further, the indirect test is not always consistent with the reasoning applied in various decisions of the Taxation Review Authority. The indirect test has been drawn primarily from the decision in *Public Trustee*, rather than these other decisions, because the Court of Appeal decision represents the law in New Zealand and has been accepted as such in subsequent cases.

1.11 This issues paper first discusses the concepts of direct and indirect uses of borrowed funds in an income earning process or business. The arrangements are analysed in light of that discussion. Cases on indirect use of borrowed funds are then examined. From these cases, various possible bases for a deductibility test for indirect interest are examined, and a conclusion is reached on the preferred basis. The remainder of the paper develops an indirect test and discusses the implications of the test.

Language used in this paper

1.12 All legislative references in this paper are to the *Income Tax Act* 1994, unless otherwise stated.

1.13 The phrase "indirect test" means the interest deductibility test outlined in this paper under which interest may be deductible in circumstances where borrowed funds are not used directly to acquire or improve income earning assets. The phrase "direct test" means the interest deductibility test applied in such cases as *Pacific Rendezvous Ltd* v *CIR* (1986) 8 NZTC 5,146 and *C of IR* v *Brierley* (1990) 12 NZTC 7,184, in which borrowed funds were directly used to acquire or improve income earning assets.

1.14 The phrases "indirect borrowings" and "indirect interest" are used as shorthand for "borrowings not directly used to acquire or improve assets", and "interest incurred on funds borrowed and not directly used to acquire or improve assets".

1.15 The phrase "income earning asset" means "an asset used in deriving the taxpayer's gross income or an asset used in the taxpayer's business which is carried on for the purpose of deriving the taxpayer's gross income".

1.16 The phrase "non-income earning asset" refers to assets that produce exempt income, assets that are private in nature and other assets that are not held for the purpose of producing income.

1.17 The words "income earning activity" and "business" are used to refer to the activities in sections DD 1(b)(i) and (ii), that is, an activity by which a taxpayer derives gross income and a taxpayer's business which is carried on for the purpose of deriving the taxpayer's gross income.

1.18 The arrangements that are the subjects of draft public rulings are referred to as the "arrangements".

2 Legislation

2.1 Section DD 1 states:

> Except as expressly provided in this Act, no deduction is allowed to a taxpayer in respect of any of the following sums or matters:
>
> ...

(b) Interest (not being interest of any of the kinds referred to in section DB 1(1)(e) and not being interest to which section LF 7 applies to prohibit a deduction), except so far as the Commissioner is satisfied that—

(i) It is payable in deriving the taxpayer's gross income; or
(ii) It is necessarily payable in carrying on a business for the purpose of deriving the taxpayer's gross income; or ...

2.2 Section BD 2 that provides allowable deductions states:

(1) DEFINITION An amount is an allowable deduction of a taxpayer ...

(2) EXCLUSIONS An amount of expenditure or loss is not an allowable deduction of a taxpayer to the extent that it is

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

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

3 The six arrangements covered by the draft rulings

What are the six arrangements?

3.1 This paper concerns six arrangements which are intended to be the subjects of separate public rulings. These arrangements are:

- The borrowing of (and the payment of interest on) money used by a company to repurchase shares from its shareholders as authorised by the *Companies Act* 1993, or to purchase shares from its shareholders by way of court ordered capital reduction under the *Companies Act* 1955.
- The borrowing of (and the payment of interest on) money used by a company to pay a dividend to its shareholders.
- The borrowing of (and the payment of interest on) money used by a partnership to return capital contributions to partners.
- The borrowing of (and the payment of interest on) money used by a partnership to return profits to partners.
- The borrowing of (and the payment of interest on) money used by a taxpayer to pay an income tax liability or a use of money interest liability (payable under section 121 of the *Tax Administration Act* 1994) to the Commissioner of Inland Revenue.
- The borrowing of (and the payment of interest on) money used by a company to make a payment to share losses of another company under the provisions of section IG 2(2) of the *Income Tax Act* 1994.

Analysing the six arrangements to determine if interest is deductible

Preamble — direct and indirect uses of borrowed funds

3.2 The statutory test provides that interest is deductible if it is payable in deriving gross income. Interest itself will not usually be directly payable in deriving income. The inquiry is on the use of the principal. The interest, being the cost of the use of the principal, will be connected with an income earning activity if the principal is used in that activity (See *Pacific Rendezvous* v *CIR* (1986) 8 NZTC 5,146 at 5,150, and *Ure v FC of T* 81 ATC 4100; (1981 11 ATR 484.

3.3 The question of whether interest is deductible has come before the Court of Appeal a number of times in recent years. In most of these cases, the Court had to consider whether interest was deductible when borrowed funds were directly used in a taxpayer's income earning activity, in that the borrowed funds were used to acquire or improve a taxpayer's income earning assets.

3.4 In *Pacific Rendezvous Ltd v CIR*, the taxpayer used borrowed money to add to and improve motel units, pending sale of the business. The statutory provision for interest deductions that the Court had to consider was section 106(1)(h) of the *Income Tax Act* 1976. That provision provided that interest was deductible to the extent that "it was payable on capital employed in production of the assessable income ..." The Court held that all of the borrowed funds were used in the production of assessable income. The interest was deductible and it did not matter that the company also had other considerations in mind. A similar approach was taken in *C of IR v Brierley*. In that case the Court held that the taxpayer could deduct interest on money used to buy shares which generated both income and capital profits. In this paper the principle of interest deductibility to come from these cases is referred to as the "direct test".

3.5 The only case in which the New Zealand Court of Appeal has had to consider whether interest is deductible when borrowed funds were not used directly in an income earning activity or business, is the *Public Trustee* case. In that case, the direct use of borrowed funds was to pay death duties. The Court found that the direct use of the borrowed funds did not produce income. Nonetheless, interest incurred on the funds was held to be deductible.

The arrangements

3.6 Each of the six arrangements, for which it is proposed to issue public rulings, involves money borrowed to make a payment. The first two payments are returns of capital by a company and payments of dividends. Returns of capital and payments of profits to partners by a partnership have been included because of the similarity of those arrangements with distributions by companies. The remaining two payments are payments of tax or use of money interest, and payments to share in the losses of another group company pursuant to the provisions of section IG 2(2) of the *Income Tax Act*.

3.7 In each of these arrangements, borrowed funds are used in ways that do not directly produce income. To determine whether interest is deductible in these situations, regard must be had to the law on indirect interest deductions.

3.8 Before the decision in *Public Trustee* and other cases on indirect use of borrowed funds are examined, each of the arrangements are analysed to show that they involve indirect uses of borrowed funds.

Returns of shareholders' capital

3.9 Under the *Companies Act* 1993 companies may repurchase their own shares, subject to a number of requirements set out in that Act. A court may make an order in respect of a company that is not registered under the *Companies Act* 1993, to purchase shares from its shareholders by way of capital reduction under the *Companies Act* 1955.

3.10 A return of shareholders' capital is not an activity that directly produces income. If borrowed funds are used to return capital, income is not produced. That use has no direct effect on the income earning process or business operations. Borrowed funds used in this way replace the funds contributed by shareholders as share capital, with debt.

3.11 This arrangement is the subject of draft ruling PU3502a.

Returns of capital by partnerships

3.12 A similar analysis applies where money is borrowed by a partnership to repay capital contributions. The use of funds to pay out capital to partners does not in itself produce income or contribute to the income earning process. In this situation, borrowed funds are used to alter the funding structure of the partnership, by replacing contributed capital with debt.

3.13 This arrangement is the subject of draft ruling PU3502c.

Payments of dividends or drawings to partners

3.14 A dividend is a payment by a company to a shareholder of a share of the company's profit. Similarly, drawings by partners are payments out of profits.

3.15 As payments of profits, they are payments made after the derivation of gross income. They are not made in producing that income or in carrying on a business to derive income.

3.16 These arrangements are the subjects of draft rulings PU3502b and PU3502d.

Payments of income tax and use of money interest

3.17 Income tax is not an expense that is directly related to the activity of earning income, it is a consequence of that activity. In *Smiths' Potato Crisps (1929) Ltd v I.R.C*. [1948] A.C. 508, Lord Normand said at pages 529–530 "... income tax is an impost made upon profits after they have been earned, and ... a payment out of profits after they have been earned is not within the purposes of the trade carried on by the taxpayer."

3.18 Use of money interest is payable under Part VII of the *Tax Administration Act* 1994. The regime is intended to compensate taxpayers if tax is overpaid, and the Commissioner if tax is underpaid. Use of money interest is not directly related to income earning activities, but to the payment of tax.

3.19 Payments of income tax and use of money interest are not payments forming part of an income earning activity or business, but payments made only as a consequence of that activity being carried on.

3.20 Payments of income tax and use of money interest are the subject of draft ruling PU3502e.

Payments to share in group company losses

3.21 A loss-offset payment, known as a subvention payment, is a payment made by a company in profit to a company in the same group that has a loss for tax purposes. The ability to make a payment to share losses is provided for in subpart IG of the Act. The purpose of such a payment is to reduce the tax liability of the profit company, thereby minimising the overall tax liability of the group of companies.

3.22 The payment has no direct effect on the income producing activities of the profit company. In the same way that payments of dividends and drawings to partners are payments of profits and thus not directly related to the income earning activity or business, so too are loss-offset payments made after the derivation of income when the annual profit is determined.

3.23 Payments to share in losses are the subject of draft ruling PU3502f.

Should other arrangements be the subjects of public binding rulings?

3.24 There will be many other instances where borrowed funds are only indirectly used in an income earning activity or business. The arrangements cover only a few.

3.25 Draft rulings on these particular six arrangements are being issued in response to demand from taxpayers and their agents for guidance from the Commissioner in these areas. In the interests of issuing the rulings on the arrangements, it is not proposed to attempt to identify every use of borrowed funds that should be subject to the indirect test. The Commissioner may issue further rulings on arrangements concerning interest deductibility in the future. Interested parties may wish to make submissions if it is thought that a similar ruling on some further specific arrangement should be issued to ensure consistent treatment across similar arrangements.

3.26 In analysing the issue of indirect use of borrowed funds, it has become apparent that the use of borrowed funds to replace previously borrowed funds is also an indirect use of borrowed funds. Although the use of funds to replace borrowings is not at this stage proposed to be the subject of a public binding ruling, this is a potentially important issue, because it is arguable that the indirect test proposed in this paper should apply to replacement borrowings.

3.27 Accordingly, the following discussion analyses replacement debt, and seeks submissions on whether the indirect test should apply to borrowed funds used in this way.

Replacement debt

3.28 When a taxpayer borrows to repay a debt, the direct use of the second borrowing is to repay the first borrowing. The second amount of borrowed funds is not used directly in the income earning activity or business. The replacement debt may form part of the entity' funding structure, and indirectly contribute towards the income earning process, but the direct use of the funds is to repay the previous debt. The second borrowing would not be directly used even if the original borrowing were used to acquire assets. A new borrowing does not inherit the use of the original borrowing.

3.29 Replacement debt appears to be a situation analogous to borrowing to fund a return of capital. In both situations, the new borrowing is paid to the person, whether the shareholder or the lender, who supplied the previous funding. It seems that the same principle of interest deductibility should apply to a loan whether it replaces equity or debt.

3.30 Hill J in *Roberts* and *Smith* took the opposite view on the issue of whether a replacement borrowing may inherit the use of the replaced borrowing. His Honour held that interest incurred on borrowed funds used to repay partners' capital would meet the test for deductibility because the funds would be employed in the partnership business. At page 4,388, Hill J said:

> In principle, such a case is no different from the borrowing from one bank to repay working capital originally borrowed from another; the character of the refinancing takes on the same character as the original borrowing and gives to the interest incurred the character of a working expense.

3.31 This statement has been criticised by Professor Parsons. In an article in *Taxation in Australia* (*Roberts* and *Smith: Principles of Interest Deductibility* by Professor Parsons. Taxation in Australia Red Edition. Vol.1 No.5 June 1993 p.261 at p.266) he comments on this extract from Hill J's judgment:

> The new borrowing ought not to be held to inherit the original function of the first borrowing. If it is held that it does, there will be opened a means of obtaining deductions for interest in respect of money borrowed that is used for private non-income producing purposes: the means might be described as washing a borrowing through a partnership.

3.32 Professor Parsons' comments are in relation to a partnership, because that was the entity that was the subject of *Roberts* and *Smith*. Professor Parsons' criticism of Hill J's comment is couched in terms of the consequences of Hill J's view. However, His Honour's view can be criticised from a more fundamental perspective. If a new loan is taken out, interest deductibility must be determined in relation to that loan. It is not relevant that a previous loan was taken out to acquire or improve an income producing asset. The new loan is not taken out to acquire or improve that same asset, it is taken out for the direct use of repaying the old loan.

3.33 The decision in the Canadian case of *Interior Breweries Ltd v Minister of National Revenue* [1955] C.T.C. 143, 55 D.T.C. 1090 (Exch.) supports the view that a borrowing to replace a borrowing is not directly used in the income earning activity. In that case Cameron J of the Exchequer Court held that interest was not deductible where the borrowed funds were used to pay a bank loan. His Lordship considered that the borrowed money was not used to earn income, but was "used entirely to pay off the bank loan..." (p.148).

3.34 There is also an indication in *Public Trustee* that Chief Justice Myers considered that borrowing to pay off a loan would not be a use directly producing income. At p. 452 Myers CJ compared the fact situation he was considering with the situation where a merchant borrows to pay off debt. The Commissioner had argued that the Public Trustee had not used the borrowed funds directly to produce profits (p.443). At p.452 Myers CJ said:

> If the suggestion made on behalf of the Commissioner is sound, then a merchant who borrows money to enable him to pay off debts incurred by him in his business, and to continue to employ his existing assets in production of income, would not be permitted, in the calculation of his assessable income, to deduct the interest on the moneys so borrowed.

Myers CJ rejects this suggestion. The implication is that in both the situation of a merchant paying off debt, and the Public Trustee paying death duties, the use of borrowed funds does not directly produce income.

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3.35 If the indirect test is applied to replacement debt, a large number of taxpayers will be affected. Application of the indirect test may alter the deductible result taxpayers may have considered they were entitled to under the direct use test. Taxpayers' compliance costs may be increased.

3.36 At this stage, the Commissioner has not formed the view that replacement debt is subject to the indirect test. The matter is raised in this paper to point out that borrowing to replace debt would appear to be an indirect use of borrowed funds, and that it would be consistent to treat replacement debt and returns of capital in the same way. Submissions on this analysis are welcomed. It is also raised in order to solicit submissions on the practical issues involved in applying the indirect test to replacement borrowings.

4 Legal basis for the indirect test

Legislation

4.1 Section DD 1(b) authorises the deduction of interest in certain circumstances. It provides that no deduction shall be made for interest, except so far as the Commissioner is satisfied that:

> (i) It is payable in deriving the taxpayer's gross income; or
> (ii) It is necessarily payable in carrying on a business for the purpose of deriving the taxpayer's gross income; ...

4.2 Interest is deductible if either of these two tests is satisfied.

Case law

4.3 In *Pacific Rendezvous Ltd*, the Court of Appeal interpreted the statutory provisions for interest deductions as requiring a "sufficient connection" between interest and the income earning process or business. See also *CIR* v *Banks* (1978) 3 NZTC 61,236.

Public Trustee

4.4 A sufficient connection between interest incurred on indirect borrowings and an income earning process was found to exist in *Public Trustee*. In *Public Trustee*, an estate 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.

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

4.6 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.

4.7 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 at p. 455:

> [the interest] was incurred for the very purpose of maintaining the income of the estate and preventing its reduction.

4.8 Earlier, 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 from 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? What the estate has in fact done is substantially the same thing, and has the same effect.

4.9 Clearly 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". Stated broadly, the case stands for the idea that interest is deductible if the borrowed funds have a sufficient connection with income earning assets. The connection with assets is that the borrowed funds financed the assets.

4.10 The decision might instead be interpreted more narrowly. His Honour considered that the borrowed funds maintained "the income from the assets of the estate". By this Myers CJ may have meant that interest should be deductible when the effect of the borrowing is to retain either particular assets, or the assets in general, from being sold. His Honour did not explain what it was about these circumstances that meant that the borrowings could be said to be maintaining the income earning assets.

4.11 The third strand of Myers CJ's reasoning is found in the comment that by borrowing to pay the death duties, the trustee in substance achieved the same thing as if it had sold the assets and borrowed to maintain the income from the estate. His Honour seems to suggest that the Court should recognise that the trustee could have achieved a deductible result if it had done things a different way, and, having achieved the same end result, the interest should be deductible.

4.12 These three interpretations are developed into possible bases for indirect interest tests in this paper after the other relevant cases are examined. That discussion analyses whether any of these bases can be used to support a test for indirect interest deductions.

4.13 This decision, being a decision of the Court of Appeal, is the authority on indirect interest deductions in New Zealand. Although it is an old case, it has never been questioned in subsequent New Zealand cases. Therefore, we are bound to follow it unless and until it should be overturned.

The statutory test considered in Public Trustee

4.14 The statutory test considered in *Public Trustee* was similar, but not identical to the current statutory test. Comments from the Court of Appeal in recent times suggest that the same considerations will be relevant to both forms of the statutory test.

4.15 The statutory test for interest deductions that the Court in *Public Trustee* had to consider was similar to the one considered in *Pacific Rendezvous*. The statutory provision in *Public Trustee* was section 80(1(h of the *Land and Income Tax Act* 1923. Section 80(1(h provided that no deduction was allowable in respect of interest "except in so far as the Commissioner is satisfied that it is payable on capital employed in the production of the assessable income".

4.16 The current wording was changed to bring it into line with the wording of the general deductibility provision of the Act. In *Pacific Rendezvous*, Richardson J compared the old "capital employed" test with the test in the general deductibility provision. His Honour commented that both provisions involve the same considerations of whether there is a sufficient connection between the expenditure and the income earning activity. Therefore, it seems that where a sufficient connection was found to exist under the old "capital employed" test in *Public Trustee*, the same situation would also constitute a sufficient connection under the current test for interest deductions.

Williams v *CIR* (1988) 10 NZTC 5,078

4.17 In *Williams v CIR*, the taxpayer borrowed to satisfy his spouse's matrimonial claim on a farm. The High Court found that that the interest was deductible. Barker J held that despite the concurrent use to meet the matrimonial claim, the interest was deductible because in the circumstances, the taxpayer's borrowing served to retain the farm.

Australian decisions

4.18 The Australian Full Federal Court considered an indirect use of borrowed funds in its decision in *FC of T v Roberts; FC of T v Smith* 92 ATC 4,380. It found that interest was deductible in circumstances where a partnership borrowed to repay partners their capital contributions to the partnership.

4.19 The reasoning of the leading judgment of Hill J in *Roberts* and *Smith* is somewhat different from the reasoning of the Myers CJ in *Public Trustee*. In *Roberts* and *Smith*, Hill J considered that the deduction was limited to the extent that the borrowed funds replaced the amount of partnership capital contributed by partners. His Honour considered (at p. 4,390 that:

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

4.20 According to Hill J, the value of any goodwill in a partnership would not support an interest deduction because it is not contributed capital.

4.21 This approach is not as broad as the approach taken in *Public Trustee*. Rather, it involves identifying capital originally contributed by partners, and tracking it through the life of the partnership.

4.22 Professor Parsons, an Australian tax commentator, has said (*Roberts* and *Smith: Principles of Interest Deductibility* by Professor Parsons. Taxation in Australia Red Edition. Vol.1 No.5 June 1993 p.261 at p.268.) that a better principle would come from the judgment of O'Loughlin J in *Roberts* and *Smith*. O'Loughlin J also considered that the interest should be deductible, and that the deductible amount should not be limited to the amount that replaces contributed capital. His Honour considered that interest on borrowing to effect the distribution of any surplus of value of assets over external liabilities should be deductible. This broader approach is closer to the *Public Trustee* approach than Hill J's judgment.

4.23 Hill J found some support for his approach in *Yeung & Anor v FC of T* 88 ATC 4193. In that case a partnership borrowed money to repay to the partners. The interest was held to be deductible. Davies J said at page 4,204:

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

4.24 The decisions in *Public Trustee*, *Roberts* and *Smith*, and *Yeung* can be contrasted with the Australian Federal Court decision in *Hayden v FCT* (1996) 33 ATR 352. The Court held that the taxpayer could not deduct interest indirectly connected to the derivation of income.

4.25 In *Hayden*, the taxpayer was the executor of a deceased estate. As a result of an action by the testator's son, the Supreme Court made an order that provision be made out of the estate for the testator's son of the amount of $150,000. The executor borrowed the amount and paid it to the son. A factor influencing her decision to borrow was to avoid selling two properties and so carry out the testator's wish to preserve the properties for the ultimate use of a religious organisation.

4.26 The taxpayer argued that the interest was incurred to satisfy the order so as to maintain the income earning assets of the estate. Spender J rejected this argument, and held that the focus must be on the use to which the borrowed funds are put.

4.27 His Honour referred to the decision in *Roberts* and *Smith* but did not expressly apply it or distinguish it. His Honour discussed *Public Trustee* and *Begg v FC of T* (1937) 4 ATD 257, 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 *FC of T v Munro* (1926) 38 CLR 153.

4.28 In *Munro*, the taxpayer borrowed and used some of the funds to buy shares. He gifted nine-tenths of the shares to his sons, and advanced the remainder of the borrowed money interest-free to the company. The borrowings were secured on the taxpayer's rent-producing properties. The taxpayer argued that the interest should be deductible, because payment of the interest was necessary in order for him to receive the rents of the rent-producing properties and the interest was therefore expended in the production of income. The Court held that the interest was not deductible. Knox C.J. said (p. 171):

> In this case 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 or that part of it which

> consisted of the rents of the freehold property. The respondent was, before the mortgage was given, entitled to the whole of these rents, and he did not gain them nor were they produced in consequence of the payment of interest. The interest was paid, not for the purpose of gaining or producing assessable income of the taxpayer, but for the purpose of satisfying *pro tanto*, a debt which the taxpayer had incurred with a view, not to the production of his assessable income, but to the production of income by the company for the benefit of its shareholders. The debt having been incurred for a purpose wholly unconnected with the production of assessable income of the respondent, I think it impossible to say that the interest paid on the amount of the debt was money wholly and exclusively laid out or expended for the production of his assessable income.

4.29 The taxpayer in *Begg* was in similar circumstances to the taxpayer in *Public Trustee*. An estate borrowed to pay certain duties relating to the estate. Reed A.J. found that there was a substantial relation between the interest and the production of income (p. 270). The borrowings enabled the estate to continue to produce income. The use of the borrowings to pay duties was a purpose of the estate. Like the Court in *Public Trustee*, the Court found that in the circumstances before it, the interest did have a sufficient connection with income, but did "not wish to be understood as attempting to lay down an exhaustive test" (p. 270).

4.30 Whilst in *Begg* the Court was prepared to find that in the circumstances there was a sufficient connection between the interest and the taxpayer's income, in *Munro* the Court found that the necessary connection did not exist.

4.31 In *Hayden*, Spender J chose to apply *Fletcher & Ors v FC of T* 91 ATC 4950 for supporting the proposition that interest is deductible when the direct use of the borrowed funds produces income. His Honour appeared to also follow *Munro* for the proposition that interest is not deductible when there is only an indirect connection with interest. Rather than view *Munro* as an instance where the indirect connection was not sufficient, Spender J seemed to reject the idea that an indirect connection could ever be a sufficient connection. His Honour supported his view by noting that if an indirect connection be accepted as sufficient, then interest on money borrowed to pay school fees would be deductible.

4.32 In contrast, Professor Parsons (*Roberts* and *Smith: Principles of Interest Deductibility* by Professor Parsons. Taxation in Australia Red Edition. Vol.1 No.5 June 1993 p.261 at p.267.) considers that *Munro* and *Begg* are quite compatible. Professor Parsons makes this comment when observing that Hill J in *Roberts* and *Smith* questions the authority of *Begg* having regard to *Munro*. Professor Parsons says that in *Munro*, the Court rejected the argument that interest is deductible when its payment is charged over rent-producing property, so that non-payment of the interest would mean the taxpayer would be deprived of the property. Professor Parsons explains that in comparison, in *Begg*, the Court accepted the principle that interest is deductible when the borrowing sustains the income earning assets from otherwise being sold.

4.33 Professor Parsons' analysis of the two fact situations seems to be the better one. In *Munro*, the funds were directly used for a use that did not produce income. The connection with income was argued to be that the funds were secured over rent-producing property. The funds were associated with income producing property, but did not serve to retain those properties. In *Begg*, the borrowed funds were used to continue the income earning process, in that they were used to pay estate duties and other administrative expenses of the estate, to avoid the alternative of realising income earning assets. Professor Parsons considers that the facts in *Begg* supported a finding of a sufficient connection between interest and the income earning process.

4.34 Myers CJ in *Public Trustee* distinguished *Munro* on the basis that in comparison with *Munro*, in *Public Trustee*, the money borrowed was not employed for purposes independent of the income earning property, but were borrowed for purposes instrumental in retaining the income earning property. Myers CJ also added that unlike *Munro*, the death duties were a voluntary debt. The relevance to Myers CJ's reasoning of the expenditure being involuntary is not simply the fact that the death duties were involuntary, but because that fact meant that if the duties were not paid, then the income producing properties would have been sold because the estate would have had to have met the expenditure. Therefore, there was a real connection between income and the expenditure for which the borrowed funds were used.

4.35 To return to *Hayden*, Spender J apparently supports his reasoning that an interest deduction should not be allowed when funds are not used directly to produce income, by saying that uses such as to pay school

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fees would give rise to an interest deduction. Although that may be so, it does not mean that the interest does not have a sufficient connection with income. Interest might have a sufficient connection with income, but be an excluded deduction on the different basis that it is private in nature.

4.36 In summary, in the two early cases, *Begg* and *Munro*, an indirect connection was found on the facts to be sufficient in *Begg*, but not in *Munro*. In the more recent case *Hayden*, the Court was reluctant to follow *Begg*, and seemed to reject an indirect approach. The Court did so by relying on *Munro* for the proposition that an indirect connection was not sufficient, and by taking account of the questionable basis that an indirect connection is less of a connection if the direct use of the funds is for private use.

4.37 To the extent that the decisions in *Roberts* and *Smith*, and *Hayden* are inconsistent with the decision in *Public Trustee*, New Zealand courts must follow *Public Trustee* because it is a binding precedent.

Canadian decisions

4.38 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.

4.39 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 sought to deduct interest on a loan used to pay to a bank to honour a guarantee in respect of companies with which it was associated. The taxpayer was not successful. The Court held that following *Bronfman*, an interest deduction could not be claimed in reliance on the argument that the borrowing enabled the taxpayer to retain income earning assets. The test for interest deductions would be satisfied if the direct use of the funds was to produce income. The Court recognised that in some exceptional circumstances interest may be deductible when borrowed funds are not directly used to produce income.

4.40 The judgment of Robertson J.A., although not the majority judgment, is interesting in that he examines the law on indirect interest deductions. Following *Bronfman*, His Honour concluded that the main test for interest deductibility was that the direct use of the borrowed funds must produce income. His Honour found since *Bronfman*, the argument that interest should be deductible where the borrowing preserves income-producing assets was not accepted in Canadian courts. If the only connection with income is that the borrowing preserves income producing assets, then the connection with income is too remote. However, in some exceptional circumstances, possibly those in *Trans-Prairie Pipelines Ltd. v MNR* [1970] CTC 537 (mentioned in the next paragraph), interest could be deductible where the direct use of the funds was not in the income earning activity. In no circumstances can interest be deducted where the direct use of the borrowed funds is for private use, or for use in funding assets that produce exempt income.

4.41 The decisions in *Bronfman* and *Alberta* have greatly confined the application of the decision in *Trans-Prairie Pipelines Ltd. v MNR* [1970] CTC 537. In the latter case the taxpayer issued debentures and used the money to redeem preference shares. The Exchequer Court held that the interest incurred on the debentures was deductible because the money borrowed through the debentures replaced the money that was returned to the preference shareholders.

4.42 In *Chase Manhatten Bank of Canada v R* [1997] 2 CTC 3097, McArthur T.C.J. held that following the decision in *Bronfman* and *74712 Alberta*, the principle in *Trans-Prairie* did not extend beyond borrowed funds used to replace accumulated profits, to borrowed funds used to replace paid up capital and the entire net value of the company's assets.

4.43 As is the case with Australian decisions that are not compatible with *Public Trustee*, New Zealand courts must follow the decision in *Public Trustee*, to the extent that these Canadian decisions are inconsistent with *Public Trustee*.

Canadian legislation

4.44 The Canadian government has introduced draft legislation to allow interest deductions in certain situations where borrowed funds are not used directly in an income earning activity. The legislation is intended to confine some of the effects of the *Bronfman* decision. Although the legislation was introduced in 1991, it is still in draft form. In the meantime, following *Trans-Prairie*, Revenue Canada has a practice of allowing interest deductions on money borrowed to redeem shares or to pay dividends, to the extent that a corporation has accumulated profits.

Taxation Review Authority cases

4.45 In TRA cases, interest deductions have usually been denied to individuals for interest incurred on funds applied indirectly in deriving income, on the grounds that the connection with income is too slight, and secondly, but with less emphasis, because the interest is private in nature (see for example *Case* N63 (1991) 13 NZTC 3,483). The TRA has not recognised that there may be a sufficient connection with income where borrowed funds are not directly used to produce income. This general approach is not consistent with the decision of the Court of Appeal in *Public Trustee*. The Court in *Public Trustee* held that there may be a sufficient connection with income when borrowed funds are used only indirectly in an income earning activity.

4.46 As will be explained shortly, the proposed indirect test develops this idea further, and adds that the interest is not deductible under the indirect test when the borrowed funds are used directly for private purposes. Following an exhaustive consideration of the leading authorities and after developing a conceptual framework needed to apply them consistently, the preferred reason is not, as the TRA has said, that there is an indirect connection with income, but that the interest deduction is not available for the different reason that it is barred by the statutory prohibition for deductions of a private nature.

4.47 Often the reasoning in the TRA cases is that, following *Pacific Rendezvous*, the test for interest deductibility involves determining the direct use of the borrowed funds. In *Case* S5 (1995) 17 NZTC 7,036 at p.7,041, Barber DJ said "deductibility does not flow from indirect or side benefits of a loan transaction but from the direct financial advantage from the actual use of the loan capital." These TRA cases have generally not heard submissions arguing *Public Trustee*.

4.48 In cases heard by the TRA before the decision in *Pacific Rendezvous* where *Public Trustee* was considered, it was distinguished on the grounds that on the facts before the TRA the purpose of the loan was not to retain an income earning asset but to purchase a house (see *Case* C16 (1978) 3 NZTC 60,142 and *Case* D31 (1979 4 NZTC 60,668.

4.49 In cases heard after *Pacific Rendezvous*, the TRA has consistently held that the purpose of a borrowing is not a relevant consideration. The only relevant consideration is the use of the borrowed funds. In most of these cases, the decisions in *Public Trustee* (or *Williams v CIR* were not argued or considered in so far as they establish a principle of deductibility of interest where funds are not used directly to produce income. (See for example *Case* N63 and *Case* P56 14 NZTC 4,386.)

4.50 In *Case* L76 (1989) 11 NZTC 1,440, *Public Trustee* was distinguished on the grounds that in *Public Trustee* Myers CJ considered that the statute under which the duty was imposed, and the loan permitted to be raised, in itself created the nexus required. The duty was not a voluntary debt, and the borrowing authorised by statute was not a voluntary expense incurred. Keane DJ held that that lack of discretion was not present in this present case. Keane DJ seemed to question the decision in *Public Trustee*, noting the dissenting judgment of Northcroft J.

4.51 In the analysis of the *Public Trustee* decision in the next section, it is concluded that the involuntary nature of the expenditure was not crucial to the Court's reasoning, and should not be seen as the *ratio* of the case.

4.52 In *Case* T16 (1997) 18 NZTC 8,095, the taxpayers unsuccessfully argued that in borrowing to obtain their new residence, they retained their old residence and received rental income from it and therefore the interest should be deductible. Barber DJ questioned the decision in *Public Trustee*. He said:

> With respect, I have often thought that, in *Public Trustee v C of T*, the Court of Appeal were rather stretching a point because the borrowing by the Public Trustee in that case was not used or applied in a direct enough sense to gain income and achieve deductibility of interest for the estate. The Public

> Trustee <u>used</u> the borrowings to pay death duty owed by the estate. That was not a use that sought to produce assessable income in any direct sense.

4.53 An exception to the general approach of the TRA is *Case* P56 (1992) 14 NZTC 4,386. *Case* P56 concerned borrowed money used by a partnership for partners' drawings. Most of the original partnership capital was borrowed and the partnership made losses in all but one year. The partnership borrowed money which was then taken by the partners as drawings. The TRA disallowed the deduction of interest on the basis that there were no partners' funds and therefore there was no money for the partners to take. Notably, Judge Willy said (p. 4,396:

> ... if the partners had introduced all of the necessary capital by way of cash or debt-free borrowings the interest bill would have been less; reflecting in either profits or smaller losses. In those circumstances the partners would have been entitled to withdraw that capital investment as drawings, replacing it with borrowed money upon which the partnership would have incurred interest. In that case the Commissioner could have no complaint because the taxpayer is free to fund his business capital as he wishes.

4.54 These comments reflect a view similar to that of Hill J in *Roberts* and *Smith*, who considered that an interest deduction should be allowed in respect of borrowed funds used to replace partners' capital contributions.

What is the application of the TRA cases?

4.55 The reservations of the TRA may be acknowledged, but the decision in *Public Trustee*, being a decision of the Court of Appeal, represents the law until it is overturned by that Court or the Privy Council, or its application is confined by legislation. The other possibility is that the reservations expressed in some TRA cases are correct at least to some degree, so that the principle in *Public Trustee* should be seen as a narrow one. A narrow interpretation of *Public Trustee* is examined in the next section.

4.56 The TRA decisions are consistent with the indirect test in that they have disallowed deductions for interest that are private in nature. However, the main reason is usually because there is not a sufficient connection with income, and the private nature of the interest is a secondary reason. In contrast, the proposed indirect test admits a connection with income where funds are not directly used to produce income.

5 Possible bases for an indirect interest deductibility test

Introduction

5.1 The statutory test for interest deductions requires that interest must be payable in deriving the taxpayer's gross income, or necessarily payable in carrying on a business for the purpose of deriving the taxpayer's gross income. To satisfy the test, the courts have found that the borrowed funds must have a connection with the taxpayer's income earning process or business.

5.2 *Public Trustee* establishes that interest may be deductible when borrowed funds are not used directly in an income earning process or business. Myers CJ did not frame an indirect test, but decided that, in the circumstances he had to consider, the interest was deductible.

5.3 In framing an indirect interest test, it is clear that in the circumstances of the *Public Trustee* case, a sufficient connection with income was found to exist. From *Public Trustee*, we have drawn three possible bases for that connection, and attempted to develop these into tests for indirect interest deductions. In the following section, examined each of these approaches is outlined, and their strengths and weaknesses examined

Basis One: the financing assets approach

5.4 In *Public Trustee*, Myers CJ said (at p. 452):

> ... 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.

5.5 The relationship between the assets and the borrowing arose because the borrowing had the effect of leaving the equivalent amount of money in the assets. Therefore, the assets were retained and the income from them was maintained. In saying that the borrowing had the effect of leaving the equivalent amount in the assets, the Court was assuming that the borrowing changed the financing of the assets. They were saved from being sold, because the equity which was funding the assets was replaced by the new debt. After the borrowing, the trustee still had the assets, but it had more debt. In this way, the financing of the income earning assets was changed from equity to debt. The new debt went into the assets and financed them.

5.6 Based on the Court's reasoning, if the Court was asked to consider a future borrowing for the same purpose, it would seem logical that the interest would be deductible, provided that there was still equity in the income earning assets. The first borrowing would have reduced equity in the assets. If there is no equity remaining, the assets would no longer be available to be financed by a further borrowing. In the Court's words, an amount equivalent to the amount borrowed could no longer be "left" in the income earning assets.

5.7 In this way, a connection with income can be established under an analysis which may be referred to as the "financing assets approach". For assets to be acquired, or continue to be owned, they must be financed. A taxpayer's income earning assets must be financed either by the taxpayer's own funds (called equity) or debt. If the assets that are financed are used in an income earning process, then those funds, whether they are sourced from equity or debt, are also used in the income earning process, and so interest incurred on those debt funds is deductible.

5.8 This idea that assets are financed by a taxpayer's equity and debt was discussed in *Yeung & Anor*, in the context of a repayment of capital. At p. 4,204, Davies J said:

> In an income-earning enterprise, both income (sic, loan) and equity capital may be invested in assets directed to the earning of income. In such an event, if equity capital is repaid and loan capital replaces it, interest payable on the loan capital will ordinarily be an allowable deduction from the income derived from the asset. This is because the assets held represent the equity and the loan capital and, if the assets are directed to the earning of income, then both the loan capital and the equity capital which they represent are devoted to the earning of assessable income.

5.9 This financing assets analysis may be applied to the arrangements. An indirect borrowing, used for any of the purposes of the arrangements, has a connection with income if it finances income earning assets. Any indirect borrowing will finance income earning assets if the total amount of the taxpayer's debt associated with those assets, whether direct or indirect, does not exceed the market value of the assets. In this situation, the funds must be reflected in assets, and so the borrowed funds will be used in relation to those assets.

5.10 If a taxpayer's income earning activity is totally debt funded, and there is no equity, any further indirect borrowing used for one of the purposes of the arrangements will not finance assets. In this situation, the assets are already fully funded by debt. The further indirect borrowing cannot alter the financing of the assets, and so will not have a connection with assets. Therefore, if there is no equity left in assets, any new borrowing used for one the indirect uses of the arrangements cannot have a connection with the assets, and therefore the interest will not be deductible.

5.11 Under the particular indirect uses that are the subjects of the arrangements, indirect debt funding will finance income earning assets by replacing a taxpayer's equity interest in assets with debt. The effect of an indirect borrowing is to alter the taxpayer's mix of debt and equity. (In contrast to the arrangements, indirect debt funding that replaces existing debt works slightly differently, and that will be discussed shortly).

5.12 In the arrangements we are concerned with, it may in some circumstances be more precise to say that an indirect borrowing replaces a liability to pay an indirect expense, where creation of that liability has already reduced equity. That is, a taxpayer may become committed to a liability before an indirect borrowing is taken out to meet that liability.

5.13 For example, a taxpayer may decide to pay a dividend. That decision will create a liability to its shareholders. Creation of that liability will reduce equity by the amount of the liability. If the taxpayer then borrows to fund payment of the dividend, the liability representing the indirect borrowing replaces the liability to pay the dividend.

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5.14 The accounting entries involved in an example of borrowing to pay a dividend show the replacement of equity with the liability to pay the dividend, and replacement of that liability with the liability represented by the indirect borrowing. In this example, a taxpayer declares a dividend of $10, and funds payment of the dividend by borrowing. Note that the amount of the indirect borrowing ($10) is not greater than the taxpayer's equity ($40). This means that there is equity funding in the assets that the indirect borrowing can replace.

Example 1

Before the indirect borrowing

Assets		Liabilities and Equity	
Cash	50		60
	10		
	40	Equity	
			40
	100		100

Before the indirect borrowing, when a dividend is declared but not yet paid

Journal One: Debit Equity 10 — Credit Dividend Payable (Liabilities) 10

Assets		Liabilities and Equity	
Cash	50		60
	10		10
	40	Equity	
			30
	100		100

Immediately after the indirect borrowing

Journal Two: Debit Cash 10 — Credit Loan (Liabilities) 10

Assets		Liabilities and Equity	
Cash	60		60
	10		10
	40		10
		Equity	
			30
	110		110

After the borrowing has been used to pay the dividend

Journal Three: Debit Dividend Payable 10 — Credit Cash 10

Assets		Liabilities and Equity	
Cash	50		60
	10		10
	40	Equity	
			30
	100		100

5.15 The example demonstrates that even in circumstances where the liability for indirect expenditure arises before the indirect borrowing, the net effect is that the indirect borrowing replaces equity.

5.16 The example also shows the connection an indirect borrowing has with income earning assets. The indirect borrowing, along with other liabilities and equity, is reflected in the amount of assets. In this example, the taxpayer borrowed $10, and used it for the indirect use of paying a dividend. The end effect on the balance sheet is that equity is reduced and liabilities are increased. The liabilities are increased by $10, the amount of the indirect borrowing. In this way the indirect borrowing can be seen to be financing the assets.

5.17 Throughout, the value of the taxpayer's assets is more than the taxpayer's liabilities. If, in another example, an indirect borrowing had the effect that the taxpayer's liabilities were more than the taxpayer's assets, interest on the indirect borrowing would not be deductible to the amount of that excess. The excess of liabilities over assets would not be financing the assets.

FC of T v Roberts; FC of T v Smith 92 ATC 4,380 and the financing assets principle

5.18 The financing assets principle is also consistent with the decision in *Roberts* and *Smith*. In *Roberts* and *Smith*, Hill J considered that an interest deduction was available to the extent that the borrowed funds replaced the amount of partnership capital contributed by partners (see pp. 4,388 and 4,390). Implicit in this idea is that one source of financing (equity) is replaced by another (debt). This same idea of funding choices underlies the principle we have been discussing. The financing assets principle states that a funding choice of borrowing has a connection with assets to the extent that there is equity in the assets. The idea that a borrowing has an impact on assets because it reduces equity in the assets, is saying the same thing as a borrowing replaces capital with debt, but expresses it differently.

5.19 Under an indirect test based on a financing assets principle, deductible interest is limited to the extent to which the funds can be represented in net assets. Hill J would limit a interest deduction even more. His Honour considered (at page 4,390 that "The provision of funds to the partners in circumstances where that provision is not a repayment of funds invested in the business, lacks the essential connection with the income producing activities of the partnership ...". According to Hill J the value of any goodwill in a partnership would not support an interest deduction because it is not contributed capital. Hill J saw the funding choices only as debt and contributed capital, and not debt and the amount of total equity.

Direct private or exempt use

5.20 This indirect test would not apply if the borrowed funds are used directly for private use or to produce exempt income. There are specific statutory prohibitions against deductions of those types of expenses in sections BD 2(2)(a) and BD 2(2)(b) of the *Income Tax Act*. Although a borrowing used for a private or exempt purpose may also have the effect of altering the financing structure of a taxpayer's income earning assets, and so have a connection with income, the statutory prohibition for deductions relating to private expenditure or expenditure derived in earning exempt income would override the potential deduction.

5.21 If an indirect interest test did not limit interest deductions where the direct use of borrowed funds is for private use, the indirect test would provide a means for obtaining deductions in respect of private expenditure.

5.22 In *Williams v CIR*, Barker J held that interest was deductible in circumstances where the direct use of the borrowed funds was for a use that might be seen as private. The taxpayer used the money to satisfy his spouse's matrimonial claim on the farm. Barker J held that despite the concurrent use to meet the matrimonial claim, the interest was deductible because in the circumstances, the taxpayer's borrowing served to retain the farm.

5.23 It is our view that interest should not be deductible under an indirect test, where the direct use of the funds is for private use, because of the operation of sections BD 2(2)(a) and BD 2(2)(b). To the extent that this view is inconsistent with the decision in *Williams*, our view differs from the approach in that case.

Does the financing assets approach establish a sufficient connection?

5.24 A criticism of the financing assets approach is that it does not necessarily establish a sufficient connection between interest and a taxpayer's income earning process. If a taxpayer's equity is not less than the amount of the indirect borrowing, it is assumed that borrowings finance assets. The assumption is based on the idea that the nature of financing is that it will be reflected in assets. Furthermore, the actual use of the borrowings is irrelevant (except if the funds are used directly for private use or to produce exempt income.

5.25 In some of the cases where they have allowed an indirect deduction, the courts appear to have attempted to establish a connection on the facts between borrowed funds and income earning assets. In *Public Trustee*, Myers CJ said, in distinguishing *Munro* (p. 454:

> The borrowed money was not employed ... for purposes alien to or independent of the property, and, ... 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 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.

5.26 Reed AJ in *Begg* referred to several factors which linked the borrowed funds to the income earning assets. These factors included preservation of the assets, the duty of executors to pursue a course which did not involve heavy losses of capital, and the fact that the duties paid for with the borrowed funds related to the estate. At p. 270 he said:

> But, it seems to me, the effect of the relevant decisions, and the passages which I have quoted, is that money laid out or expended which has a substantial relation to the production of income is allowable as a deduction. In some cases it can be said that the expenditure of the money has nothing at all to so with the production of income; in others, for one reason or another that it does play a real part in

> producing the income. The facts of each case must be examined in order to determine what part, if any, the expenditure does play; and it may be that an expenditure which is what I may call too remote, will not be allowed.

5.27 The factors identified in the cases do not provide guidance for other fact situations, and in particular, to the arrangements that are the subjects of the draft public rulings. The cases do not lay down a general rule and there does not seem to be any common factor that would provide a reason for establishing a connection between interest and income for any particular taxpayer. The only common factor seems to be the idea that an indirect borrowing retains income earning assets. That idea as the basis of an indirect test is examined in the next section. As will be discussed, it seems to have serious problems as a test.

5.28 For this reason, it is suggested that a broader test is to be preferred, based on the financing assets analysis. It is consistent with the cases, despite the suggestion in *Public Trustee* and *Begg* that a finding on the facts may provide the link with income.

Basis Two: the retaining assets approach

5.29 The second basis for an indirect interest test to be considered is one that may be referred to as the "retaining assets approach".

5.30 It is an alternative analysis to the financing assets approach. The retention of assets approach is that indirect interest should be deductible in circumstances where the effect of the indirect borrowing is that income earning assets are retained from being sold.

5.31 Briefly, the issues involved in this approach are the following. It is attractive in that it seems to reflect best the words of Myers CJ in *Public Trustee*. However, it is unsatisfactory in that it seems to rely on what a taxpayer *notionally* did. That is, it seems to look to the economic substance of what a taxpayer achieves by an indirect borrowing, rather than what the taxpayer actually did with the borrowed funds.

5.32 The retention of assets approach can be rejected on the further basis that it would seem to support unlimited indirect interest deductions. That result clearly cannot have been the intention of Parliament. Also, it may lead inevitably to a "tagged assets" approach, which involves compliance issues of such extent that that approach also cannot have been the intention of Parliament.

Public Trustee — the basis of the retention of assets approach

5.33 In *Public Trustee*, Myers CJ explained the basis for his decision in several key sentences of his judgment.

5.34 At p. 452, Myers CJ said 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.

5.35 As noted earlier in this paper, the learned Chief Justice then said (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.

5.36 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 at p. 455:

> [the interest] was incurred for the very purpose of maintaining the income of the estate and preventing its reduction.

5.37 Earlier (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 from 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? What the estate has in fact done is substantially the same thing, and has the same effect.

5.38 In the first sentence quoted in paragraph 5.34, when Myers CJ said that the borrowing "left the money so borrowed or its equivalent in capital assets in the estate", he can be taken to mean that without the borrowing the equivalent amount would not have been left in the assets. Those assets would have been sold to realise that amount and income would have been reduced.

5.39 In the next two sentences quoted in paragraphs 5.35 and 5.36, his Honour says that the borrowing maintained income. It is implicit in these statements that maintenance of income was achieved through the retention of income earning assets.

5.40 The sentences quoted indicate that Myers CJ considered that the interest was deductible because the effect of the borrowing was to retain the assets, and therefore income from the assets was maintained.

5.41 The retention of assets approach is within the scope of the current legislative test. The statutory test, as interpreted by the courts, requires a sufficient connection between interest and a taxpayer's income or business. Under the retention of assets approach, interest on borrowings has a connection with income because the borrowings are used to retain income earning assets.

Roberts and *Smith*

5.42 In contrast, Hill J in *Roberts* and *Smith* seemed to reject the idea that an interest deduction would be available on the basis that borrowed funds retained or preserved income earning assets. Hill J's view was that interest was deductible when the borrowed funds were used to repay capital to partners because the funds would be used in the partnership business (p. 4,388.

5.43 Hill J discussed the decision in *Begg*, in which the Court held that interest was deductible in circumstances similar to those in *Public Trustee*. He saw *Begg* as accepting the idea that interest is deductible if the principle maintains income earning properties. His Honour referred to *Begg* as a "difficult case" (p. 4,389 and considered that there may be some difficulty in reconciling *Begg* with *Munro*. His view seemed to be that interest should not be deductible in circumstances such as those considered in *Munro* and *Begg* because the borrowed funds would not be used in producing income.

A problem with the retention of assets approach — is it a notional test?

5.44 The retention of assets approach is unsatisfactory in that it seems to rely on what a taxpayer *notionally* did. That is, it recognises that a taxpayer could have achieved deductibility under a direct test by selling income earning assets and borrowing to replace them. Instead, a taxpayer may achieve the same result by borrowing to fund the indirect expenditure. There are many statements in tax law that the inquiry must be to the legal relations actually entered into by taxpayers and, not the economic substance; see for example *A Taxpayer* v *C of IR* (1997) 18 NZTC 13,350 CA, *Buckley & Young Ltd* v *CIR* (1978) 3 NZTC 61,271; [1978] 2 NZLR 485 CA.

5.45 Whether or not the retention of assets approach relies on what a taxpayer notionally does, depends on whether there is any real difference between saying that a borrowing enabled a taxpayer to retain income earning assets, and saying that otherwise the assets would have been sold, and repurchased with the borrowed funds. If this is what retention means, then it is a test about what the taxpayer could have done.

5.46 It is arguable, though, that retention of assets is a different concept to the idea that assets would otherwise have been sold, and that borrowing to fund the indirect expenditure achieves that same result. Arguably, retention of assets is an activity in itself. Assets are not in fact sold, and the borrowing allows them not to be sold. Retention is the ability of a taxpayer not to have to sell assets. It is this ability that is the connection between an indirect borrowing and assets.

5.47 Despite this argument, it does seem to be a weakness of the retention of assets approach that it can be challenged as being a shorthand explanation for what the taxpayer did not do, but in substance achieved. Myers CJ alluded to this in the extract quoted above when he spoke about the substance of what the taxpayer did.

Developing the retention of assets approach — a broad retention of assets approach

5.48 It may also be possible to develop a retention of assets approach that could be applied in a broad way, and which did not involve taxpayers identifying the particular assets that are retained by an indirect borrowing. The aim in developing such an approach would be to avoid the need to identify particular assets (an approach that may be referred to as the "tagged assets" approach), because that requirement brings with it compliance problems of such extent that the result cannot have been the intention of Parliament. The tagged assets approach is discussed further below.

5.49 A broad retention of assets approach would not entail a taxpayer showing that particular income earning assets were actually retained and, as a consequence, income maintained. In other words, the taxpayer would not have to show that the assets really would have been sold if not for the borrowing. That level of detail would not be required. Instead, a broad retention of assets test would recognise that the effect of any indirect borrowing, which is carried out within certain limits, is that income earning assets are retained.

5.50 The reasoning behind a broad approach is that it is not necessary for taxpayers to show that particular assets are actually retained by borrowings, because assets may be retained even if a taxpayer had other choices of funding. Borrowing does not have to be the only choice, for it to be able to be said that borrowing retains assets.

5.51 This is because a borrowing must necessarily entail a funding choice between debt and equity. A taxpayer's assets are either funded by debt or equity. If a taxpayer borrows for an indirect use, and the taxpayer's assets are not fully represented by debt, the taxpayer must be implicitly making a choice to leave equity in the assets and so avoid selling them. Given this reasoning, under a broad retention of assets approach, the taxpayer is not required to give a level of detail about which particular assets would have been sold. The test would assume that some of the assets are retained.

5.52 The problem with this reasoning is that if the test is that assets can be retained when the taxpayer does not have to show which or how assets are being retained, it must be questioned whether retention of assets is really the reasoning behind the connection between borrowings and assets. If taxpayers do not have to demonstrate that there was any certainty that any particular asset would have been sold, then perhaps it cannot be said that assets are being retained. Either taxpayers should have to show which and how assets are being retained, or retention of assets is not the basis of the test.

5.53 If, instead, taxpayers have to show which and how assets are being retained, the basis of the test is the tagged assets approach, which will be discussed below.

Retention of assets — implications of a broad approach

5.54 It has been pointed out that a broad retention of assets approach seems to lead inevitably to a tagged assets approach. However, assuming that a broad retention of assets approach is possible, then its implications can be examined.

<u>Infinite deductions</u>

5.55 One implication of a broad retention of assets approach is that it would seem to support potentially infinite deductions of indirect interest. It follows from such a serious consequence that the retention of assets approach cannot have been the intention of Parliament. By legislating a statutory test for interest deductions, Parliament cannot have intended that the test effectively be redundant because there is no limit to the amount of interest a taxpayer can deduct.

5.56 Taxpayers could arguably justify unlimited interest deductions under the broad retaining assets approach by applying the following reasoning. Every indirect borrowing could be argued to retain income earning assets. Each time a taxpayer borrows, the taxpayer could have instead realised income producing assets to fund the indirect expenditure. A taxpayer could go on borrowing against assets, provided that the amount of each particular borrowing does not exceed the value of income earning assets. In aggregate, the borrowings could exceed the value of assets. All a taxpayer would need would be a single asset worth $1, and that asset could be retained by borrowings over and over.

5.57 Practically, a taxpayer may be limited from borrowing beyond the point at which liabilities are equal to assets. The taxpayer would be insolvent, and may be forced to stop borrowing because no-one would continue to lend or because of company law requirements. However, those factors would not affect the principle of interest deductibility.

On-going indirect interest deductions

5.58 Application of the retention of assets test to on-going interest payments also raises some difficulties. When the borrowings are first taken out to pay for an expense, they retain the assets against being sold to meet that expense. When interest is incurred over the life of the loan, that expense has been met, so the borrowing no longer retains assets in relation to that expense. At the time that interest payments are incurred, that expense has already been met, and the borrowings are still outstanding. How then, are the borrowings retaining the assets?

5.59 The best rationale for allowing an on-going interest deduction under a retention of assets approach is that if the loan had to be paid back to the lender at the time of each subsequent interest payment, that would require selling the assets. Interest will continue to be deductible, provided that the amount by which income earning assets exceed liabilities of the income earning activity is equal to or greater than the outstanding balance of the indirect borrowings.

5.60 It is not a perfect solution, because the test has moved from the rationale in the first year that the borrowings maintain the assets against a particular expense, to, in relation to subsequent interest payments, maintenance of the assets against repayment of the indirect loan. This justification for an on-going deduction moves the retention of assets approach closer to the financing assets approach in that the on-going deduction is available simply because the borrowings finance the assets.

5.61 The change in the reasoning for an on-going interest deduction raises some doubt that the on-going interest should be deductible. If two reasons are needed to support deductions in relation to the same loan, it suggests that there is no basis for the on-going interest deduction under a broad retention of assets approach.

5.62 It might be suggested if the loan retained particular assets, then the indirect interest should be deductible throughout the life of the loan, without having to ensure that assets exceed liabilities at all times. If the justification for ongoing interest deductions is that the borrowings continue to retain the particular assets that existed at the time of the borrowing, the approach on which the deduction is based is not the broad retention of assets approach, but a tagged assets approach (which is examined next). Under a tagged assets approach, there is no need to ensure that assets exceed liabilities at all times. However, the tagged assets approach also has problems, which will be discussed below.

A narrow retention of assets approach — the tagged assets approach

What is the tagged assets approach?

5.63 The tagged assets approach is a tighter and more literal version of the retention of assets approach. The tagged assets approach is that an indirect borrowing retains the particular assets that exist at the time of the indirect borrowing. As a sort of subset of the retention of assets approach, the conceptual basis is still that an indirect borrowing may retain income earning assets from being sold. In its application, it will differ in that it will involve identifying the particular assets that are retained by the borrowing.

5.64 Under the tagged assets approach, if the particular assets retained by indirect borrowings remain in the income earning process, the interest should continue to be deductible without the need to determine each year whether assets exceed liabilities by the amount of the borrowing. If those particular assets are removed from the income earning process, interest on the indirectly applied funds tagged to those assets will no longer be deductible. If the tagged assets approach was adopted as the indirect test, it would parallel the direct test in this regard.

Reconciling the tagged assets approach and *Public Trustee*

5.65 There seems to be some difficulty in reconciling *Public Trustee* with the tagged assets approach. The point of the decision is that borrowed funds may have a sufficient connection with an income earning process even though the funds are not directly used in relation to assets. It seems inconsistent with this approach to require borrowings to be tied to particular assets. If borrowings are not in fact directly used in relation to the assets, it does not seem to make sense that they should be tagged to assets. A tagged assets approach seems to be an attempt to create a direct connection between assets and indirect borrowings, when in fact the direct use of the funds is some other use.

5.66 The circumstances of the taxpayer in *Public Trustee* are consistent with adopting a financing assets approach over a tagged assets approach. The taxpayer in *Public Trustee* owned income producing and non-income producing assets. The parties had agreed that if some of the interest was deductible, it would be deductible based on the value of the income producing assets to total assets. Therefore, the Court did not have to consider the point.

5.67 It can be noted, though, that the use of a global formula, which compares income earning assets with total assets, is completely consistent with the financing assets approach, and inconsistent with the tagged assets approach. As we will discuss later under the implications of the indirect test, the financing assets approach requires such an apportionment when a taxpayer has non-income producing assets. In comparison, a tagged assets approach does not, because the indirect borrowings are tagged to the income producing assets so the borrowings cannot relate to the non-income producing assets.

<u>Could such an impractical test have been the intention of Parliament?</u>

5.68 As with any formulation of the indirect test, there are associated administrative and compliance issues with the tagged assets approach. These seem to be particularly serious under the tagged assets approach. Any change in tagged assets must be recorded, and potentially an adjustment made to the deductible amount of indirect borrowing. Taxpayers must identify, record and value tagged assets at the time of borrowing. To determine whether on-going interest payments are deductible, the borrowing must remain tagged to the asset, to ensure that the asset remains committed to the income earning process. If a new indirect borrowing is taken out, a new set of values must be made for each asset retained. The tagged assets approach also raises issues as to whether a relevant asset can be substituted by another asset, and the correct treatment when an asset is repaired or altered.

5.69 The compliance issues associated with the tagged assets approach suggest that it could not reflect the intention of Parliament in enacting a statutory test for interest deductions. It seems unlikely that the unwieldy and probably unworkable test that would result could have been the intention of Parliament. It also seems unlikely that a test requiring such detail to comply would have been legislated for with the few words of the interest deductibility provision. Taxpayers would not have any guidance for the many issues that they would face in applying the test.

The "otherwise would have had to have sold" approach

5.70 This approach is really a variant of the tagged assets approach. The basis is that an indirect borrowing may retain income earning assets from being sold. The approach takes the idea further and requires that if not for the borrowing, particular income earning assets really would have had to have been sold. Because the borrowing prevented the assets from being sold, the effect of the borrowing is that income earning assets are retained. This "otherwise would have had to have sold test" would be more difficult to satisfy than other variants of the retaining assets basis, because taxpayers would have to show on the facts that borrowing was the only option apart from selling income earning assets to fund the expenditure.

5.71 The appeal of the "otherwise would have had to have sold" approach is that it requires a taxpayer to establish that there is a certain link between borrowed funds and the income earning activity. In its focus on establishing a sufficient connection, it is consistent with *Pacific Rendezvous*. The requirement to demonstrate that a factual link exists between income and borrowed funds follows such cases as *Begg* and *Munro*. In contrast, the financing assets approach simply assumes that there is a connection between income earning assets and indirect borrowings.

5.72 As a variant of the retention of assets test, it suffers from the same weaknesses. Most importantly, it arguably looks to what notionally happened, rather than what the taxpayer actually did. In recognising that if the taxpayer really would otherwise have sold assets, this approach is saying, "this taxpayer could have achieved deductibility by selling assets and replacing them, and on the facts this taxpayer really would have sold those assets, so interest should be deductible because the taxpayer in substance achieved the same thing". It has already been pointed out that the courts have rejected an in substance approach to tax law.

5.73 The "otherwise would have had to have sold" test has all the compliance difficulties of the tagged assets approach, and adds some of its own. It would often be difficult for a taxpayer to prove that but for the borrowing, income producing assets would have had to have been sold. There would be uncertainty over whether a taxpayer had pursued every possible source of funding, or whether the taxpayer should only need to take reasonable steps to investigate alternative funding options. It would be difficult for the Commissioner to take a consistent approach. Deductibility would depend very much on the facts of particular cases. The extent of these practical problems is such that this approach cannot have been the intention of Parliament.

5.74 In summary, the "otherwise would have had to have sold" approach should be rejected. It appears to take an in substance approach to transactions. It has serious compliance issues that indicate that the approach was not the one intended by Parliament.

Retention of assets approach summary

5.75 It has been suggested that a retention of assets approach seems to underlie the judgment of Myers CJ in *Public Trustee*.

5.76 However, all the retention of assets approaches that have been examined can be criticised for taking into account the economic substance of what taxpayers hope to achieve in borrowing, rather than the transactions entered into.

5.77 A broad retention of assets approach seems to have the implication that there would be no limit to the amount of interest a taxpayer could deduct. That result could not have been the intention of Parliament.

5.78 Also, the conceptual basis for ongoing deductions under the broad approach is different to the conceptual basis for the first interest deduction for any indirect borrowing. Only the initial act of borrowing retains the assets against an expense. The on-going deduction arguably retains the assets against something different: perhaps repayment of the loan. The need to find another basis to justify the ongoing deduction suggests that the broad retention of assets approach is not a conceptual basis at all, or at least, is not a comprehensive approach.

5.79 It has also been argued that it seems doubtful that there is a broad retention of assets approach. A broad approach involves arguing that assets are retained by an indirect borrowing without any evidence that the taxpayer would have sold assets if not for the borrowing.

5.80 A narrow approach involves the idea that an indirect borrowing retains the particular assets that exist at the time of the borrowing. This tagged assets approach would not provide for infinite deductions, because the deduction would be limited in relation to the particular assets that are retained by the borrowing. However, it seems that the tagged assets approach also could not have been the intention of Parliament because it involves a very high level of compliance, and detailed record keeping from taxpayers without any legislative guidance. The tagged assets approach also seems out of step with the *Public Trustee* decision in that the Court in *Public Trustee* seem to reject an approach that involved tracing borrowed funds to income earning assets.

5.81 The "otherwise would have had to have sold" approach has the same compliance problems as the tagged assets approach, and adds further compliance requirements in asking taxpayers to demonstrate that they would otherwise have sold assets. This approach should also be rejected as not being the intention of Parliament in enacting the interest deductibility provision.

Basis Three: substance over form

5.82 The other major type of reasoning to support an interest deduction for borrowed funds not directly used to derive income is the "substance over form" approach. The basis of this approach is that the taxpayer could have sold income producing assets to finance the indirect expenditure, and then borrowed to repurchase or replace the income earning assets. In substance, the taxpayer achieves the same result by borrowing to finance the indirect expenditure, so the interest should be deductible.

5.83 There seems to be some support for a substance over form approach in *Public Trustee*. At p. 452 of the judgment, 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 from 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? What the estate has in fact done is substantially the same thing, and has the same effect.

5.84 This comment seems to suggest that the form of the transaction should be ignored. As the trustee could have sold up assets then borrowed to repurchase the assets or replacement assets, but achieved the same thing another way, then a deduction should be allowed.

5.85 The Commissioner does not support the adoption of an approach that is based on the economic substance of what the taxpayer achieves rather than the transactions entered into by taxpayers. The courts have rejected a substance over form approach generally in tax law, saying that the correct approach is to have regard to the true legal relations and not to the economic substance; see for example *A Taxpayer v C of IR*, and *Buckley & Young Ltd v CIR.*

5.86 Secondly, Myers CJ's comments might be read as not supporting a substance over form approach, but as giving the reasoning why the borrowing served to finance or retain assets. What His Honour is perhaps saying is that because the taxpayer's other course of action was to realise assets and repurchase, the effect of the borrowing was to prevent that happening and thereby finance or retain the assets.

Should the principle in *Public Trustee* be limited to trusts?

5.87 One view is that the application of the *Public Trustee* decision should be limited to situations involving trustees of trusts and executors of estates. In this view, these taxpayers are different because they have a fiduciary duty to their beneficiaries to act in their best interests. This duty includes maintaining the assets of the estate.

5.88 It is considered that this interpretation can be rejected. It was not part of the Court's reasoning that the trustee had a fiduciary duty to beneficiaries to maintain the assets of the estate. Certainly the trustee borrowed in order to maintain the income producing assets. That was its direct purpose in borrowing. Its motivation might have been its duty to the beneficiaries. However, that point was not mentioned by the Court. As the existence of the trustee's duty was not relevant to the reasoning of the Court, any type of taxpayer, not only a trust, should be able to apply the decision in *Public Trustee*.

5.89 Further, there seems to be no reason that it should be relevant that the taxpayer was a trustee. Many taxpayers have special duties to others. A company, for example, has rigorous standards to meet in relation to its shareholders and also to others it deals with. There is no reason why a company, or any other taxpayer, should be treated any differently to a trust in relation to interest deductions.

Should the principle in *Public Trustee* be limited to involuntary expenses?

5.90 The Commissioner has previously taken the view (TIB) that interest is deductible in relation to certain indirect uses of borrowed funds, following the *Public Trustee* decision, if the expense to which the borrowings are applied is involuntary in nature. The Commissioner now takes the view, shared by others (Susan Glazebrook and Jan James in *NZ Journal of Taxation* 199 p.153), that the involuntary nature of the expense did not form part of the ratio of the Court. The ratio of Myers CJ appears at pp. 452–453 of the judgment. The factors essential to His Honour's decision are that the borrowing enabled the equivalent amount to be left in assets, and that assets were preserved and income was maintained.

5.91 Myers CJ discussed the relevance of the involuntariness of an expense at pp. 453–455 in distinguishing *Ward and Co., Ltd. v Commissioner of Taxes* [1923] and *Federal Commissioner of Taxes v Munro* (1926) 38 CLR 153.

5.92 In the court's view, the factor which distinguished those two cases from *Public Trustee* was that the expense was not connected to the income producing activity. In *Ward*, the expense was incurred to influence public opinion against taking a step that would partly destroy the profit-bearing thing. In *Munro*, the taxpayer had already acquired a rent-producing property, and chose to borrow using the property as security and to use the borrowed funds for purposes unrelated to that property. In comparison, in *Public Trustee*, interest on the borrowed funds was connected to the income earning process because the borrowed funds served to finance or retain assets.

5.93 It is acknowledged, however, that in distinguishing *Ward* and *Munro*, Myers CJ seemed to imply that on the facts there was a connection in the situation before him that did not exist on the facts in those other cases. As we have discussed, we have relied on *Public Trustee* to support a broad principle of interest deductibility based on the idea that borrowings finance assets, and not a narrow principle, such as the "otherwise would have had to have sold" approach, based on the facts of each taxpayer.

5.94 In fact, the indirect test proposed in this paper may give an interest deduction to taxpayers whose circumstances are similar to those of the taxpayers in *Ward* and *Munro*. In *Munro*, the taxpayer borrowed for a use that did not produce income. The taxpayer argued the interest was deductible because if it were not paid, the income producing properties over which the loan was charged would be sold. The Court rejected the argument on the grounds that the loan did not affect the properties. Rent was produced before and after the loan was taken out.

5.95 Ignoring for a moment that the direct use of the borrowed funds was for private use, the interest would be deductible under the proposed indirect test, provided the value of the income producing properties was equal to or exceeded the value of liabilities. The taxpayer would not have to demonstrate that the borrowing contributed somehow to the rent producing properties, as the court seemed to imply in *Munro*. The proposed indirect test would not require a connection to the degree required in *Munro*. However, the proposed indirect test would not enable an interest deduction in the fact situation of *Munro*, to the extent that the funds were directly used for private use, because of the statutory prohibition for deductions that are private in nature.

5.96 Similarly, the indirect test may provide that interest is deductible in the fact situation in *Ward*. The interest would be deductible if the value of assets were not exceeded by the value of liabilities. The taxpayer would not have to demonstrate that on the facts there was a connection between the expenditure and the use of the principal.

5.97 In *Case* L76, Keane DJ distinguished *Public Trustee* on the basis that the duty payable was not voluntary. This factor, in Keane DJ's view, created the nexus with income because the taxpayer had no discretion on whether to pay the expense. With respect, we have reached a different view.

5.98 It should be noted that the view that the voluntariness or involuntariness of an expenditure was not part of the *ratio* of *Public Trustee* represents a change in the Commissioner's view of the law.

A relevant academic article

5.99 In a recent article (Burford, K *Hayden's Case: Over-use of the "Use Test"* Taxation in Australia Red Edition, June 1997, Volume 5, No 5 p.262), Karen Burford expressed her view that rather than labelling cases as establishing a "use" test or a "maintenance of income producing assets" test, one should look to a more general principle. Ms Burford suggests that the general principle is that interest is deductible if there is a sufficient connection between interest and the earning of assessable income.

5.100 It is clear that there must be a sufficient connection between interest and the income earning process, but that statement is not helpful in determining whether in the arrangements we are concerned with, interest will or will not have a sufficient connection with income. The indirect test goes that step further. Note that the direct test, which has clearly been endorsed by the courts, has the extra step of examining the use of borrowed funds to determine whether a sufficient connection exists between interest and the income earning process.

6 Implications of the indirect use test

6.1 From this analysis, it can be seen that interest on any borrowing that is not directly used in an income earning activity or business, may be deductible if the borrowing finances income earning assets.

6.2 This section examines the implications of this test.

Direct private or exempt use

6.3 Interest cannot be deducted in reliance on this indirect test if the taxpayer who borrows the funds uses the funds directly for private use or to acquire or improve assets that produce exempt income. A taxpayer directly uses funds for private use when the funds are used to acquire or improve private assets, or when funds are used to buy private items which are consumed.

6.4 Interest is the cost of borrowing funds. It takes its character from the use of the funds. If the funds are directly used for private use or to acquire assets that produce exempt income, the interest is private or exempt in nature.

6.5 Under section BD 2(2)(a), expenditure that is of a private nature cannot be deducted. Under section BD 2(2)(b), expenditure that is incurred in deriving exempt income is not an allowable deduction. These specific statutory prohibitions will override the application of the indirect test.

How much indirect interest can be deducted?

6.6 An indirect borrowing can finance assets to the extent that they are not already fully funded by debt. If assets are fully debt funded, then an indirect borrowing does not have the effect of financing the assets.

6.7 Therefore, interest on any indirect borrowing will be deductible to the extent that the amount borrowed, totalled with any other indirect borrowings of the taxpayer, does not exceed the value of income earning assets less direct debt invested in those assets.

6.8 Indirect borrowings are added together in this equation. As indirect borrowings are not attached to particular assets, interest on previous indirect borrowings must be determined on an on-going basis. On-going deductions are discussed more below.

6.9 If the amount of indirect borrowings exceeds the amount of income earning assets less direct debt invested in those assets, the indirect interest is deductible on the portion of the indirect borrowings that does not exceed the amount of income earning assets less direct debt invested in those assets.

How are assets valued?

6.10 Under the financing assets approach, indirect borrowings finance assets up to the point at which a taxpayer's assets are fully debt funded. To calculate the point at which a taxpayer's assets are fully debt funded, liabilities are subtracted from the aggregate market values of assets. The amount arrived at is equity, being the taxpayer's ownership interest in its assets. It is this equity that can be replaced by indirect debt, that can then be seen as financing the assets.

6.11 In this assets minus liabilities equation, market value is used because the calculation then arrives at the portion of assets that are still available to be financed by indirect borrowings. It identifies the equity financing in assets. If instead historical cost was used, the full extent of a taxpayer's equity interest in his or her assets would not be taken into account. A taxpayer's equity interest in assets includes any rise or fall in the value of the assets since they were first acquired. Any increase in the value of assets should be able to be financed, just as any decrease in value should not be able to be financed. Following this reasoning, assets should be valued at market value.

6.12 The use of market value also follows from the idea that in financing assets through borrowings, a taxpayer is making a choice from the funding alternatives available. If the taxpayer did not borrow, and instead sold assets to meet an expenditure, naturally the amount the taxpayer would receive with which to meet the expenditure would be the market value of its assets. The other option open to taxpayers may be to raise equity. If a taxpayer raises equity, investors would want to see that their funds are reflected in assets that potentially could be sold at market value to return their investment.

Market value and Public Trustee

6.13 The use of market value is also consistent with the decision in *Public Trustee*. Myers CJ said at p. 452:

> ... 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.

And 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.

And at p. 455:

> [the interest] was incurred for the very purpose of maintaining the income of the estate and preventing its reduction.

6.14 The implication in these statements of Myers CJ is that income was maintained, and money left in the income earning assets, because the borrowing retained the assets from being sold. If the money had not been borrowed, the trustees would have had to have sold income producing assets to obtain the money to pay the death duties. If the assets had been sold, the amount that would have been obtained would have been the market value of the assets.

Market value — sold together or separately?

6.15 The market value of assets may depend upon whether assets are sold separately or together. Assets may be more valuable sold together than separately.

6.16 The appropriate value would seem to be the market value of assets that would be realised if a taxpayer's assets were sold together. There are two reasons for this view. One is that the indirect test recognises that a taxpayer's assets may be financed by indirect debt up to the market value of total income earning assets. Because a taxpayer has the potential to borrow to that extent, it does not seem consistent to value assets differently if a taxpayer chooses not to totally debt fund the income earning activity.

6.17 The other reason is that if assets were valued on the basis that they were sold separately, then the indirect test would involve identifying the relationship borrowings have to particular assets. Taxpayers would be encouraged to focus on which particular assets might be sold and in which combinations, because those factors would have a bearing on whether the taxpayer could borrow more than if assets were sold separately. That would seem inconsistent with the conceptual basis of the financing assets approach which does not attempt to link assets with particular assets.

Non-arm's length values

6.18 Assets should be valued at a true market value. If assets are valued above market value, the excess should not be included in calculating the allowable amount of an indirect interest deduction. The inflated extent of that value is not an amount able to be financed or able to be realised on sale. Examples are a non-arm's length profit, to the extent that it exceeds market value, and an internal revaluation of an asset to the extent that the amount of the revaluation exceeds market value.

6.19 Canada has introduced draft legislation which would allow interest deductions for money borrowed by a company or partnership to make distributions to shareholders or partners. The draft legislation specifically excludes inflated profits for non-arm's length profits, and revaluations of assets that are above market value.

Which assets are relevant?

Assets must be saleable

6.20 Consistent with the view that assets must be valued at market value is a requirement that assets must be saleable. Market value is the value that is obtained for an asset if it is sold.

6.21 A requirement that assets should be saleable is also consistent with *Public Trustee*. The Court found that the interest was deductible because the assets would otherwise have been sold.

6.22 It is acknowledged that it could be argued that assets need not be saleable. If the indirect test is confined to the type of situation considered in *Public Trustee*, where it seems the taxpayer would otherwise have sold assets, then relevant assets should be saleable assets. However, the financing approach is broader than the fact situation in that decision. It requires only that assets can be financed. The only limitation in this simple statement of the rule is that for interest to be deductible, indirect borrowings must not exceed equity. (The exception is if the borrowings are used to replace a liability, in which case equity is not affected. In that situation, the liabilities must not exceed assets after the borrowing.)

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6.23 Although there are arguments either way, we consider that the law would limit assets to saleable assets. Use of saleable assets is consistent with the requirement to value assets at market value and with *Public Trustee*. As a consequence of this position, potential disputes are avoided over certain marginal assets, and whether they are in fact assets. Examples are research and development expenditure, and deferred tax expense.

6.24 The Canadian draft legislation on interest deductions in relation to money borrowed to make distributions also limits relevant assets to assets that can be sold. The rationale (From a paper "The Draft Legislation on Interest Deductibility: A Technical and Policy Analysis" by B.J. Arnold and T. Edgar in (1992), Vol.40 No.2/no. 2 p.267.) behind the Canadian legislation is that the borrowed funds are indirectly used to earn income when a distribution is made, because the taxpayer could have sold the assets, used the proceeds of the sale to make the distribution, and then borrowed to replace the assets. The limit placed on interest deductions under the proposed legislation is, therefore, calculated on the value of assets that the taxpayer could realise to make the distribution.

Goodwill

6.25 It is considered that goodwill should be included as an asset for the purposes of the indirect test. Some attention is paid to goodwill because it was specifically mentioned by Hill J in *Roberts* and *Smith*, and because it seemed to have some qualities not shared by other assets.

6.26 Hill J's view in *Roberts* and *Smith* was that interest should only be deductible on borrowings replacing contributed capital, and not to the extent that borrowings replace goodwill. As discussed, however, the indirect test we have developed, based on *Public Trustee*, is broader than Hill J's test. We consider that the law supports a test based on the idea that indirect borrowings may finance assets. Hill J's narrower idea, that only borrowings used to replace capital contributed by partners have a connection with an income earning process, has not been adopted. Therefore, Hill J's comments on goodwill are not applicable to the indirect test.

6.27 The second aspect of goodwill is that, unlike many other assets, it is often not saleable on its own. The indirect test includes only assets that are saleable. We considered whether this should mean that goodwill should not be included in the indirect test

6.28 If a taxpayer borrows only up to a level where the indirect borrowing is able to finance a portion of assets, the borrowings will not be financing the goodwill, but will be financing other assets that are saleable on their own. If the taxpayer borrows right up to the extent of net assets, goodwill will be financed by indirect borrowings. In these circumstances, the taxpayer's alternative is to sell the whole of its income producing activity, including goodwill.

6.29 So, in theory, borrowings will not be financing goodwill when borrowings are less than the maximum amount. In practice, though, there is no need for taxpayers to identify whether goodwill is, or is not, included, because it will be included when a taxpayer borrows right up to the amount at which assets equal liabilities.

6.30 There is a contrary argument that goodwill should not be included as a relevant asset because it is not an asset that currently produces income.

6.31 In his paper "Interest Deductibility" presented to the 1996 Institute of Chartered Accountants conference, Dr Geoff Harley makes some comments about goodwill and indirect interest deductions. Dr Harley makes the point that the difference between goodwill and tangible assets in this context is that tangible assets are physically at work. Goodwill reflects the future earnings, and while it is an asset in this sense, it is not physically committed in the process. Thus Dr Harley considers that goodwill should be excluded from any indirect test. His view is only tentative, "because of the obvious imperfection in the balance sheet allocation".

6.32 Dr Harley suggests that goodwill is not actually an asset in the same way as a tangible asset. It is a calculation of future profits, but not an asset which itself directly brings in income. The authors of *Fundamentals of Accounting* (Susan Glazebrook and Jan James in *NZ Journal of Taxation* 199 p.119) say "Accounting also tends to show certain unexpired costs as assets even though in some such cases it may be difficult to be sure there is a possible future benefit, e.g. ... sums paid for goodwill on the acquisition of another business ..."

6.33 However, although goodwill may be calculated as the discounted value of future profits, that calculation is founded on the attraction an asset or business has to customers. The definition given by Lord Macnaghten in *Inland Revenue Commissioners v Muller Ltd* [1901] A.C. 217 is commonly (From *The Valuation of Company Shares and Businesses* M.S. Adamson 1986 The Law Book Company Seventh Edition, p.38 "many [writers on the subject] refer to the oft-quoted words of Lord Macnaghten ...") cited:

> Goodwill is the benefit and advantage of the good name, reputation and connection of a business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old-established business from a new business at its first start ...

Goodwill is defined in *Fundamentals of Accounting* (Harrison J, Horrocks J and others, Second NZ edition 1987) as "the probability that the old customers will revert to the old place". Goodwill can be viewed, then, an asset committed at work in the income earning process.

6.34 There are also other considerations that would support excluding goodwill from the indirect test. If goodwill is simply a premium cost of the business, and not an accurate calculation of the value of an asset which will bring in income, its connection with income is only indirect. To include it as an asset in the indirect test would be to allow interest deductions on borrowings applied indirectly to the income earning process or business to support an asset which is only indirectly connected with income.

6.35 From a policy perspective, excluding goodwill from the indirect test would make the boundaries of the indirect test clearer. Valuation disputes are likely to arrive with goodwill.

6.36 As was explained at the start of this discussion on goodwill, the view is taken that goodwill should be an asset for the purposes of the indirect test. It is a saleable asset, as required by the indirect test, and there seems to be no convincing reason to exclude it from the test. However, because there are other views, interested parties may wish to make submissions on the appropriate treatment of goodwill.

Other marginal assets (and liabilities)

6.37 Consideration has been given to whether the draft rulings or the commentary should contain a definition of "asset". On balance, it does not seem necessary. In most situations, there should be no uncertainty over whether an item is an asset.

6.38 In straightforward situations, assets are simply those items that are available to pay liabilities. In *Page v International Trust Agency & Industrial Trust Ltd* (1893) 62 LJ Ch 610 at page 613, Kekewich J said that in the liquidation context, "assets" means that which is available for payment of debts on taking proper accounts in the liquidation. In its other sense, he said:

> Even such a well established corporation as the Bank of England publishes a statement of its assets and liabilities, the assets including everything that is available to meet the liabilities.

6.39 Assets, for the purposes of the indirect test, are limited to assets that may be sold and are able to be financed. This limit means that many items which may have raised uncertainties over whether they should be included as assets in the indirect test are not included.

6.40 Case law in which marginal types of assets have been considered has commonly dealt with unsaleable assets. An example of an item which was not clearly an asset for certain purposes was considered in *Cronje & Others v Minister of Economic Affairs, Boputhatswana & another* 48 SATC 209. At page 213, the Court had to consider whether a development allowance payable in cash under income tax legislation was an asset. The Court held that the allowance was not an asset because it could not be assigned to someone else. The issue of whether an unassignable right is an asset was also considered in *O'Brien v Benson's Hosiery (Holdings) Ltd* [1979] STC 735. As an item that could not be sold would not be included under the indirect test, any possible dispute about these types of assets would not arise.

6.41 In Australia, the Income *Tax Assessment Act* 1936 defines "asset" for a number of purposes, most notably for the capital gains provisions. The definition for capital gains tax purposes is broadly framed, and would be a broader concept than the common law notion discussed in *Page*. The number of amendments to the definition of asset, and the number of rulings issued by the Australian Tax Office on the matter suggest that the Australian concept of asset raises complex issues.

6.42 To avoid adding unnecessary complexity to the indirect test, the commentary and rulings do not attempt to define the meaning of "asset". In *Page v International Trust Agency & Industrial Trust Ltd* the question of what constituted an "asset" appeared to be an easy enough concept in most cases, and there is the comfort that the requirement that assets must be able to be sold and must be able to be financed will remove many types of property or rights in respect of which it is unclear whether they are assets.

6.43 The commentary and draft rulings do not define "liabilities". It is expected that in most situations there will be little doubt over whether an item is a liability.

On-going indirect interest deductions

The indirect test must be satisfied at all times

6.44 The *Income Tax Act* requires taxpayers to calculate their income on an annual basis. The core provisions in part BC of the *Income Tax Act* 1994, particularly sections BC 5, BC 7, and BC 8 provide for the calculation of a taxpayer's income tax liability *for an income year*. It is based on the annual gross income less annual allowable deductions, to arrive at net income. Net income less available net losses leaves taxable income, to which the applicable tax rate is applied. This calculation is performed at the end of the income year.

6.45 Although a taxpayer's tax liability is calculated at balance date for the income and deductions relating to that previous year, the interest deductibility provision must be satisfied throughout the whole year. Sections DD 1(b)(i) and (ii) are satisfied if interest is payable **in deriving** the taxpayer's gross income, or **in carrying on** a business for the purpose of deriving the taxpayer's gross income [emphasis added].

6.46 In *CIR* v *Banks* (1978) 3 NZTC 61,236, the Court of Appeal commented at p. 61,241 on the general deductibility provision (then section 111 if the *Income Tax Act* 1954. The Court said that the statutory requirement that expenditure "be incurred **in gaining or producing** the assessable income" [emphasis added] meant that the concern of the section is with the relevant factual situation at the time the expenditure for which the deduction is sought is incurred. Although the words of section 111 of the 1954 Act are different to the words of the interest deductibility provision in section DD 1(b), the tense is the same. *Banks* is authority for the proposition that deductibility of an expense should be considered at time each instance of an expense is incurred, and not at the end of the year.

6.47 It should be noted that the Court in *Banks* made this point to emphasise that the relevant time was not the time when an ongoing commitment to an expenditure was first incurred (such as rates payable in respect of a house or interest on a home mortgage. Instead, the time to consider deductibility is in the year in which the particular instances of the ongoing expense are incurred. The Court was distinguishing between a taxpayer's current circumstances and the taxpayer's circumstances in previous years, and not between the end of the year and at times during the year that is the concern of the arrangements. However, the Court's point, that the relevant time to consider deductibility of an expense is the time at which the expenditure is incurred, is equally applicable to either situation.

6.48 A similar view was taken in relation to interest in *Banks* and in *CIR* v *Pacific Rendezvous Ltd* (1986) 8 NZTC 5,146. In *Banks* at p. 61,246, Richardson J said that section 112(1)(g) of the *Income Tax Act* 1954 "is concerned with how the capital was employed **during the period** in which the interest claimed was incurred ...".[emphasis added]. In *Pacific Rendezvous*, at p. 5,150 Richardson said of section 106(i(h of the *Income Tax Act* 1976, the precursor to the current interest provision, that "The paragraph speaks in the present. Its concern is with how the capital was employed during the period in which the interest in question was incurred ...".

6.49 Interest is incurred throughout the period a loan is outstanding, though interest payments may be required at certain intervals. Therefore, the statutory test for interest deductions must be met at all times throughout the periods to which interest payments relate.

Implications for the indirect test

6.50 The indirect test differs from the direct test in that the indirect test will not be satisfied on an on-going basis simply if it is met at the time of borrowing, and the income earning assets existing at that time remain in the income earning activity or business.

6.51 Under the direct test, provided that income earning assets in relation to which the direct funds were used stay in the income earning activity, it seems that there is no need to determine at the time of each interest payment whether the direct funds can still be traced into the particular income earning asset that the funds were used to acquire or improve.

6.52 In contrast, indirect borrowings are not tagged to particular assets. Interest on indirect borrowings is deductible if the borrowings are able to finance assets. As indirect borrowings are only able to finance assets, and are not actually used to acquire or improve any assets, there is only an indirect connection between the borrowings and the income earning process. As asset values change, and loan balances alter, this connection may be lost. Therefore, indirect interest will only be deductible if the indirect test must be satisfied throughout the whole period that the indirect interest is incurred.

6.53 It also follows from the "floating" nature of indirect borrowings that indirect interest may continue to be deductible if the income earning assets that exist at the time an indirect borrowing is taken out are sold or replaced. The indirect borrowing can still finance assets, but they may be different assets than existed when the borrowing was first taken out.

The amount of an indirect interest deduction may change

6.54 The practical outcome of the indirect test for on-going interest payments is that the deductible amount of indirect interest could change at the time of each interest payment with changing asset values and direct and indirect loan balances.

Example 2

As at 31/3/X1 a company has an asset worth $100,000, of which $70,000 was borrowed directly by the company when purchasing the asset.

On 31/3/X1 the company pays a dividend of $15,000 to its shareholders using borrowed money. This borrowing is indirect in nature.

As the company had net assets of $30,000 there would be sufficient net assets to claim the interest deduction.

As at 31/3/X2 the company's asset is worth $80,000.

The company still has direct borrowings of $70,000 and indirect borrowings of $15,000.

The market value of the income earning asset is $80,000. Of that amount, $70,000 is financed by direct debt. Only $10,000 of equity remains to be financed by the indirect debt. Therefore, only interest on $10,000 of the indirect borrowings is deductible.

6.55 A taxpayer would be affected in this way if the taxpayer had a high debt to equity ratio. If a taxpayer had a small amount of debt in proportion to equity, changes in asset values and loan balances would not be likely to have the effect that the value of liabilities would become greater than the value of assets. Thus a taxpayer with a small amount of debt in proportion to equity would not be faced a fluctuating amount of an indirect interest deduction.

6.56 A taxpayer with non-income earning assets would also be affected if the proportion of income earning assets to total assets changes. For example, a borrowing might finance a sole trader's house and business premises. Only a portion of the interest, based on the ratio of the value of the business premises to the value of both the premises and the house would be deductible. If, in the next year, the house declines in value and the business premises appreciate, the allowable indirect interest deduction will increase.

6.57 It must be recognised that the indirect test may involve significant compliance costs. Compliance costs of the indirect test are discussed later in this paper.

An Australian commentator's view

6.58 It is interesting to see how an Australian commentator, Professor Ross Parsons, applies an indirect test to on-going indirect interest payments.

6.59 Professor Parsons has developed a similar principle to the indirect test, based mostly on the decision in *Roberts and Smith* in an article entitled "*Roberts* and *Smith*: Principles of Interest Deductibility" (Harrison J, Horrocks J and others, Second NZ edition 1987). His view is that indirect borrowings should not be tagged to particular assets. From *Roberts* and *Smith*, he concludes that the principle is that interest is deductible if the borrowing sustains the acquisition or holding of assets. Assets are sustained when the borrowing is a replacement of capital contributed to an activity. In this respect, Professor Parsons' principle is more limited than the indirect test, because the Court in *Roberts* and *Smith* (as expressed in the leading judgment of Hill J) considered that the interest deduction extended only to borrowings used to replace contributed capital.

6.60 Professor Parsons discusses the problems in formulating how this test applies to on-going interest payments in the following extract. By way of background to this quotation, at page 270 of his article, Professor Parsons discusses how the principle might apply to sole traders. He says that interest on any borrowings taken by the owner of a business that exceeds any entitlement of the owner to a return of capital contributed by him or to profits of the business would be non-deductible.

6.61 To the extent of the excess, in Professor Parsons' words, the function of the borrowing should be seen not as a sustaining of the continued holding of assets of the business, but as providing funds to be taken by the owner for his or her private use. The denial of interest deductions may be retrospective to the time of the borrowing or, perhaps, to the time when the taking of assets for private use came to exceed the amount of the owner's entitlements and then to the extent of the excess.

6.62 Professor Parsons then goes on to discuss on-going interest payments:

> Those consequences [i.e. of a sole trader 'returning capital'] will parallel those I think should follow where an asset acquired with borrowed funds ceases to be an asset of a business. That aspect of the deductibility of interest on borrowed funds has been given little attention in the authorities, although it is generally assumed that, where a borrowing can be traced into the acquisition of an asset or other income-producing asset, interest will be deductible while the asset remains a business asset or an income-producing asset, whether or not it was such when acquired (IT 166).
>
> And I believe it is generally assumed that if a business asset or other income-producing asset acquired with borrowed funds is sold, deductibility of interest will continue or will arise anew if the proceeds of sale can be traced into the acquisition of new business assets or income-producing assets, or into assets that become business assets or income-producing assets (IT 2661, IT 166, TD92/D194). Business assets for that purpose will include cash that is working capital.
>
> The general assumption may not be as confident in the latter instances as in the former.
>
> The application of rules of that kind, which stem from the accepted principle, will pose special problems where they become relevant as rules from the new principle [i.e. his indirect test equivalent]. The problems will concern the identification of business assets sustained by the borrowing and the extent to which they are so sustained.
>
> Within the accepted principle, tracing will give a prima facie identification, but tracing is not a possible exercise where the new principle is involved.
>
> *Roberts* and *Smith* have launched a new principle, but rules guiding its operation remain to be framed, rules that cannot have the assistance of tracing.
>
> Which may explain why the Commissioner was so obviously reluctant to embrace the new principle, pronouncing in the High Court through his counsel that the new principle was 'pregnant with avoidance possibilities'.
>
> The judgment of Hill J affords the means within the principle for ensuring that those possibilities of avoidance are stillborn, but there is much yet to be done in advising the Commissioner and taxpayer of the scope of the principle.

6.63 Professor Parsons raises some difficulties in determining whether an indirect interest deduction is available on an on-going basis, but does not suggest a solution. He does, however, reject the idea that tracing indirect borrowings to particular assets is the answer. The Court in *Roberts* and *Smith* said that a strict tracing was not necessary in the circumstances of Mr Smith and Mrs Roberts.

Apportionment across all assets

6.64 Up to this point, we have been loosely referring to assets, assuming that they are income earning assets. However, a taxpayer may own non-income earning assets. Under the financing of assets approach, an indirect borrowing is not used in relation to any particular asset. Potentially, an indirect borrowing finances all a taxpayer's assets, to the extent that they are not funded by debt. These assets might be income earning, private, earning exempt income or otherwise not held as part of an income earning activity. (All of these types of assets that are not income earning are referred to collectively as non-income earning assets.)

6.65 If a taxpayer has assets that are not income earning, not all of the indirect interest should be deductible. Part BD of the Act prohibits deductions of a private nature and deductions incurred in earning exempt income. Interest on funds used in connection with private assets or assets earning exempt income is therefore not deductible. Interest connected with assets which produce no income does not satisfy the statutory test providing for interest deductions, because there is no link with income. (Interest on funds used to acquire or improve private assets would also fail for this reason.)

6.66 Therefore, an indirect interest deduction should be reduced to reflect the portion of any indirect borrowings that potentially finance non-income producing assets. These steps are set out in more detail shortly. For the moment, the principle is that the deductible amount of interest is the total amount of the interest on indirect borrowings reduced by the ratio of net income earning assets to total net assets.

How direct and indirect borrowings are treated in calculating an indirect interest deduction

Difference between direct and indirect debt

6.67 Direct debt is debt used directly to derive gross income or in a business carried on to derive gross income. Direct debt will be debt used to acquire or improve income earning assets, or debt used to meet expenditure that contributes to the derivation of gross income or to the profit-making activities of a business. An example of that sort of expenditure is salaries and wages.

6.68 Indirect debt is debt that is not directly related to profit-making.

6.69 A tax liability will be an indirect debt. It is a debt to the Commissioner. Tax is not an expense incurred in deriving gross income. It is a consequence of earning income, but is does not actually contribute to deriving that income. This view is consistent with the conclusion earlier in this paper that borrowing to pay tax is an indirect use of borrowed funds.

Direct debt

6.70 Indirect borrowings may finance income earning assets to the extent to which they are not already financed by debt. Direct debt should be subtracted from asset values to arrive at the amount able to be financed. If a taxpayer has only income producing assets, direct debt can be subtracted as a total amount from the total amount of asset values.

6.71 In comparison, if a taxpayer has non-income producing assets, to calculate the ratio of income earning assets to total assets, direct debt is subtracted from the value of each asset in which it is invested. If direct debt is not taken out of individual asset values before the ratio is determined, the ratio of income earning assets to total assets will give a false picture of which assets indirect borrowings can finance. By simply subtracting total direct debt from total assets, the result will not reflect whether there is a greater or lesser amount able to be financed in income producing assets compared with non-income earning assets. The result would instead average the amount able to be financed in income earning assets and non-income earning assets.

Previous indirect debt

6.72 Indirect debt already held by a taxpayer and the latest indirect borrowing should, in contrast, be treated as a global amount. Indirect debt is not attached to assets. Indirect debt "floats", and is available to finance each asset that is not fully debt financed. Therefore, if a taxpayer has more than one indirect debt, the indirect test calculation should total all indirect debt, before seeing whether there is any amount in income earning assets that the aggregate indirect debt can finance.

Steps involved in calculating an indirect interest deduction

6.73 This section outlines how a taxpayer should calculate an indirect interest deduction.

6.74 Taxpayers with both income producing and non-income producing assets will have to perform more calculations than other taxpayers. The steps required of taxpayers in that situation are set out after the steps required of taxpayers with only income producing assets.

(a) ***Taxpayers with only income producing assets***

No deduction for direct private or exempt use

(i) If the indirect borrowings are directly used for private use or to acquire assets producing exempt income, none of the interest is deductible. If the borrowings are not used in that way, the taxpayer should calculate the indirect interest deduction using the following steps in respect of each loan repayment.

Subtract direct debt

(ii) Subtract direct debt from the market values of saleable assets to arrive at a value for each asset. Total these values.

Can all the assets be financed by the indirect debt?

(iii) If the amount of total indirect borrowings is less than or equal to the amount calculated in step (ii), all the indirect interest is deductible.

Can some of the assets be financed by the indirect debt?

(iv) If the amount of indirect borrowing is more than the amount calculated in step (ii), there are not sufficient income earning assets to be financed by the indirect borrowings. Only a portion of the indirect borrowings can finance the income earning assets, so only the interest on that portion of the indirect interest is deductible. The portion is based on the extent to which the indirect borrowings can finance the income earning assets.

(b) ***Taxpayers with both income earning and non-income earning assets***

No deduction for direct private or exempt use

(i) If the indirect borrowings are directly used for private use or to acquire assets producing exempt income, none of the interest is deductible. If the borrowings are not used in that way, the taxpayer should calculate the indirect interest deduction using the following steps in respect of each loan repayment.

Subtract direct debt

(ii) Subtract direct debt from the market value of all saleable assets in which it is invested.

Calculate the ratio of income earning assets to total assets

(iii) Express as a ratio the amount of total income earning assets less direct debt invested in each asset, to the amount of total assets less direct debt invested in each asset.

Apportion indirect borrowings to income earning assets

(iv) Multiply the balance owing on the amount of total indirect borrowings, both the new borrowing and previous indirect debt, by the ratio calculated in step (iii) to arrive at the amount of indirect borrowings apportioned to the income earning assets.

Can all the income earning assets be financed?

(v) If the amount arrived at in step (iv) is less than or equal to the amount of income earning assets less direct debt, all the indirect interest owed on the borrowings apportioned to the income earning assets is deductible. This amount is the total interest on the indirect borrowings multiplied by the ratio calculated in step (iii).

Can some of the income earning assets be financed?

(vi) If the amount arrived at in step (iv) is greater than the amount of income earning assets less direct debt, some of the indirect interest may be deductible.
(vii) The deductible amount is the interest incurred on the portion of indirect borrowings already apportioned to income earning assets, multiplied by the ratio of income earning assets less direct debt, to the total indirect debt multiplied by the ratio of income earning assets less direct debt to total assets less direct debt.

The indirect test expressed as formulae

Step 1 — ascertain the variables

The following variables need to be ascertained in respect of each loan payment:

i the interest incurred on the loan payment; and
p the balance owing on total indirect liabilities at the time of the loan payment; and
ia the total income earning assets less liabilities of the income earning process at the time of the loan payment; and
ta total assets less total liabilities, other than indirect liabilities, at the time of the loan payment.

"Assets" include only those assets which can be sold. Assets are valued at their market values.

"Income earning assets" means assets that are held for the purposes of producing gross income or for the purposes of producing the gross income of a business. They do not include assets which are private in nature, produce exempt income, or are held otherwise than for the purpose of producing gross income.

"Liabilities of the income earning process" are liabilities that are used to acquire or improve assets or that are otherwise used to directly produce gross income. Indirect liabilities (the amount represented by the variable *p* are excluded.

"Indirect liabilities" are all liabilities of a taxpayer that are not liabilities of the income earning process. These include borrowings to repurchase shares, borrowings to pay a dividend, borrowings to pay income tax and borrowings to make a payment to share losses of another company under the provisions of section IG 2(2).

Step 2 — the extent to which the borrowed funds indirectly produce gross income

Indirect interest is deductible to the extent to which the result of the borrowing is to finance income earning assets.
i Apportion the interest

The first calculation is to apportion the interest on the new loan in accordance with the extent to which the borrowings can finance the income earning assets. This amount of interest is *dx* and is calculated as follows:

If $(ia \div ta \geq 1; dx = i \times 1$

If $(ia \div ta < 1; dx = i \times (ia \div ta$
ii) The extent to which the principal can finance the income earning assets

The next step is to calculate the extent to which the principal owing on the borrowed funds can finance the income earning assets. This amount of principal is equal to *P1* and is calculated as follows:

$P1 = p \times (ia \div ta$

iii) Ascertain the deductible amount of interest

The deductible amount of interest is:

If *P1* is less than or equal to *ia*, the allowable deduction is *dx*.

If *P1* is greater than *ia*, then in these circumstances, the indirect borrowing is greater than the value of income earning assets less direct debt. The deductible amount is calculated according to the extent to which *P1* is reflected in *ia*. The deductible amount will be *dy* which is calculated as follows:

$dy = dx \times (ia \div P1)$

Example 3

Company C takes out an indirect loan ("Loan One") of $100 in January 1997. Interest on that loan is $10. In January 1998, Company C takes out a further indirect loan ("Loan Two") of $200, with interest of $30.

Company C makes a loan repayment of $10 on Loan One in August 1998. Two dollars of the repayment is interest and $8 is principal. At that time, $30 is owing on Loan One and $150 is owing on Loan Two.

Company C's assets are as follows:

	Income earning activity	*Private activity*	**Total**
	$	$	$
Assets	100	100	200
Less Direct Liabilities	50	10	60
Equity	**50**	**90**	**140**

The interest payment is $2. The total indirect principal owing is $180.

<u>Calculations</u>

$2 × 50 ÷ 140

Apportioned interest is 71 cents.

$180 × 50 ÷ 140

$64.29 of the indirect principal is reflected in the income earning assets.

$64.29 is greater than the income earning assets of $50.

Therefore, the apportioned interest is reduced to reflect the extent to which the indirect borrowings finance the income earning assets:

$0.71 × 50 ÷ 64.29 = $0.55

Therefore, 55 cents of the $2 interest incurred is deductible.

Compliance costs

6.75 The indirect test will often involve significant time and resources in calculating a taxpayer's indirect interest deduction.

6.76 The compliance costs may be incurred in the following ways:

- Compliance costs in obtaining valuations of assets.

- Compliance costs in requiring calculations of the indirect test in respect of every payment of indirect interest.
- Disputes over what is the correct market value of assets.
- The difficulty for the Commissioner to obtain retrospective market valuations when he is not satisfied with a taxpayer's valuation.
- Identifying the on-going balance of indirect borrowings.
- Separate identification of direct and indirect borrowings.
- Private assets must be valued. They will create special valuation difficulties, because normally taxpayers will not need to value those assets and so will not have records to assist or experience in valuing those assets.

6.77 At its worst, the indirect test may entail valuations of assets and calculation of the indirect test at the time of each indirect interest payment. That exercise may be costly and time consuming.

6.78 It has been suggested that if historical cost is used as the method of valuing assets, some compliance issues would be removed. By using historical cost, the same value is attached to an asset over the years that a taxpayer owns it. The use of historical cost would remove any need to value assets at the time of an indirect borrowing and in subsequent years.

6.79 However, the use of historical cost is not consistent with the conceptual basis of the indirect test. The indirect test is based on the idea that an indirect borrowing may finance income earning assets. From this, it follows that assets should be valued at market value because the market value of assets is the amount able to be financed by debt. Market value also follows from the reasoning of the Court in *Public Trustee*. Thus, the appropriate value of assets is market value. The historical cost of assets is irrelevant, except that it could be used as a matter of convenience for taxpayers wanting to check that they were within the limits of the indirect test without obtaining market valuations.

6.80 Taxpayers could also avoid the need for asset valuations in circumstances where a taxpayer had a small amount of indirect borrowing and much more equity than debt. Such taxpayers could safely assume that they were within the limits of the indirect test without performing the calculations.

6.81 Taxpayers who do not have any private or non-income producing assets will not need to perform the apportionment calculation. If a taxpayer has no assets other than income producing assets, all indirect borrowings must be financing income producing assets, if there is a sufficient balance of income earning assets less liabilities.

6.82 As many companies do not have non-income producing assets, they will not need to apportion across assets. Many sole traders will be out of the indirect test anyway, because their indirect use of funds will be for private use. Therefore they will not be faced with the compliance issues. The only arrangement out of the six proposed rulings that will apply to them is borrowings used to pay income tax.

6.83 On the other hand, many companies will need to apportion. These will include companies holding shares in wholly owned subsidiaries paying exempt dividends, and companies that have advanced interest free loans, being non-income producing assets.

6.84 It should be stressed that a taxpayer would know about these compliance and administrative issues before entering into an indirect borrowing. Those issues could be weighed up as part of the taxpayer's decision to enter into the borrowing. They can be seen as the cost to taxpayers of having the advantage of a wider interest deductibility test.

6.85 At the same time it is acknowledged that Parliament has been trying to reduce the tax compliance burden. However, the role of the Rulings Unit is to provide the Commissioner's view of the law. Our rulings must be interpretations of the law, and compliance issues are only relevant if they are relevant to how the law is interpreted.

6.86 Other formulations of the indirect test have been considered that appeared to be legitimate interpretations of the relevant law, in part with a view to seeing whether another interpretation could reduce the compliance burden. As discussed already, these other possible approaches also have high compliance burdens. They were rejected because after examination it seemed that they cannot have been the intention of Parliament.

6.87 Nonetheless, the compliance issues are raised in the issues paper to seek the views of commentators on the practicality of the indirect test.

7 Other issues relating to the indirect test

Shares held in subsidiary companies

Double counting of assets

7.1 The proposed test in the Canadian draft legislation specifically excludes shares in companies where the taxpayer holds more than 10% of the shares. The reason for this exclusion is to prevent double counting of a single set of assets. This would happen where, for example, the shareholding company had no assets other than shares in a company with assets, and both companies borrowed to the extent of their assets. The underlying assets would be counted twice.

7.2 Under the indirect test proposed in this paper, a parent company and its subsidiary could deduct indirect interest in relation to the same set of underlying assets, provided that the subsidiary is not wholly owned. There is no mechanism within the law to prevent companies in a group deducting indirect interest on borrowings which relate to, effectively, the same set of assets.

7.3 Companies in wholly owned groups would not be able to deduct indirect interest in respect of the same set of assets. Dividends from a 100% owned company are exempt pursuant to section CB 10(2). Thus the shares held by the parent in the subsidiary would be assets producing exempt income. If the parent borrows funds and uses them indirectly, they would not be financing income earning assets, but would be financing assets producing exempt income.

7.4 If the subsidiary company were not 100% owned, the dividends received from it would not be exempt. The mischief identified in the Canadian draft legislation may occur if both the parent and the subsidiary borrow to the extent of the value of the shares in reliance on the indirect test.

7.5 It may be that in practice the situation of a holding company and subsidiary both being debt-funded and the funds being represented only by the underlying assets would not occur, because no one would be prepared to lend to that extent. If a group of companies in that situation defaulted on loan payments, and the lender required assets of the group to be realised in satisfaction of the debt, the total amount the lender could receive would be only the value of the underlying assets.

Use of a subsidiary to avoid the limits of the indirect test

7.6 A subsidiary company may be used to increase an indirect interest deduction in another way. A taxpayer who holds shares in a subsidiary will be able to use those shares as an asset in the indirect test. Like any asset, the shares will be valued at market value. The value of the shares may reflect the assets of the subsidiary. That value may include the value of assets which would not form part of the indirect test if they were owned directly by the parent.

7.7 For example, a subsidiary may spend a lot on research and development, and recognise the expenditure as an asset. The subsidiary could not use that asset in the indirect test. However, the parent might increase the value of the shares it holds in the subsidiary to take account of the promise of future earnings from the subsidiary.

7.8 A taxpayer could, intentionally or unintentionally, use a subsidiary as a way of avoiding the limits of the indirect test. In some circumstances, the use of a subsidiary in this way may constitute tax avoidance. In others, it may be simply a consequence of a corporate structure.

When a taxpayer's purpose is not to derive income

7.9 A taxpayer might borrow for a purpose unrelated to the income earning activity. Interest on those funds may be deductible under the indirect test if its requirements are satisfied, even though the direct use of the funds is not in an income earning activity, and even though the taxpayer's purpose is unrelated to an income earning activity.

7.10 A taxpayer's purpose in borrowing is not a relevant consideration under the indirect test proposed in this paper. The indirect test simply allocates indirect interest across assets, without considering the purpose of a borrowing.

7.11 It should be noted that in *Public Trustee*, it was relevant to the Court's decision that the trustee's purpose in borrowing was to retain income earning assets. However, purpose has not been included as a relevant consideration in the indirect test. As a test, or a requirement of a test, a taxpayer's purpose in borrowing gives no guidance as to when interest is deductible in the arrangements which are the subjects of the draft binding rulings.

7.12 For example, if a taxpayer borrows to return capital, when is its purpose in doing so to finance assets? The taxpayer's main purpose in borrowing will be to return capital. The decision to do so by borrowing may be influenced by a number of factors, including the need to retain assets, and the desire to make the best use of capital and debt in terms of financial returns. When borrowed funds are used indirectly, the taxpayer's purpose, or its dominant purpose, will be the use to which the funds are put. The borrowing is the vehicle to achieve that end and usually will not be a purpose in itself.

7.13 This view can also be supported by an argument based on the decision in *Pacific Rendezvous*. This argument was accepted by Barker J in *Williams v CIR*. In *Pacific Rendezvous*, the Commissioner argued that the taxpayer should be able to deduct only a portion of interest incurred, because the taxpayer's dominant purpose in using the borrowed funds was to make capital improvements to its income producing assets. The Court rejected the argument, saying that provided the funds were all used in the production of income, the existence of another purpose cannot be invoked to deny the conclusion that capital was employed to produce income.

7.14 Although the words considered by the Court in *Pacific Rendezvous* — whether capital was employed in the production of income — were different from the current statutory test, nevertheless the reasoning of the Court remains valid. The current test is satisfied if the interest has a sufficient connection with income. If a sufficient connection with income is established, concurrent purposes of achieving capital returns do not affect the connection with income. Similarly, concurrent purposes of the direct use to which borrowed funds are put, do not affect a connection with income established under the indirect test.

Capital use

7.15 It might be thought that interest could be capital in nature, and therefore not deductible. Capital expenditure is an excluded deduction under section BD 2(2)(e). However, interest will not be an excluded deduction for the reason it is a capital expense, because section BD 2(2)(e) does not apply to Part D of the Act, including the interest deductibility provision in section DD 1(b).

7.16 In other jurisdictions, interest may be non-deductible for the reason that it is a capital expense; see, for example, *Wharf Properties v Commissioner of Inland Revenue* [1997] STC 351 (Privy Council).

Tax avoidance

7.17 The draft rulings exclude tax avoidance arrangements subject to Subpart BG of the Act and arrangements where part or all of the arrangement or the use of the borrowed funds is a sham.

7.18 The draft rulings and the commentary to them do not consider or analyse all or even many situations where either of these two exclusions will apply. A general statement is made, rather than an attempt to identify every instance where the rulings could be relied upon to avoid tax.

7.19 The commentary may refer to specific instances where the indirect test might be used to avoid tax. An example is where assets are over-valued.

7.20 Another is where a use of borrowed funds is manipulated to make the use appear to be a direct use when the actual use is indirect. The limits to deductibility applying to the indirect test do not apply to the direct use test, and taxpayers might prefer to structure borrowings so that funds are directly used, or appear to be directly used, in an income earning activity or in a business.

7.21 These examples have been discussed because they have been raised as potential issues. There may be many other ways the indirect test could be used to avoid tax. The intention is that a general statement in the rulings will cover all tax avoidance, and the application of that general statement is not limited by the examples that are discussed in the commentary.

7.22 The rulings are also drafted to exclude arrangements subject to the thin capitalisation rules contained in Part FG of the Act. Those rules are designed to ensure, in the case of a New Zealand taxpayer controlled by a single non-resident, and which has a disproportionately high level of New Zealand group debt funding, an appropriate apportionment to the New Zealand taxpayer of the worldwide interest expense of the group. As there is specific statutory provision for that situation, the indirect test cannot override the situations covered by Part FG.

8 Does the indirect test apply similarly to all types of taxpayers?

8.1 In this section, the discussion examines how the indirect test applies to different types of taxpayers.

8.2 Particular attention is paid to partners, because there is an argument that would limit the use of the indirect test by partners. The argument is that when the borrowed funds are used indirectly in the partnership, but directly for private purposes of the partners, interest on the borrowed funds should not be deductible. If this argument was accepted, partnerships would be disadvantaged over other types of entities, in that indirect interest deductions relating to the partnership activity would be limited.

Companies and trusts

8.3 Companies and trusts may apply the indirect test, with the usual limits which apply to all taxpayers. The special feature of these taxpayers is that an interest deduction will usually not be denied for the reason that it is private in nature.

No private use

8.4 Companies and trusts arguably do not have a private or domestic dimension.

8.5 The Court of Appeal considered the concept of private and domestic expenditure in *C of IR* v *Haenga* (1985) 7 NZTC 5,198. Richardson J said at page 5,207 that:

> ... an outgoing is of a private nature if it is exclusively referable to living as an individual member of society and domestic expenses are those relating to the household or family unit.

8.6 The concept of an "individual member of society" means natural person individuals, and does not include companies and trusts. It cannot be sensibly said that a company or trust would have a household or family unit. Companies are separate taxpayers from their individual shareholders. Where a trustee is an individual, the law treats him or her as acting in a capacity different to that as a private person. A company or trust will not, therefore, have domestic expenses.

8.7 A similar view of the concept of private and domestic expenditure was reached in the Australian Board of Review case, *Case 50* (1955) 5 CTBR(NS):

> Without attempting an exhaustive definition of either variety of expenditure, losses or outgoings of a private nature **we** take to mean here losses or outgoings relating solely to the person incurring them as an individual member of society where that society is the society of human beings, e.g., travelling expenses incurred by a person to and from his place of employment: see particularly 12 CTBR *Case 34*. Losses or outgoings of a domestic nature **we** take to mean here losses or outgoings which relate solely to the house, home, or family organisation, of the person incurring them ...

8.8 If an asset funded by a company is used for the private purposes of a director, shareholder, or employee of a company, it would arguably still be contributing to the income earning activity of the company. Its contribution would be for reward for services, or in the case of a shareholder, to encourage continued investment. The benefits are taxed as dividends or fringe benefits.

8.9 The scheme of the Act might support this view that expenditure by a company on its shareholders and employees is for the purposes of the company's business. The ability of a company to attach imputation credits and the deductibility of the value of fringe benefits and fringe benefit tax perhaps suggests that it is generally recognised in the *Income Tax Act* that such expenditure is an appropriate act of a company's income earning activity.

8.10 If a company or trust can in some unusual situations be said to have incurred interest expense that is private in nature, then in those situations the interest will not be deductible.

Companies and trusts that are partners

8.11 The indirect test applies without any special qualifications to companies and trusts who are partners in a partnership. An interest in a partnership is simply another income earning asset of the company or trust. As we will discuss, an issue arises with individuals who are partners, because they may use funds borrowed by the partnership for their private use. This issue is discussed below. As companies and trusts cannot use borrowed funds for their own private use (except perhaps in some exceptional circumstances, an interest deduction will not usually be denied to a company or trust that is a partner, on the grounds that the interest is private.

Individuals — including individuals in partnership

8.12 The other type of taxpayer seeking to deduct interest is the individual natural person taxpayer. Individuals carrying on an income earning activity or business can apply the indirect test. The indirect test applies in the same way to individuals as it does to companies and trusts, except that often an individual will use the funds directly for private use and so section BD 2(2)(a) will deny the interest deduction.

8.13 A practical consideration is that individuals seeking to apply the indirect test will usually have private assets, so will have the difficulty of valuing these at market value.

Comparison with Professor Parsons' test

8.14 Professor Parsons has suggested (*Roberts* and *Smith: Principles of Interest Deductibility* by Professor Parsons. Taxation in Australia Red Edition. Vol.1 No.5 June 1993 p.261 at p.267. that a similar test for interest may exist in Australian law, following the decision in *Roberts* and *Smith*. The principle that Professor Parsons draws from *Roberts* and *Smith* is more limited than the proposed indirect test, because the scope of that decision is narrower than the decision in *Public Trustee*. The decision in *Roberts* and *Smith* was that an interest deduction may be taken in relation to a return of capital or profits, and accordingly, Professor Parsons limits the application of his test to those situations.

8.15 Under Professor Parsons' test, there may be few circumstances when an individual who is not a partner can apply the test. The concepts of a return of capital or profits from the income earning activity or business of a sole trader would not seem to apply. An individual is a single entity, so cannot make a return of capital or profits to himself or herself because he or she already has those amounts.

8.16 The indirect test will have much wider application for individuals than Professor Parsons' test. The test is not limited to returns of capital or profits.

Tax on employment income

8.17 The only draft ruling of the proposed six rulings that will apply to individuals is that concerning interest on borrowings to pay tax.

8.18 If indirect test is met, individuals will be able to deduct interest incurred on funds borrowed to pay tax on employment income. The prohibition for deductions relating to employment in section BD 2(2)(c) excludes expenditure "incurred in deriving income from employment". Tax is not incurred in deriving the income. The discussion above analysing the arrangement involving borrowing to pay tax concluded that tax is a cost only indirectly related to earning income.

Individuals in partnership

8.19 To explain how the indirect test applies to individuals with interests in partnerships, it is helpful to break the discussion down into two categories: individuals seeking interest deductions related to a partnership where the individual has the liability for the borrowing, and individuals seeking interest deductions related to a partnership where the partnership has the liability for the borrowing. These categories are discussed in turn.

Borrowing is made by the individual

8.20 In these circumstances, the same principles apply as those that apply to an individual who is not a partner. The only difference is that an individual who is a partner has an interest in a further income earning activity.

8.21 The value of the partnership interest is the amount of cash the individual could realise if he or she retired from the partnership. In some cases, the amount may be nominal.

Borrowing is made by the partnership

The problem

8.22 The particular difficulty relating to partnership borrowings is that it is the partners who deduct the interest and not the partnership. If the partners use the borrowed funds for private use, then arguably the interest is not deductible, despite the fact that the borrowing relates to the partnership which may consist only of income earning assets.

8.23 A partnership is not a taxpayer. Each partner claims any expenses related to the partnership. Section 42(1)(b)(ii) of the *Tax Administration Act* 1994 provides that:

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

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

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

8.25 Therefore, interest deductibility is considered in relation to each partner. Private use of the borrowed funds by the partners arguably may disqualify the interest from the indirect test. Further, even if partners do not use indirect funds for private use, the indirect interest deduction may still be more limited in comparison with a comparable borrowing by a company. This is because if the interest deduction is considered in relation to each partner, and not the partnership, the interest deduction will have to be apportioned across each partner's non-income earning assets.

8.26 Despite the fact that interest expenses are claimed by partners and not partnerships, it is possible to mount a reasonable argument that if a borrowing is made by a partnership, it does not relate to any of the partners' other assets. If that argument is accepted, the interest deduction claimed by each partner would not be denied because of any private use of the funds by partners, and the deduction would not need to apportioned across partners' other assets. (The deduction may need to be apportioned across the assets of the partnership if the partnership has assets producing either exempt income or no income.

The argument

8.27 The argument needs to establish that funds borrowed by a partnership are not related to partners of the partnership. In essence, the argument is that the partnership is not the same thing as any one of the partners.

8.28 It seems that an expense of a partnership is an expense of the firm, and not of any particular partner. The *Partnership Act* 1908 is declaratory of various matters relating to partnerships. That Act defines "partnership" in section 4(1) as follows:

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

8.29 Thus, partners receive partnership income jointly, and have joint liability for partnership expenses.

8.30 In *Crowe v Commissioner of Taxation* (1958) 100 CLR 532, a partnership took out life insurance on the life of each partner. The firm paid the premiums, and each premium was debited to the partner to whose life it related. The Court found that the premiums were expenses of the firm, and not expenses of each member.

Fullagar J held that the firm paid the premiums in respect of each partner for itself, and not on behalf of each member. The premiums were paid jointly, and not by any one of them only. His Honour said at p. 535:

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

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

8.32 So if a partnership borrows to return capital or profits to partners, it seems that the partners do not receive borrowed funds for private use. They receive capital or profits. The nature of the amount they receive will be reflected in the partnership accounts. From this, as the partners do not receive the borrowed funds, the funds are not directly used for private use, and the indirect test may apply.

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

8.34 This argument is supported by the decision in *Roberts* and *Smith*. Hill J considered that funds borrowed and used to return capital to partners were not used for private use: they were used to return capital, and so were employed in the partnership business because they replaced the funds withdrawn.

Weakness of the partnership argument

8.35 However, this argument is not completely robust. A partnership is viewed as a collection of individuals in determining the deductibility of interest. The individual partners, and not the partnership, claim any interest deductions. For these reasons, it could be argued that the borrowed funds are linked with the partners, and not the partnership.

8.36 Also, it seems difficult to ignore the fact that in a return of capital or distribution of profits, the direct use of the borrowed funds is for private use. The response would be that the partners do not directly receive the borrowed funds, instead they receive capital or profits.

Conclusion

8.37 Despite these problems, the argument to support the proposition that partners can apply the indirect test in relation to partnership assets only, and not with reference to each partner's assets, has a reasonable basis and seems appropriate to adopt in the context of interest deductibility.

Partners — comparison with Australian legislation

8.38 It is interesting to compare the New Zealand situation with that in Australia. Under Australian law, unlike New Zealand tax law, income and expenditure relating to a partnership are calculated as if the partnership is a taxpayer. "Net income" is defined in section 90 of the *Tax Assessment Act* 1936 as follows:

> 'net income' in relation to a partnership, means the assessable income of the partnership, calculated as if the partnership were a taxpayer who was a resident, less all allowable deductions ...

8.39 In comparison, in New Zealand deductions relating to the partnership are determined in relation to each partner. Section 42(1)(b)(ii) of the *Tax Administration Act* 1994 states:

> In the case of partners ... There shall be no joint assessment, but each partner shall make a separate return of income, taking into account the share of the gross income derived from the firm by that

partner and the allowable deductions **of that partner** in respect of that gross income, and shall be separately assessed accordingly. [Emphasis added]

8.40 Like the situation in New Zealand, in Australia a partnership is not liable to pay tax relating to partnership income. However, the fact that the partnership income or loss is calculated as if the partnership is a taxpayer is a significant difference from the New Zealand situation where the deductions relate to the individual partners. In New Zealand, expenses relate to the individual partners, and potentially the private exclusion in section BD 2(2)(a) of the *Income Tax Act* may apply. In Australia, it is less arguable that the private exclusion applies, because, for the purposes of calculating net income of a partnership, the partnership is ring-fenced.

Qualifying companies and partnerships in loss

8.41 An issue has been raised regarding the application of the indirect test to "qualifying companies".

Loss attributing qualifying companies in loss

8.42 If a loss attributing qualifying company is in loss, and deducting "indirect interest", it may pass that loss to shareholders. A portion of the company's loss would be deemed to be an allowable deduction of each shareholder, under sections HG 16 and BD 2. That deduction could be claimed against other income of the shareholder, or carried forward as a loss to following years. The direct use of the borrowed funds may be for the private use of the shareholders. An example would be where the borrowed funds were used by a LAQC in loss to return share capital or pay a dividend. In that situation, the shareholders will be allowed a deduction which amount would correspond to the amount of interest deducted by the company and the funds could be viewed as being directly used for private use. In short, they would effectively be deducting interest on funds used for private use.

Partnerships in loss

8.43 The same issue also arises with partners. If a partnership makes the borrowing, it has been concluded above that even though the direct use of those funds might on one view of the matter be for the private use of the partners, the interest deduction is not disqualified for the reason that the funds are used for private use. Thus the partners may be able to deduct interest on funds borrowed in the partnership name. If the partnership is in loss for the year, the partners will be able to deduct the loss from other income.

8.44 In fact, even if the partnership is not in loss, the partners can be seen as deducting interest on funds directly used for private use. This is the same issue just discussed in the immediately preceding section on partnerships. The issue extends to partnerships in profit, because the partners and not the partnership claim all partnership expenses. The partnership may be in profit, and the partners may deduct interest on funds used directly for their private use. In comparison, deductions relating to the business of a qualifying company are claimed by the company, and only effectively passed to shareholders when there is a net loss in the company.

Is this issue a problem?

8.45 A view could be taken that this issue does not raise any concerns. A LAQC or partnership should in theory be able to fully debt-fund its business. That this may create a loss, which can be passed on for use by the economic owner of the business, might be seen as fair.

Why the interest is not private

8.46 Even if the scenario is seen as one which is not consistent with broad tax policy ideals, it is arguable that the law cannot be interpreted in a way to disallow the interest deduction.

8.47 Returning to the qualifying company, it is difficult to label as "private" a loss passed to shareholders, which includes an amount attributable to an "indirect" interest deduction claimed by the company. The conclusion reached above under the "Companies and Trusts" subheading was that a company cannot in most, if not all, situations incur expenditure that is private.

8.48 Even if a company could incur private expenditure, the amount of loss attributable to shareholders pursuant to section HG 16 does not retain the character of each of the components that make up that loss, and so the loss could not be viewed as a private loss.

8.49 Under section HG 16, a shareholder having an effective interest in a loss attributing qualifying company is deemed to incur an amount of loss equal to the net loss of the company multiplied by the shareholder's effective interest in the company. A "net loss" is defined under section OB 1 to be a net loss determined under section BC 6. Section BC 6(3) states:

> If for an income year a taxpayer's annual allowable deductions are more than the taxpayer's annual gross income, the difference is the taxpayer's net loss for the year, and the taxpayer is deemed to have net income for that year of zero.

8.50 The amount of loss a shareholder of a LAQC can deduct is not in part the interest incurred by the company. The amount of the deduction is two stages removed from the components of the net loss deducted by the company. First, a shareholder's portion of the loss is a portion of a net figure. It is not a portion of interest and other expenses incurred by the company. Second, the shareholder is deemed under section HG 16 to incur an amount of loss. The shareholder does not actually claim a portion of the loss experienced by the company. Instead, the shareholder is attributed an amount deemed to be a loss, the calculation of which is based on the net loss experienced by the company.

8.51 As the amount received by a shareholder is not an interest deduction, but a deemed loss, it is hard to see how the deemed loss can be seen as interest which is private. To be private, it would need to be traced back to the use of the borrowed funds by the company, and even then, it is doubtful whether use of the funds by the company could be "private".

8.52 Another reason why the loss passed through to shareholders is not private in nature, is because arguably the direct use of the borrowed funds is the use they are put to by the company, and not the use to which they are put to by the shareholders. For example, if the borrowed funds are used to return capital or pay a dividend, the direct use of the borrowed funds is to return capital or to pay a dividend. From the shareholder's perspective, each receives a dividend or share capital. A shareholder may directly use the amount received by way of dividend or share capital for private use. Shareholders do not receive the use of the borrowed funds. Only the company receives the right to use the borrowed funds. Therefore, there is no direct private use of the borrowed funds. This view is consistent with that taken by Hill J in *Roberts* and *Smith*. His Honour considered that funds borrowed and used to return capital to partners were not used for private use: they were used to return capital, and so were employed in the partnership business because they replaced the funds withdrawn.

Possible argument

8.53 A possible argument that might counter this issue of a qualifying company or partnership in loss passing the loss to shareholders or partners, is to argue from the opening words of the interest deductibility provision that the Commissioner takes the view that the interest incurred by the company does not satisfy the test. Section DD 1(b) provides that interest is not deductible *except so far as the Commissioner is satisfied* that:

- It is payable in deriving the taxpayer's gross income; or
- It is necessarily payable in carrying on a business for the purpose of deriving the taxpayer's gross income; or ...

8.54 There does not seem to be any judicial consideration of the italicised words. Analysing the words as a matter of statutory interpretation, the argument is probably not sustainable. The Commissioner must be satisfied only that the interest is payable in deriving gross income or in carrying on a business. The Commissioner's satisfaction is not required that the interest is not a prohibited deduction of a private nature under a different section, section BD 2(2)(a). The Commissioner could only potentially rely on the words to disallow a deduction if it were considered that there were not a sufficient connection between the interest and the derivation of income or a business. The Commissioner could not argue that there is not a sufficient connection when a LAQC whose assets exceed liabilities borrows to pay the funds directly to shareholders. For every other taxpayer, the conclusion is there is a sufficient connection with income in those circumstances and the interest is deductible.

Excessive salary

8.55 There is a twist on this issue when a LAQC pays an excessive salary to a shareholder, director, or a relative of a shareholder or director. Under section GD 5, the Commissioner may take the view that a portion of a salary paid to a shareholder or director (or relative of a close company is excessive. A close company is defined, broadly speaking, to be a company with five or fewer natural person shareholders holding 50% or more of the shares. If the Commissioner takes that view, the excessive amount is a non-deductible dividend. Although the dividend is not assessable to the shareholder, as a dividend, it is not an allowable deduction to the company. As it is not an allowable deduction, it cannot contribute to a loss that could be attributed to shareholders by a LAQC.

8.56 However, section GD 5 does nothing to stop the company borrowing to pay the excessive salary. Although section GD 5 may deem an amount to be a dividend, the indirect interest on money borrowed to pay both the dividend and the salary can contribute to a loss able to be attributed to the shareholder.

Non-cash dividends

8.57 The Act does limit interest deductions relating to a qualifying company in one way. Under section HG 9(3), an interest deduction on money borrowed to buy shares in a qualifying company is limited to the extent that the shareholder receives non-cash dividends. The purpose of this restriction is to prevent a shareholder receiving an exempt non-cash dividend (for example, a company car) and also obtaining a deduction for interest (Taxation Education Office Newsletter 58, 16 July 1992, p.11).

8.58 This provision recognises, as does the indirect test, that interest deductions should not be available where the funds are used for private use. Note that exempt fully imputed cash dividends of a shareholder in a qualifying company could be used for private use.

Conclusion on qualifying companies

8.59 Passing a loss to shareholders (or partners contributed to by an interest deduction for funds used to fund private expenditure may be seen as creating tax leakage. On the other hand, it could be seen as acceptable that a company (or partnership may choose to debt-fund its assets, and for the consequent loss to be used by the economic owners of the business.

8.60 Even if this situation is viewed as creating tax leakage, the interest deduction cannot be denied on the grounds that it is private is nature. There would need to be specific legislation to limit the interest deduction or the loss attributed to shareholders or claimed by partners.

9 Preliminary conclusions

9.1 The following conclusions have been raised on a preliminary basis and the following matters are for discussion.

How to analyse the six arrangements in order to determine if interest is deductible

9.2 The six arrangements are the borrowing of money and its use to return capital by a company, pay dividends, return capital to partners, pay profits to partners, pay tax or use of money interest, and make a payment to share in the losses of another group company pursuant to the provisions of section IG 2(2) of the *Income Tax Act*.

Should other arrangements be the subject of public binding rulings?

9.3 None of these uses of borrowed funds directly produces income. They either replace equity or profit funding, or are payments made after the derivation of profits.

9.4 There may be many other situations where borrowed funds are not used directly in deriving income. For example, replacement debt appears to be an indirect use of borrowed funds.

9.5 Draft rulings on other arrangements have not been included at this stage, but submissions are welcomed on whether rulings on other arrangements should be issued in the future.

Legal basis for the indirect test

9.6 The statutory test for interest deductions requires a sufficient connection between interest sought to be deducted, and the derivation of income. A sufficient connection was found to exist in *Public Trustee*.

9.7 From the *Public Trustee* case, it can be seen that interest on any borrowing that is not directly used in an income earning activity or business may be deductible if the result of the borrowing is to leave the borrowings or their equivalent in the taxpayer's assets. Expressed a slightly different way, the indirect test is that interest will be deductible if the borrowed funds finance income earning assets.

9.8 Other possible bases for an indirect test were examined and rejected. An approach arguing that an indirect borrowing may retain all of a taxpayer's assets (the "broad retaining of assets" approach was rejected because it seems to be a test about what taxpayers achieve in substance rather than what they achieve by the transactions entered into. It was also rejected because it could be used to support unlimited interest deductions. That result cannot have been the intention of Parliament.

9.9 An approach arguing that an indirect borrowing may retain the particular assets that exist at the time of an indirect borrowing (the "tagged assets" approach was rejected because the compliance required would be so extensive that the approach also could not have been the intention of Parliament. An approach based on the idea that but for the borrowing, a taxpayer would otherwise have sold assets, was rejected for the same reason. These approaches also seem to rely upon what taxpayers notionally do, rather than the transactions taxpayers enter into.

9.10 Also rejected was an approach that would recognise that the substance of an indirect borrowing may equate to direct use of borrowed funds in the taxpayer's income earning activity, because it was considered unlikely to be supported by the courts.

9.11 Consideration has been given to whether any principle to come from *Public Trustee* should be limited to trusts, or to involuntary expenditure, but it was concluded that neither fact formed part of the essential reasoning of the Court.

Indirect use — the test

9.12 Interest will be deductible under the indirect test if the amount borrowed finances income earning assets. Indirect borrowings may finance assets if the following elements are met.

<u>Private or exempt use</u>

9.13 Interest cannot be deducted in reliance on the indirect test if the direct use of the borrowed funds is for private use or to acquire assets that produce exempt income. Under section BD 2(2)(a), expenditure that is of a private nature cannot be deducted. Under section BD 2(2)(b), expenditure that is incurred in deriving exempt income is not an allowable deduction. These specific statutory prohibitions will override the application of the indirect test.

<u>How much indirect interest can be deducted?</u>

9.14 Interest on any indirect borrowing will be deductible to the extent that the amount borrowed, totalled with other indirect borrowings, does not exceed the value of income earning assets less direct debt invested in those assets.

<u>How are assets valued?</u>

9.15 Assets are to be valued at market value. Market value gives the value of assets that are able to be financed. Use of market value is also consistent with *Public Trustee*.

<u>Which assets are relevant?</u>

9.16 Assets taken into account must be saleable. This requirement follows from the requirement to use market value, and from *Public Trustee*.

9.17 Goodwill is included in the test because it is a saleable asset. There are some arguments that would exclude it.

9.18 The terms "assets" and "liabilities", have not been further defined because it seems that there should not be much debate over whether assets and liabilities are included in the test, particularly if only saleable assets are included.

<u>On-going interest deductions</u>

9.19 Interest will be deductible to the extent that the indirect test is satisfied throughout the whole period that indirect interest is incurred.

9.20 The deductible amount of indirect interest may change throughout the period the loan balance is outstanding as the market value of assets, and loan balances, change.

Apportionment

9.21 Indirect borrowings will finance all of a taxpayer's assets. If a taxpayer has non-income producing assets, not all of any indirect interest incurred by the taxpayer will be deductible.

9.22 The deductible portion is based on the ratio of income earning assets less direct debt to total assets less direct debt.

How direct debt and previous indirect debt are treated in calculating an indirect interest deduction

9.23 Direct debt is subtracted from the value of assets in which it is invested.

9.24 Indirect debt is not attached to assets. To determine whether indirect interest is deductible, all indirect debt is added together. The interest is deductible to the extent that the total indirect debt does not exceed the amount of assets less direct debt.

Compliance costs

9.25 Compliance costs may be high for some taxpayers. These costs might be seen as the cost of a wider interest deductibility test.

Shares held in subsidiary companies

9.26 Shares held in subsidiary companies may create a tax advantage for a group of companies applying the indirect test.

When a taxpayer's purpose is not to derive income

9.27 A taxpayer's purpose in taking out an indirect borrowing is not relevant to the indirect test. This position is consistent with *Pacific Rendezvous*.

Capital use

9.28 Interest will not be an excluded deduction for the reason it is a capital expense, because section BD 2(2)(e) does not apply to Part D of the Act, including the interest deductibility provision in section DD 1(b).

Tax avoidance

9.29 The arrangements described in the draft rulings exclude arrangements entered into to avoid tax, and sham transactions.

Does the indirect test apply similarly to all types of taxpayers?

9.30 The principle does apply in the same way to all taxpayers. Often individuals will not be able to apply the test because the direct use of the borrowed funds will be for private use. Companies and trusts will not usually incur interest that is private.

9.31 If a taxpayer is an individual in a partnership, and funds are borrowed by the partnership and passed on to partners as a return of capital or profits for the partners' private use, the position taken in this paper and in the draft rulings and commentary is that the interest deduction will not be denied for the reason that the interest is private. The reason is that a borrowing made by a partnership relates only to partnership assets, and the interest is incurred jointly by the partners and not by any one partner.

Qualifying companies

9.32 A loss attributing qualifying company may apply the indirect test when it is in loss. If the borrowed funds are used to make a return of capital or pay a dividend, and the loss attributed to the shareholders, the shareholders might be seen as effectively taking a deduction for private expenditure. The same view might be taken of a partnership in loss and distributing borrowed amounts to partners.

9.33 There is no legal basis for denying an interest deduction to a qualifying company in this situation. On one view, it may be acceptable that an activity can debt-fund its assets, and that its economic owner participate in the loss.

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