INTEREST DEDUCTIBILITY—*ROBERTS AND SMITH*—BORROWING TO REPLACE AND REPAY AMOUNTS INVESTED IN AN INCOME EARNING ACTIVITY OR BUSINESS

Note (not part of the Rulings): Rulings BR Pub 10/14 – 10/19 ("the Rulings") are a reissue of public rulings BR Pub 07/04 – BR Pub 07/09. BR Pub 07/04 – BR Pub 07/09 were published in *Tax Information Bulletin* Vol 19, No 6 (July 2007), and applied for the period beginning on 22 May 2007 and ending on 22 May 2010.

The Rulings, and accompanying commentary, are essentially the same as BR Pub 07/04 – BR Pub 07/09 and commentary. However, BR Pub 07/04 – BR Pub 07/09 were issued when the Income Tax Act 2004 was in force. The Rulings and commentary have been updated to reflect the repeal of the Income Tax Act 2004 and the enactment of the Income Tax Act 2007. In addition:

- the commentary has been updated to reflect subsequent case law; and
- minor changes have been made to the Rulings and commentary to improve their precision and to assist readers' understanding.

These changes do not result in the Rulings differing to BR Pub 07/04 – BR Pub 07/09 as to the scope of the Arrangements to which they apply, or in their conclusions on the application of the taxation laws to those Arrangements.

INTEREST DEDUCTIBILITY—FUNDS BORROWED BY A PARTNERSHIP TO RETURN CAPITAL CONTRIBUTIONS

PUBLIC RULING – BR Pub 10/14

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

Taxation Law

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

This Ruling applies in respect of section DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a partnership to return capital to partners who previously invested that capital.

The Arrangement includes only:

- a partnership carrying on a business for the purpose of deriving assessable and excluded income both at the time the partnership borrows the funds and at the time the interest on those funds is payable; and
- arrangements where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include arrangements where interest is deductible under section DB 7 (section DB 7 applies to companies).

For the avoidance of doubt, the Arrangement also does not include arrangements where subpart BG of the Act applies to void the arrangement (subpart BG relates to tax avoidance arrangements).

This Ruling is subject to Part FE of the Act. (The purpose of Part FE is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer. The rules in Part FE are commonly referred to as the “thin capitalisation rules”.)

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Any partner’s share of the interest will be deductible by that partner to the extent that the partner’s capital contribution was used directly in the partnership’s business, or used to repay borrowed funds on which the interest was deductible.

- Any partner’s share of the interest will not be deductible by that partner under the *Roberts and Smith* replacement and repayment principle to the extent that the borrowed funds are used by the partnership to pay current year income to the partner, or are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 23 May 2010 and ending on 23 May 2015.

This Ruling is signed by me on the 27th day of October 2010.

Susan Price
Director, Public Rulings

INTEREST DEDUCTIBILITY—FUNDS BORROWED BY A PARTNERSHIP TO RETURN PROFITS

PUBLIC RULING – BR Pub 10/15

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

Taxation Law

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

This Ruling applies in respect of section DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a partnership to pay profits to partners.

The Arrangement includes only:

- a partnership carrying on a business for the purpose of deriving assessable or excluded income both at the time the partnership borrows the funds and at the time the interest on those funds is payable; and

- arrangements where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include arrangements where the interest is deductible under section DB 7 (section DB 7 applies to companies).

For the avoidance of doubt, the Arrangement also does not include Arrangements where subpart BG of the Act applies to void the arrangement (subpart BG relates to tax avoidance arrangements).

This Ruling is subject to Part FE of the Act. (The purpose of Part FE is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer. The rules in Part FE are commonly referred to as the "thin capitalisation rules".)

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Any partner's share of the interest will be deductible by that partner to the extent that the profits are past years' profits that were used directly in the partnership's business or used to repay borrowed funds on which the interest was deductible.

- Any partner's share of the interest will not be deductible by that partner under the *Roberts and Smith* replacement and repayment principle to the extent that the borrowed funds are used by the partnership to pay current year income to the partner, or are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 23 May 2010 and ending on 23 May 2015.

This Ruling is signed by me on the 27th day of October 2010.

Susan Price
Director, Public Rulings

INTEREST DEDUCTIBILITY—FUNDS BORROWED BY A COMPANY TO REPURCHASE SHARES

PUBLIC RULING – BR Pub 10/16

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

Taxation Law

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

This Ruling applies in respect of section DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a company to repurchase shares from its shareholders as authorised by the Companies Act 1993.

The Arrangement includes only:

- a company carrying on an assessable or excluded income earning activity or a business for the purpose of deriving assessable or excluded income both at the time the company borrows the funds and at the time the interest on those funds is payable; and

- arrangements where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include arrangements where the interest is deductible under section DB 7 (section DB 7 applies to companies).

For the avoidance of doubt, the Arrangement also does not include Arrangements where subpart BG of the Act applies to void the arrangement (subpart BG relates to tax avoidance arrangements).

This Ruling is subject to Part FE of the Act. (The purpose of Part FE is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer. The rules in Part FE are commonly referred to as the "thin capitalisation rules".)

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows.

- Interest will be deductible in the circumstances described in the Arrangement to the extent that the borrowed funds are used to repurchase shares funded by capital contributed by the shareholders or past years' profits. The contributed capital or past years' profits must have been used directly in the company's assessable or excluded income earning activity or business, or used to repay borrowed funds on which the interest was deductible.

- Interest will not be deductible to the extent that the borrowed funds are used by the company to pay current year income to a shareholder, or are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 23 May 2010 and ending on 23 May 2015.

This Ruling is signed by me on the 27th day of October 2010.

Susan Price
Director, Public Rulings

INTEREST DEDUCTIBILITY—FUNDS BORROWED BY A COMPANY TO PAY DIVIDENDS

PUBLIC RULING – BR Pub 10/17

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

Taxation Law

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

This Ruling applies in respect of section DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a company to pay dividends to its shareholders.

The Arrangement includes only:

- a company carrying on an assessable or excluded income earning activity or a business for the purpose of deriving assessable or excluded income both at the time the company borrows the funds and at the time the interest on those funds is payable; and

- arrangements where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include arrangements where the interest is deductible under section DB 7 (section DB 7 applies to companies).

For the avoidance of doubt, the Arrangement also does not include Arrangements where subpart BG of the Act applies to void the arrangement (subpart BG relates to tax avoidance arrangements).

This Ruling is subject to Part FE of the Act. (The purpose of Part FE is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer. The rules in Part FE are commonly referred to as the "thin capitalisation rules".)

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows.

- Interest will be deductible to the extent that the dividends are funded by past years' profits or contributed capital that was used directly in the company's assessable or excluded income earning activity or business, or used to repay borrowed funds on which the interest was deductible.

- Interest will not be deductible to the extent that the borrowed funds are used by the company to pay current year income to a shareholder, or are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 23 May 2010 and ending on 23 May 2015.

This Ruling is signed by me on the 27th day of October 2010.

Susan Price
Director, Public Rulings

INTEREST DEDUCTIBILITY—FUNDS BORROWED TO REPAY DEBT

PUBLIC RULING – BR Pub 10/18

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

Taxation Law

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

This Ruling applies in respect of section DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a taxpayer or a partnership to repay borrowed funds to the person who invested those funds in the taxpayer or partnership.

The Arrangement includes only:

- a taxpayer or a partnership carrying on an assessable or excluded income earning activity or a business for the purpose of deriving assessable or excluded income both at the time the taxpayer or partnership borrows the funds and at the time the interest on those funds is payable; and

- arrangements where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include arrangements where the interest is deductible under section DB 7 (section DB 7 applies to companies).

For the avoidance of doubt, the Arrangement also does not include Arrangements where subpart BG of the Act applies to void the arrangement (subpart BG relates to tax avoidance arrangements).

This Ruling is subject to Part FE of the Act. (The purpose of Part FE is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer. The rules in Part FE are commonly referred to as the "thin capitalisation rules".)

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Interest will be deductible in the circumstances described in the Arrangement to the extent that the funds that are repaid:

    - were used directly in the taxpayer's or partnership's assessable or excluded income earning activity or business; or

    - were used by a company and the interest was deductible under section DB 7; or

    - were used by a company to purchase shares and the interest was deductible under section DB 8; or

- were used for one of the Arrangements in Public Rulings BR Pub 10/14 – BR Pub 10/17, and met the requirements for interest deductibility in those Rulings; or

- were used to retain income earning assets from sale and satisfied the elements of the *Public Trustee* case (*Public Trustee v CIR* [1938] NZLR 436) set out in the Commissioner's Interpretation Statement IS0082 *Tax Information Bulletin* Vol 18 No 6 (July 2006); or

- themselves repaid, either directly or through a series of borrowings used to repay borrowings, other borrowed funds in respect of which the interest was deductible.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 23 May 2010 and ending on 23 May 2015.

This Ruling is signed by me on the 27th day of October 2010.

Susan Price
Director, Public Rulings

INTEREST DEDUCTIBILITY—FUNDS BORROWED TO MAKE A PAYMENT TO A GROUP COMPANY

PUBLIC RULING – BR Pub 10/19

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

Taxation Law

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

This Ruling applies in respect of section DB 6 and section IC 5.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a company to make a payment under section IC 5 to another company that has a net loss.

The Arrangement does not include arrangements where the interest is deductible under section DB 7 (section DB 7 applies to companies).

For the avoidance of doubt, the Arrangement also does not include Arrangements where subpart BG of the Act applies to void the arrangement (subpart BG relates to tax avoidance arrangements).

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Interest will not be deductible in the circumstances described in the Arrangement.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 23 May 2010 and ending on 23 May 2015.

This Ruling is signed by me on the 27th day of October 2010.

Susan Price
Director, Public Rulings

COMMENTARY ON PUBLIC RULINGS BR PUB 10/14 – 10/19

1. This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Rulings BR Pub 10/14 – 10/19 ("the Rulings").

2. The Rulings and commentary express the Commissioner's view of the principles relating to interest deductibility in the Australian Full Federal Court decision in *FC of T v Roberts*; *FC of T v Smith* 92 ATC 4 ("*Roberts and Smith"*).

3. The commentary is organised under the following headings:

   - Summary
   - Legislation
   - How the sections of the Act, other than section DB 7, apply in relation to interest deductibility
   - Scope of the Rulings and commentary
   - Analysis of the *Roberts and Smith* case
   - Arrangements to which the replacement and repayment principle applies
   - When interest is not deductible under the replacement and repayment principle
   - Other matters.

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

Summary

4. The interest deductibility test is satisfied if there is a sufficient connection between interest incurred and assessable income. The sufficient connection is established if the borrowed funds on which interest is incurred are used in deriving assessable income or in a business carried on for the purpose of deriving assessable income.

5. In *Roberts and Smith* the borrowed funds were not used directly in deriving income, but the Court held that the interest is deductible.

6. *Roberts and Smith* is authority that there is a sufficient connection between interest and income when the interest is incurred on borrowed funds used to replace an amount previously invested in an income earning activity or business and to return the amount to the person who invested it. The link with income is through the new borrowings taking the place of funds that have a sufficient connection with assessable income or in respect of which interest was deductible through the operation of section DB 7 or section DB 8. Capital contributions, past years' profits and debt are all capable of being replaced.

7. The case applies only where the amount replaced and repaid is owed to a person separate to the income earning activity or business. It does not apply to sole traders.

Legislation

8. The relevant provisions of the Income Tax Act 2007 are sections DA 1, DA 2, DA 3, DB 1, DB 6, DB 7 and DB 8.

PART D DEDUCTIONS

Subpart DA General rules

DA 1 General permission

Nexus with income

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

(a) incurred by them in deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income; or

(b) incurred by them in the course of carrying on a business for the purpose of deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income.

General permission

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

Avoidance arrangements

(3) Section GB 33 (Arrangements involving depreciation loss) may apply to override the general permission in relation to an amount of depreciation loss.

Defined in this Act:

amount, assessable income, business, deduction, depreciation loss, excluded income, general permission, loss

DA 2 General limitations

Capital limitation

(1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.

Private limitation

(2) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the **private limitation**.

Exempt income limitation

(3) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income. This rule is called the **exempt income limitation**.

...

Relationship of general limitations to general permission

(7) Each of the general limitations in this section overrides the general permission.

DA 3 Effect of specific rules on general rules

Supplements to general permission

(1) A provision in any of subparts DB to DZ may supplement the general permission. In that case, a person to whom the provision applies does not have to satisfy the general permission to be allowed a deduction.

Express reference needed to supplement

(2) A provision in any of subparts DB to DZ takes effect to supplement the general permission only if it expressly states that it supplements the general permission.

Relationship of general limitations to supplements to general permission

(3) Each of the general limitations overrides a supplement to the general permission in any of subparts DB to DZ, unless the provision creating the supplement expressly states otherwise.

Relationship between other specific provisions and general permission or general limitations

(4) A provision in any of subparts DB to DZ may override any 1 or more of the general permission and the general limitations.

Express reference needed to override

(5) A provision in any of subparts DB to DZ takes effect to override the general permission or a general limitation only if it expressly states that—

(a) it overrides the general permission or the relevant limitation; or

(b) the general permission or the relevant limitation does not apply.

Part E

(6) No provision in Part E (Timing and quantifying rules) supplements the general permission or overrides the general permission or a general limitation.

DB 1 Taxes, other than GST, and penalties

No deduction

(1) A person is denied a deduction for the following:

(a) income tax:

(b) a tax imposed in a country or territory outside New Zealand that is substantially the same as income tax:

(c) ancillary tax, unless listed in subsection (2):

(d) a civil penalty under Part 9 of the Tax Administration Act 1994:

(e) a tax, a penalty, or interest on unpaid tax that is—

(i) payable under the laws of a country or territory outside New Zealand; and

(ii) substantially the same as a civil penalty as defined in section 3(1) of the Tax Administration Act 1994, or a criminal penalty under Part 9 of the Act, or interest imposed under Part 7 of the Act.

Some ancillary tax excluded

(2) Subsection (1) does not apply to—

(a) pay-as-you-earn (PAYE):

(b) fringe benefit tax (FBT):

(c) employer's superannuation contribution tax (ESCT):

(d) resident withholding tax (RWT):

(e) non-resident withholding tax (NRWT).

Link with subpart DA

(3) This section overrides the general permission.

...

DB 6 Interest: not capital expenditure

Deduction

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

Exclusion

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

...

Link with subpart DA

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

DB 7 Interest: most companies need no nexus with income

Deduction

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

Exclusion: qualifying company

(2) Subsection (1) does not apply to a qualifying company.

Exclusion: exempt income

(3) If a company (**company A**) derives exempt income or another company (**company B**) that is part of the same wholly-owned group of companies derives exempt income, subsection (1) applies to company A only if all the exempt income is 1 or more of the following:

(a) dividends; or

(b) income exempted under section CW 58 (Disposal of companies' own shares); or

(c) income exempted under section CW 60 (Stake money) and ancillary to the company's business of breeding.

Exclusion: non-resident company

(4) If a company is a non-resident company, subsection (1) applies only to the extent to which the company incurs interest in the course of carrying on a business through a fixed establishment in New Zealand.

Exclusion: interest related to tax

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

Consolidated groups

(6) Section FM 12 (Expenditure when deduction would be denied to consolidated group) may apply to allow a deduction under this section to a company that is part of a consolidated group.

...

Link with subpart DA

(8) This section supplements the general permission and overrides the capital limitation, the exempt income limitation, and the withholding tax limitation. The other general limitations still apply.

DB 8 Interest: money borrowed to acquire shares in group companies

Deduction: borrowing to acquire group company shares

(1) A company is allowed a deduction for interest incurred on money borrowed to acquire shares in another company that is part of the same group of companies.

Exclusion: group not in existence at year end

(2) Subsection (1) does not apply if the 2 companies are not part of the same group of companies at the end of the tax year that corresponds to the income year in which the deduction is allowed.

Deduction: interest after resident's restricted amalgamation

(3) A company is allowed a deduction for interest incurred on money borrowed to acquire shares in another company that has ended its existence on a resident's restricted amalgamation.

Exclusion: group not in existence immediately before resident's restricted amalgamation

(4) Subsection (3) does not apply if the 2 companies were not part of the same group of companies immediately before the resident's restricted amalgamation.

Application from income year of resident's restricted amalgamation

(5) Subsection (3) applies in the income year in which the resident's restricted amalgamation occurs and in later income years.

Consolidated groups

(6) Section FM 12 (Expenditure when deduction would be denied to consolidated group) may apply to allow a deduction under this section to a company that is part of a consolidated group.

...

Link with subpart DA

(8) This section supplements the general permission and overrides the capital limitation, the exempt income limitation, and the withholding tax limitation. The other general limitations still apply.

Roberts and Smith principle not relevant to section DB 7 deductions

9. The interest deductibility legislation distinguishes between companies and other taxpayers. Interest incurred by companies is automatically deductible— that is, there is no requirement to satisfy a nexus test— except for certain exceptions. The effect of this is that most companies seeking interest deductions will obtain them under section DB 7, rather than by applying *Roberts and Smith*. *Roberts and Smith* may apply to companies that do not come within section DB 7.

10. Under section DB 7, interest incurred by a company is automatically deductible, provided the statutory exceptions in sections DB 7(2) – (5) do not apply. The exceptions are:

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

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

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

12. The following paragraphs provide an overview of the relevant deductibility provisions, and their relationship with each other.

13. Section DB 6(1) provides that:

> A person is allowed a deduction for interest incurred.

14. Section DB 6(3) states that:

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

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

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

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income; or

(b) incurred by them in the course of carrying on a business for the purpose of deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income.

General permission

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

16. Consequently, in considering the application of the Act to interest expense, a person must satisfy the test under the general permission that the expenditure (interest in this case) is incurred in deriving assessable income (or excluded income) or incurred in carrying on a business for the purpose of deriving assessable (or excluded income). This test is the same in all relevant respects to the tests under the Income Tax Act 1994 and the Income Tax Act 2004.

17. The concept of "excluded income" requires some comment in relation to how it is dealt with in this commentary. "Excluded income" is defined and specified to include, for example, GST, fringe benefits, certain life insurance premiums or claims derived by persons carrying on the business of life insurance, and other specific classes of income (see sections YA 1 and BD 1(3) and subparts CX and CZ). The addition of the reference to "excluded income" in the general permission does not alter the principles applying to the deductibility of interest. The same principles apply to excluded income. However, because the concept of "excluded income" is a statutory mechanism used to deal with certain types of income, and does not affect the principles of interest deductibility, for ease of reference "excluded income" is not referred to further in this commentary.

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

DA 2 General limitations

Capital limitation

(1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.

Private limitation

(2) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the **private limitation**.

...

Relationship of general limitations to general permission

(7) Each of the general limitations in this section overrides the general permission.

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

> **DA 3 Effect of specific rules on general rules**
>
> ...
>
> *Relationship between other specific provisions and general permission or general limitations*
>
> (4) A provision in any of subparts DB to DZ may override any 1 or more of the general permission and the general limitations.
>
> *Express reference needed to override*
>
> (5) A provision in any of subparts DB to DZ takes effect to override the general permission or a general limitation only if it expressly states that—
>
> (a) it overrides the general permission or the relevant limitation; or
>
> (b) the general permission or the relevant limitation does not apply.
>
> ...

20. The capital limitation is expressly overridden in relation to interest by section DB 6(4) (section DB 6(1) is reproduced to give context):

> **DB 6 Interest: not capital expenditure**
>
> *Deduction*
>
> (1) A person is allowed a deduction for interest incurred.
>
> ...
>
> *Link with subpart DA*
>
> (4) This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.

Summary of the legislation relating to interest deductions

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

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

Scope of the Rulings and commentary

22. Except for BR Pub 10/19, the Rulings and commentary only consider deductibility under the *Roberts and Smith* principle. The scope of BR Pub 10/19 (and related commentary) is wider: it states that interest on borrowed funds used to make subvention payments is not deductible under the general permission on any basis.

Analysis of the *Roberts and Smith case*

Introduction

23. Courts have established that the general test for interest deductibility requires a sufficient connection between the interest incurred on borrowed funds and the derivation of income. This sufficient connection depends on the use to which the assets provided with the borrowed funds are put (see *Eggers v CIR* (1988) 10 NZTC 5,153, per Richardson J, and *Pacific Rendezvous Ltd v CIR* (1986) 8 NZTC 5,146; per Cooke P at p 5,148, per Richardson J at pp 5,151-5,152 and per Somers J at p 5,155). In most cases, the test is satisfied when the borrowed funds are used directly in an income earning activity or business in that they are used to acquire income earning assets.

24. In a limited number of cases, notably *Roberts and Smith* and *Public Trustee v CIR* [1938] NZLR 436, the courts have held that the borrowed funds were used in relation to the income earning assets, and that the connection was sufficient for deductibility, even though the funds were deployed outside the income earning activity or business. The application of *Roberts and Smith* is discussed in this commentary, and the application of *Public Trustee* is discussed in Interpretation Statement IS0082—*Interest Deductibility—Public Trustee v CIR*[1].

The facts of Roberts and Smith

25. The Australian decision in *Roberts and Smith* concerned the deductibility of interest incurred by a partnership that borrowed in order to repay partners part of their capital contributions. Judgment was given on two appeals heard together.

26. The facts were that new partners were to join the partnership, but the cost of contributing an amount equal to the capital of the existing partners was too high. To make it easier for the new partners to join the partnership, the partners decided to decrease the amount of the existing partners' capital by borrowing to repay partners their capital contributions. The Australian Full Federal Court held that the interest on this borrowing was deductible.

27. Hill J, who delivered the leading judgment, considered that the deduction was limited to the extent that the borrowed funds replaced the amount of partnership capital contributed by partners. His Honour explained (at p 4,390):

> The provision of funds to the partners in circumstances where that **provision is not a replacement of funds invested in the business**, lacks the essential connection with the income producing activities of the partnership business. [emphasis added]

[1] *Tax Information Bulletin* Vol 18 No 6 (July 2006)

28. Hill J explained his reasoning in the following passage (at p 4,390):

> Let it be assumed that the original partnership capital in the Lord Lindley sense [i.e. contributed capital] was $10 and that the balance in the account designated as "the capital account" of the partnership was $125,000, which included goodwill. That would mean that the equity of each partner in the partnership, assuming five partners, was $25,000. But it could not be said that each partner had invested funds totalling $25,000 as capital in the partnership. A cheque for $25,000 drawn on the partnership bank account would not operate to repay the partner any funds invested. The partnership capital would remain as $10, and all that would happen is that there would be a borrowing which was used to pay the partner $25,000. That borrowing would reduce the partner's equity in the partnership, but it could not represent a replacement of capital invested. The partnership assets would remain constant. The goodwill would still be worth $125,000; it would not have been distributed to the partners, nor could it be.
>
> On these facts, there could be no question of there being a refund of a pre-existing capital contribution. Rather, looking at the facts objectively, the only purpose of the borrowing would be the provision of funds to the partners to which they were not entitled during the currency of the partnership (save of course by agreement among themselves). The provision of funds to the partners in circumstances where that provision is not a replacement of funds invested in the business, lacks the essential connection with the income producing activities of the partnership, or, in other words, the partnership business.
>
> … If at least $125,000 of the amount in that account represents partnership capital in the Lord Lindley sense, undrawn profit distributions, advances by partners **or other funds which have actually been invested in the partnership** and which the partners were entitled to withdraw in June 1984, then in my view the taxpayer is entitled to succeed. [emphasis added]

29. His Honour considered that interest is deductible in this type of situation only if the borrowed funds replace amounts that have actually been invested in the partnership. The reason for this is that the borrowed funds take on the character of the funds they are replacing only if in fact they have the effect of replacing funds used in the business. Capital contributions can be replaced by borrowings that are used to pay out these contributions to partners. Hill J explains that goodwill is not an amount invested in an income earning activity, and so it cannot be repaid to anyone, and therefore borrowed funds cannot take the place of that goodwill. Similarly, with asset revaluations, the revalued portion of the asset is not an amount that has been invested so it cannot be repaid to anyone.

30. Therefore, *Roberts and Smith* applies if an amount is able to be replaced by borrowed funds and if the amount replaced is then returned to the person who invested it. The link with income comes through the new borrowings taking the place of funds that have a sufficient connection with assessable income. Capital contributions, undrawn profits and advances are all capable of being replaced.

31. This principle from *Roberts and Smith* is referred to in this commentary as the "replacement and repayment principle".

Whether the borrowed funds are used in an income earning activity

32. In Hill J's view, in the circumstances of *Roberts and Smith* the borrowings replaced the capital that had been paid in by the partners. A question might be raised as to how borrowings can be said to replace funds invested in an income earning activity or business, when the borrowings were actually paid direct to the partners and were never paid into the partnership. The "replacement" occurs in the books of the partnership in

that equity is reduced and debt increased. There might seem to be some difficulty in understanding how one debt, with its own parties, conditions, and direct use can inherit the deductibility status of a completely different debt. A basic principle of deductibility would seem to be that deductibility of any item should depend on the circumstances in which it is incurred. A further issue is that if the direct use of the borrowed funds is a private use, for example the private use of partners in a partnership, then it might be argued that the prohibition against deductions of a private nature in section DA 2(2) might apply.

33. Hill J supports his reasoning by saying that interest on a debt that replaces a debt is deductible. But that statement is not an explanation, and it is not clear that a debt replacing a debt inherits its deductibility status. A contrary approach was taken in the Canadian decision in *Interior Breweries Ltd v Minister of National Revenue* [1955] CTC 143; 55 DTC 1090. 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. Cameron J considered that the borrowed money was not used to earn income, but was "used entirely to pay off the bank loan…" (at p148).

34. However, *Interior Breweries* does not appear to have been applied in any later cases. In Canada, the reason is that legislation was introduced to reverse its effect. It seems likely that the decision may not be accepted in New Zealand or Australia if it were argued. Although New Zealand and Australian courts have been cautious about allowing deductions relating to indirect uses of borrowed funds (particularly in the lower courts in regard to cases where there has been private use of funds), they have not taken as strict an approach as the Canadian courts have taken. *Roberts and Smith* is an Australian example of acceptance by a court that interest may, in some situations, be deductible when the borrowed funds are not used directly to derive income.

Approach to identifying the use of borrowed funds in New Zealand

35. In New Zealand, as in Australia and Canada, the interest deductibility test involves considering the use of the borrowed funds and the connection between the funds and the derivation of income. However, the New Zealand courts have held that the use of funds encompasses not only the direct use of the funds, but also the outcome of that use. In *Public Trustee* the borrowed funds were applied in payment of death duties. It was argued that the funds were used to retain assets. The dissenting judge in *Public Trustee*, Northcroft J, had the following view about how the borrowed funds were used (at p 459):

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

36. Northcroft J's view was not shared by the majority. The majority held that the capital was used in the payment of the debt and to retain assets. Callan J held that borrowed capital used in retaining assets is employed in the production of assessable income, just as capital used in acquiring assets is employed in the production of assessable income. Therefore, the case is authority that in identifying how borrowed funds are used as required by the statutory test, the use of funds will not only encompass the actual application of the funds, but will include the outcome of the

application. This interpretation is consistent with the meaning of "use" in the *Concise Oxford Dictionary* (Oxford University Press, 11th ed, 2004):

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

37. This definition involves two aspects: deployment (ie, application) and outcome. A similar conclusion was reached in *Pacific Rendezvous*. The use of the funds was held to be in acquiring assets for the motel business and in augmenting the company's capital. *Pacific Rendezvous* therefore established that if borrowed funds are used in deriving assessable income, and the sufficient connection is established, it does not matter that the funds are also used to achieve a non-taxable outcome. In the Commissioner's opinion, this same reasoning applies to the *Roberts and Smith* situation. If the sufficient connection is established through the use of the borrowed funds, that connection is not lost if there is a second, non-income-related outcome. In *Roberts and Smith*, the two outcomes were the replacement of funds that had a sufficient connection with the derivation of assessable income, and the use of the funds by partners for non-partnership and possibly private uses.

38. Following Hill J's judgment, and applying the understanding of "use" that New Zealand courts have taken, the Commissioner's opinion is that borrowings used to replace and repay amounts invested in an income earning activity or business will have a sufficient connection with income. In those circumstances, the new borrowings take on the character of the money they replace, and the interest will be deductible if the original funds were used directly in the income earning process. Deductibility will not be affected by a concurrent non-income earning use of the borrowed funds.

Requirement of the replacement and repayment principle—the funds must return to their owners

39. An element of the *Roberts and Smith* replacement and repayment principle is that the repaid funds are returned to the person who originally paid them. The principle stated by Hill J in *Roberts and Smith* is as follows (at p 4,390):

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

40. When the borrowed funds are used to enable funds invested in income earning activities to be repaid to the person who invested them, the borrowed funds have the necessary connection with the income earning activity of the partnership or business. This connection arises because the borrowed funds, in effect, replace the repaid funds. As a result, the borrowed funds take the place of the repaid funds and so take on the deductibility nexus of the replaced funds. By contrast, *Roberts and Smith* does not apply when the borrowed funds are paid to a person who did not invest funds into the income earning activity. In this situation, even though the borrowed funds would be recorded as a liability against the assets, there is no necessary connection between the borrowed funds and the income earning activity. This is because the borrowed funds do not replace any funds invested in the income earning activity.

41. This distinction can be understood from a statutory interpretive point of view. If the *Roberts and Smith* principle extended to borrowings used to

replace any amounts in an income earning activity or business, then interest on those funds would in most cases be deductible. That result would be inconsistent with the presence of a statutory test for deductibility that requires a sufficient connection between interest and income. For example, a business might borrow and use the funds for a non-income use, such as to make a nil interest loan to a sister company, to invest in a company that was barred from making distributions, or to pay criminal fines. The argument might be made that as the borrowing would be reflected in the business' liabilities, it was used in the income earning activity. However, borrowed funds used in that way are not connected with the income earning activity of the business. No amount is repaid, and therefore the borrowings cannot inherit any connection with income.

42. Professor Ross Parsons discussed this issue in his paper "Roberts and Smith: Principles of Interest Deductibility"[2]. He argued that the *Roberts and Smith* principle should not be simply that a borrowing inherits the deductibility status of the original borrowing. If that were the rule, then there "would be opened a means of obtaining deductions for interest in respect of money borrowed that is used for private non-income producing purposes". In the Commissioner's opinion, an interpretation of the deductibility provision that would lead to all interest being deductible, in the context of a provision that the Courts have said requires a sufficient connection and apportionment where that connection is not established, cannot be correct.

43. Therefore, in the Commissioner's view, the *Roberts and Smith* principle requires that funds repaid are returned to the person who invested or advanced them.

New Zealand cases relevant to Roberts and Smith

Case P56

44. The approach of the Taxation Review Authority in *Case P56* (1992) 14 NZTC 4,386 is similar to the Commissioner's interpretation of *Roberts and Smith*. In this decision, partners borrowed to draw out more than they had invested in the partnership. The interest was held to be non-deductible. Willy DJ said that if the partners had replaced capital investments, they would have been entitled to interest deductions (at p 4,396).

Case M127

45. *Roberts and Smith* appears to be inconsistent with *Case M127* (1990) 12 NZTC 2,817. *Case M127* concerned a husband and wife operating a coffee lounge business. They had $76,000 of their own equity invested in the business. There was little available cash. They wished to buy a new dwelling house, and had some cash outside of the business, but were $70,000 short. The partnership paid $70,000 to the husband and wife as individuals. This put the partnership account into overdraft. The partnership then borrowed to repay the overdraft, leaving it with a credit balance of $2,304. In summary, the borrowed funds were used by the partnership to pay back a loan to the bank, which had been taken out to repay partners their capital so that they could buy a house. The effect on

[2] Professor Ross Parsons "Roberts and Smith: Principles of Interest Deductibility" (1993) 1 Taxation in Australia (Red Edition) 261 at p.266

the partnership's balance sheet was that the capital contributed by the partners was replaced by the loan.

46. The objectors argued that the borrowed money was used in the production of income. It does not appear from the judgment that they specifically argued that the loans replaced their equity. The case was heard before *Roberts and Smith* was decided, so the taxpayers did not have that case available as a precedent.

47. It is helpful to consider *Case M127* in the context of the general principles of interest deductibility. The direct test for interest deductibility, followed in *Pacific Rendezvous v CIR* and *CIR v Brierley* (1990) 12 NZTC 7,184, requires borrowed funds to be traced to a use that derives income. *Roberts and Smith* is authority that a strict tracing is not required if the borrowing replaces funds and the replacement involves a replacement of money actually invested. The direct use of the borrowed funds in *Roberts and Smith* was to pay capital out to partners, who may have used the funds for private use. Hill J said (at p 4,388):

> A tracing approach, if carried beyond the payment to the partner, encourages the argument raised by the Commissioner in the present case that the funds were used for the private purpose of the partner who received them. But that fact will not preclude the deductibility of the outgoing. The funds to be withdrawn in such a case were employed in the partnership business; the borrowing replaces those funds and the interest incurred on the borrowing will meet the statutory description of interest incurred in the gaining or production of the partnership of assessable income.

48. In *Case M127*, if a strict tracing approach is applied, the loan was used to pay off a business overdraft. That overdraft loan can be traced to private use by the partners. If *Roberts and Smith* is applied to the facts, the second loan can be seen as replacing the overdraft, which in turn replaced the equity. The equity was used directly to fund the partnership's business, and therefore, there is a sufficient connection with income such that the interest is deductible. This reasoning was not argued, or applied by Bathgate DJ. Bathgate DJ held that the interest was not deductible. The case is, therefore, incompatible with *Roberts and Smith*. The objectors might have still failed on the facts, had they argued *Roberts and Smith*, because a large proportion of the $76,000 appears to have been made up of goodwill.

49. In the absence of *Roberts and Smith*, Bathgate DJ held in *Case M127* that the borrowed funds were used for private purposes. His Honour considered that the first loan by way of overdraft was used to buy the house, that the second loan paid back the overdraft, and that neither loan was used in producing partnership income. Instead, the loans were used to purchase the house for the objectors. The interest incurred by the partners was private in nature.

50. The decision in *Case M127* is therefore inconsistent with the decision in *Roberts and Smith*. Although *Case M127* is from the New Zealand jurisdiction, a decision of the Full Federal Court of Australia has precedent value. In the circumstances of this issue the Commissioner considers that a higher New Zealand court would follow *Roberts and Smith* rather than the Taxation Review Authority's decision in *Case M127*.

Arrangements to which the replacement and repayment principle applies

Introduction

51. Paragraphs 52 – 109 below explain the Commissioner's position on when interest will be deductible under the *Roberts and Smith* replacement and repayment principle. These paragraphs are organised under the following headings:

- Returns of capital to partners: BR Pub 10/14
- Payments of past years' profits to partners: BR Pub 10/14 and BR Pub 10/15
- Share repurchases: BR Pub 10/16
- Payments of dividends: BR Pub 10/17
- Replacement of debt: BR Pub 10/18.

Returns of capital to partners: BR Pub 10/14

52. BR Pub 10/14 applies to interest on borrowed funds used by a partnership to return capital to partners who invested that capital into the partnership.

53. The *Roberts and Smith* replacement and repayment principle applies to borrowed funds used to repay partners their capital contributions to the partnership. Interest is deductible on borrowings used to repay capital to partners, to the extent that the capital that was repaid was used in earning assessable income.

54. This view is based on the conclusion that a partnership can transfer property to a partner. However, a partnership is not a legal entity. A partnership consists of a collection of rights and obligations between the partners, and ownership of partnership assets is vested in the partners, not the partnership. It could be argued, therefore, that a partnership cannot repay partnership property to a partner, because the partner already owns that property.

55. A key concept of partnership law is that partners do not have individual rights to partnership property. This point was made in *Hadlee & Sydney Bridge Nominees Ltd v CIR* (1993) 15 NZTC 10,106 (PC). Delivering the judgment of the Privy Council, Lord Jauncey stated (at para 5):

> First of all as a matter of general law, to quote the words of *Richardson* J [in *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1991) 13 NZTC 8, 116 (CA)] he "does not have title to specific partnership property but has a beneficial interest in the entirety of the partnership assets and in each and every particular asset of the partnership. (*Lindley on Partnership* 15th Edition, page 516)". He can enforce this interest against his co-partners to the extent of seeing that the partnership assets are used for the benefit of the partnership but he cannot assign it to a non-partner. This beneficial interest, expressed in terms of its realisability, is in the nature of a future interest taking effect in possession on (and not before) the determination of the partnership (*Lindley and Banks on Partnership*, 16th Edition, p 457).

56. Lord Jauncey referred to Richardson J's judgment in *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1991) 13 NZTC 8, 116 (CA). In his judgment, Richardson J stated:

> A share in a partnership is a chose in action. It is a fractional interest in the future profits of the partnership business and in a surplus of assets over liabilities on a winding up. The partner does not have title to specific partnership property but has a beneficial interest in the entirety of the partnership assets and in each and every particular asset of the partnership (*Lindley on Partnership* 15th ed, 516; *Maw v Maw* [1981] 1 NZLR 25).

57. In *CIR v Boanas* (2008) 22 NZTC 22,046, the High Court referred (at para 64) to this passage from Richardson J's judgment. In *Boanas*, Dobson J noted (at para 65) that Richardson J's judgment was consistent with the Partnership Act 1908, in particular section 23(1):

> All property and rights and interests in property … must be held and applied by the partners exclusively for the purposes of the partnership and in accordance with the partnership agreement.

Dobson J held (at para 67) that the "application of substantive partnership law" meant that none of the partners could deal with any portion of the whole of the partnership property as if it were their own.

58. Molloy says in *Principles of the Law of Partnership* that a receipt received by a partnership remains a receipt of the partnership alone, which is to say by the partners jointly[3]. He says that if an amount is partnership property, it is not an individual entitlement of any particular partner. The individual partner does not derive several income (i.e. each partner's individual allocation of income) until it has been ascertained whether the overall result for the relevant fiscal period has been that the firm has derived any net assessable income.

59. The point was made in *Crowe v Commissioner of Taxation* (1958) 100 CLR 532 that there is a distinction between partnership property and each partner's individual property. The case was concerned with an expense, rather than income, but is relevant because it makes the point that partnership property is not the same as the individual entitlements of the partners. In *Crowe* a partnership took out a policy on each of the lives of its four partners. Each policy was for the benefit of all four partners. The premiums were paid by the firm and the policy was in the name of the firm. A provision of the Australian Commonwealth income tax legislation permitted the deduction of "amounts paid by the taxpayer as premiums or sums for insurance on the life of the taxpayer." Fullagar J said that if any of the partners were to have:

> … effected an insurance on her own life, and the partnership had paid a premium on the policy at her request and debited the amount to an advance account in its books, I should have said that she ought to be held to have "paid" the premium, although no money or money's worth passed from her hand to the hand of the insurer.

60. The issue in *Crowe* was whether payment by the firm, of the premium on a policy that the firm itself had taken out, had been payment by the taxpayer. Fullagar J answered the question in the negative:

> [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.

[3] *Principles of the Law of Partnership,* Webb and Molloy, (Butterworths, Wellington, 6th edition, 1996) para. 11.235

The insurance contracts were taken out in the name of the firm, and the firm (and not each individual partner) paid the premiums. The premiums were paid by the partners jointly. It was therefore not a payment made by any one of the individual partners.

61. Similarly, in the Commissioner's view, income of a firm is derived by the partners jointly, and not individually by each partner. This is consistent with Richardson J's judgment in *Hadlee and Sydney Bridge Nominees Ltd v CIR* (CA). In this decision, his Honour observed that the statutory regime for the taxation of partnership income, among other things, treated partnership income as derived by the partners jointly:

> 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. **The gross income is derived by the partners jointly** and the partners severally claim the deductions to which they are entitled as taxpayers in terms of the legislation. All that is reflected in sec 10 and various general provisions of the [Income Tax Act] 1976 ….[Emphasis added]

62. Richardson J referred to section 10(1) of the Income Tax Act 1976 as reflecting the principle that gross income is derived by partners jointly. Section 10(1) has since been replaced by section 42 of the Tax Administration Act 1994. Section 42 largely resembles section 10(1) and also reflects the principle that gross income is derived by partners jointly:

> **Returns by joint venturers, partners and partnerships**
>
> (1) This section applies when 2 or more people derive income jointly or have deductions jointly.
>
> …
>
> (3) In the case of partners,—
>
> (a) if the partnership of the partner is a limited partnership registered under the Limited Partnerships Act 2008 or is a partnership that would carry on a business in New Zealand ignoring section HG 2 of the Income Tax Act 2007, then the partners must make a joint return of income that includes—
>
> (i) the total amount of income derived by the partners as members of the partnership; and
>
> (ii) the partners' partnership shares in the income; and
>
> (iii) a summary of the deductions of each partner:
>
> (b) there is no joint assessment, but each partner must make a separate return of income under section 33, including the income derived by the partner as a member of the partnership, and the partner's deductions. Each partner is separately assessed.
>
> (4) In any other case, each person shall make a separate return taking into account that person's share of the joint income and deductions. Each person is separately assessed.

63. In 2007, after the Rulings were originally issued, section HG 2(1) was enacted. When the original Rulings were issued there was no equivalent legislative provision. Section HG 2(1) provides that partnerships are transparent for income tax purposes unless the context otherwise requires. This means that, for the purposes of calculating their obligations and liabilities under the Act, the partners (and not the partnership) are generally treated as:

- carrying on activities and having the status, intention and purpose of the partnership; and

- holding property that a partnership holds, being parties to an arrangement to which the partnership is party, and doing or being entitled to a thing that the partnership does or is entitled to, in proportion to their partnership share.

64. Section HG 2(1) does not alter the principle that partnership income is derived by the partners jointly, and that partnership property is owned jointly, and not individually by each partner. The words "[f]or the purposes of a partner's liabilities and obligations under the Act" make clear that section HG 2(1) applies only in respect of the calculation of a partner's tax obligations and liabilities. Accordingly section HG 2 does not affect the partners' individual rights to partnership property under general law as developed in the case law discussed above.

65. In summary, partners own an undivided interest in partnership property, and do not have individual title to any particular items of partnership property. Consequently, there can be a valid legal transfer of property from a partnership to a partner, because the nature of the legal ownership changes from joint ownership to ownership by a single person. Therefore, the *Roberts and Smith* principle can apply to partnerships. The *Roberts and Smith* case of course involved a partnership, and so is authority for this point.

66. It should be noted that a return of capital, whether by a partnership or a company, is not connected with income simply because it is an ordinary part of running a business. A return of capital is not part of the income earning activity, it is a transaction relating to the structure of the business. However, there is a sufficient connection with income in this arrangement because, following *Roberts and Smith*, borrowing to return capital has the effect of replacing and repaying the funding of the income earning activity. In these circumstances, the borrowed funds continue the connection the repaid funds had with income.

Payments of past years' profits to partners: BR Pub 10/15

Introduction

67. BR Pub 10/15 states that:

- interest **is** deductible to the extent that the borrowed funds are used to repay past years' profits to the partners if those profits are used by the partnership in its income earning activities; and

- interest **is not** deductible to the extent that the borrowed funds are used to pay current year income to partners, or are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill.

The following paragraphs explain the Commissioner's reason for distinguishing between past years' profits and current year income. BR Pub 10/14 also denies interest deductions where borrowed funds are used to pay current year income to partners. The Commissioner's position on unrealised asset revaluations and internally generated goodwill is discussed later: see paragraphs 111—116.

68. Past years' profits in a partnership, which Hill J in *Roberts and Smith* refers to as undrawn profit distributions, can be viewed as amounts contributed by partners. If a partner does not withdraw profits, they are allocated to partners equally, or in accordance with the divisions in the partnership agreement (*Principles of the Law of Partnership*).[4] The accounting treatment might be to carry profits to the credit of the partner's respective current accounts by book entry calculated at the end of the accounting period. Although there may not be any active reinvestment by the partners themselves, this process can reasonably be seen as an investment of capital.

69. Therefore, in the Commissioner's view, past years' profits can be seen as reinvestments by partners in the partnership and the replacement and repayment principle may apply. Interest is deductible on borrowings used to repay past years' profits to partners, to the extent that those profits were used in earning assessable income or in the partnership business.

Payments of current year income to partners: BR Pub 10/14 and BR Pub 10/15

70. The Commissioner's opinion is that the principle from *Roberts and Smith* does not extend to borrowings purporting to return the current year income that has not yet been identified as profits. The reason is that current year income is not an amount that has been invested in the partnership by the partners, and so cannot be repaid to partners.

71. The principle from *Roberts and Smith* is that interest may be deductible if borrowed funds repay funds invested in an income-earning activity or business carried on to derive income. The issue with current year income is whether it is an amount that can be repaid. To be repayable, it must have been paid into the partnership by someone. The amount can only have been paid in if someone other than the partnership has had an entitlement to it at some time. Therefore, the issue is to decide whether partners can be said to have become individually entitled to current year income at some time before any purported replacement.

72. To consider this question, the legal nature of current year income is examined. If current year partnership income is owned by individual partners at any point during the year, it could in theory be invested by partners in the partnership business.

Whether current year income is partnership property or property of individual partners

73. The conclusion has already been reached that there is a distinction between partnership property and property belonging to individual partners. In considering the application of *Roberts and Smith* to current year income, the next step is to ascertain whether it is partnership property, or property of individual partners.

[4] *ibid* paragraphs 2.48 and 4.109

74. The Partnership Act 1908 is silent on the treatment of current year income. It provides for the division of profits in section 27:

> 27. Rules as to interests and duties of partners—
>
> The interests of partners in the partnership property, and their rights and duties in relation to the partnership, shall be determined, subject to any agreement (express or implied) between the partners, by the following rules:
>
> (a) All the partners are entitled to share equally in the capital and profits of the business, and must contribute equally towards the losses, whether of capital or otherwise, sustained by the firm:
>
> ...
>
> (d) A partner is not entitled, before the ascertainment of profits, to interest on the capital subscribed by him:

75. Under section 27, partners are entitled to share in any profits, subject to any agreement to the contrary. The concept of "profits" is not defined. There is no particular guidance in the Partnership Act as to when the division and allocation of profits occurs.

76. It has been held in Australia that, for tax purposes, the amount that forms part of each partner's individual income is only ascertainable once partnership accounts have been prepared, and that this would normally be at year end. In *FC of T v Galland* 86 ATC 4885 the High Court of Australia held that in the absence of an agreement stating a different balance date, accounts of the partnership would be required to be taken each year as at 30 June and a partner's share of the partnership income would be distributed to the partner as at that date. The High Court said:

> ...although a partner is not usually entitled to call for a distribution of profits or net income until accounts have been prepared, he has an individual interest in the net income of the partnership, notwithstanding that the precise amount of his interest cannot be determined until the accounts are prepared for the relevant period.

77. The High Court's view is that partners are not (usually) entitled to current year income. The partners have an individual interest in the net income of the partnership, but not an immediate entitlement to the current year income. *Galland* was quoted by Hill J in *Roberts and Smith* as authority for the proposition that a partner's share of the partnership income is derived by the partner only once annual accounts of the partnership have been prepared. Hill J said:

> In the absence of agreement, accounts for the partnership would be required to be taken each year as at 30 June and a partner's share of the partnership income would be derived by him as at that date: *FC of T v Galland.*

78. Further, it is in the nature of profits that they have to be identified before anyone can become entitled to them. Fletcher Moulton LJ provided a definition of "profits" in *Re Spanish Prospecting Co. Ltd* [1911] 1 Ch 92 at 98-99[5] (cited in *Galland*):

> The word "profits" has, in my opinion, a well-defined legal meaning, and this meaning coincides with the fundamental conception of profits in general practice, although in mercantile phraseology the word may at times bear meanings indicated by the special context which deviate in some respect from this fundamental

[5] This definition was adopted by Williams J in *Dalgety v Commissioner of Taxes* [1912] NZLR 260 at 261-262, and discussed in Higgins & Fletcher *The Law of Partnership in Australia and New Zealand (*LBC Information Services, Pyrmont, NSW, 8th ed, 2001

> signification. “Profits” implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at two dates … We start therefore with this fundamental definition of profits, namely, if the total assets of the business at the two dates be compared, the increase which they show at the later date as compared with the earlier date (due allowance of course being made for any capital introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the period in question.

79. As Fletcher Moulton LJ points out, as a matter of logic, profits can be known only once they are calculated. They can be calculated only when the amounts of income and expenses for the relevant fiscal period are known. Although amounts will come in that will in due course form profits, until the fiscal period has ended, the amount of profits cannot be known. It follows, in the Commissioner’s opinion, that an entitlement cannot arise until the amount can be known, and it can be known only at the end of the fiscal period. This period, as Fletcher Moulton LJ says, is generally annual.

80. Therefore, the Commissioner’s opinion is that a partner does not have an individual entitlement to current year income. Current year income is owned by all of the partners jointly. Individual partners have an ownership interest in it in common with the other partners, but not an entitlement to their potential individual share until profits have been calculated and allocated for a fiscal period.

Discussion of current year income in Roberts and Smith

81. In applying the law to the case he was considering, Hill J in *Roberts and Smith* explained that it was necessary to identify whether the partners received a refund of capital, or whether they received amounts in excess of their capital. Hill J considered capital to be the aggregate amounts contributed by the partners for the purpose of commencing or carrying on the partnership business (at p 4,389). The partnership accounts he was considering did not separate out the contributed capital from other items. He thought that it was possible that the amount of capital represented in the partnership accounts included (at p 4,390):

- contributed capital;
- internally generated goodwill;
- undrawn distributions;
- profits of the year not yet distributed; and
- asset revaluations.

In Hill J’s view, the items that could be replaced with a deductible result were (at p 4,390):

- contributed capital;
- undrawn profit distributions;
- advances made by partners; and
- other funds that have actually been invested in the partnership and which the partners were entitled to withdraw.

82. Hill J did not include “internally generated goodwill”, “asset revaluations” and “profits of the year not yet distributed” (i.e. current year income) as amounts able to be replaced. Internally generated goodwill and asset revaluations are discussed later: see paragraphs 111—116 below. Hill J’s view was that the types of amounts that could be replaced with a deductible result were funds that had actually been invested in the partnership and which the partners were entitled to withdraw at the time of the borrowing.

83. In contrast, Hill J considered that undrawn distributions that have been allocated to partners, but not paid out (i.e. past years’ profits) can be replaced with borrowings and the interest would be deductible.

Application of the Roberts and Smith principle and the law on partnerships to current year income

84. Partners do not have rights to current year income as it arises during the year, because it is partnership property. Profits are generally determined at the end of the year and, until this happens, the partners are not entitled to current year income. This means that any drawings taken from the partnership’s current year income can only be a partner’s anticipated share of the profits. Current year income cannot, therefore, be an amount invested in the partnership by the partners. As it is, in the Commissioner’s opinion, essential for the *Roberts and Smith* replacement and repayment principle that the funds must be repaid to someone, there must be someone who has had an entitlement to them. Therefore, to be repayable, someone must have invested the funds in the income earning activity or business. Current year income has not been invested so the *Roberts and Smith* principle does not apply to it.

Difference between current year income and past years’ profits

85. Past years’ profits can be distinguished from current year income because partners have become entitled to them, either at a time specified under the partnership agreement or, in the absence of a partnership agreement, when the partnership accounts are required to be taken (*FC of T v Galland*) and they have been notionally allocated to partners. Their status is then as advances to the partnership or new investments of capital. Hill J considered that past years’ profits could be viewed as amounts invested, and that they could be repaid with a deductible result.

Share repurchases: BR Pub 10/16

86. BR Pub 10/16 applies to interest on borrowed funds that are used by a company to repurchase shares from its shareholders (as authorised by the Companies Act 1993).

87. A repurchase of shares by a company involves a payment by a company to its shareholders of amounts previously contributed by shareholders. The repurchase of bonus share issues that were funded by past years’ profits can also be seen as involving a payment by a company to its shareholders of amounts previously contributed by shareholders. The effect of the payment by the company is a diminishment of the shareholder’s capital holding in the company. This arrangement is analogous to a return of capital or past years’ profits to partners in a partnership.

88. Therefore, in the Commissioner's view, the replacement and repayment principle may apply to share repurchases (including repurchases of bonus issue shares). Interest is deductible on borrowings used to repay share capital or past years' profits to shareholders, to the extent that the capital or profits were used in deriving the company's assessable income.

89. It should be noted that interest incurred by companies will generally be deductible under section DB 7, the provision that gives companies in most situations an automatic deduction for interest, and that *Roberts and Smith* would be an alternative basis for deductibility for interest incurred on borrowed funds used to repurchase shares.

Payments of dividends: BR Pub 10/17

90. BR Pub 10/17 applies to interest on borrowed funds used by a company to pay dividends to its shareholders.

91. The *Roberts and Smith* replacement and repayment principle applies to borrowings used to pay dividends sourced from past year profits, usually described as retained earnings, to shareholders. There is, however, some conceptual difficulty in bringing a company's retained earnings within this principle. The difficulty is in analysing retained earnings as amounts contributed by shareholders. Company profits are not allocated to shareholders at the end of each year. Retained earnings are added to the existing retained earnings. Directors may decide to distribute some of these as dividends or they may decide not to. Shareholders are not immediately entitled to retained earnings in the way that partners are entitled to partnership profits.

92. There are, however, similarities between a partnership's past years' profits and a company's retained earnings. They share the characteristic that the amount has been finally settled for the year, and the theoretical amount each shareholder (or partner) is entitled to can be established. They can, in a sense, be seen as the amount a shareholder or partner has invested into the business. The features of partnership profits that do not suggest they have been invested by partners are also shared by retained earnings. Both retained earnings and partnership profits are at the disposal of the business until the decision is made to pay them out. Just as partners may not necessarily make any active decision to reinvest past profits, shareholders would not usually make any decision to reinvest profits in the business. For these reasons, the Commissioner's opinion is that payment of dividends from retained earnings can be viewed as sufficiently analogous to payments to partners of partnership past years' profits, such that both should be treated the same in determining interest deductibility.

93. Therefore, in the Commissioner's view, retained earnings can be treated as notional reinvestments by shareholders in the company and the replacement and repayment principle should apply. Interest is deductible on borrowings used to pay dividends to shareholders, to the extent that those profits were used in income earning.

94. The Commissioner considers that the *Roberts and Smith* principle does not apply where the borrowed funds are used to pay current year income to a shareholder. In paragraphs above 70—85 above, it was concluded that the *Roberts and Smith* principle cannot apply where a partnership uses borrowed funds to replace current year income. The basis for this conclusion was that individual partners do not have an immediate

entitlement to current year income, and therefore they cannot be considered to have invested the income into the partnership. Similarly, shareholders in a company do not have an immediate entitlement to the company's current year income, and therefore they cannot be considered to have invested that income into the company.

95. If company profits are distributed as bonus issues, then similarly the amount represented by the shares can be seen as capital able to be replaced under the replacement and repayment principle.

96. As already mentioned, interest incurred by companies will generally be deductible under section DB 7, the provision that gives companies in most situations an automatic deduction for interest, and that *Roberts and Smith* would be an alternative basis for deductibility for interest incurred on borrowed funds used to pay dividends.

Replacement of debt: BR Pub 10/18

97. BR Pub 10/18 applies where borrowed funds are used to replace and repay funds to the person who lent them to the taxpayer or partnership.

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

99. If the first refinancing takes on the character of the debt it replaces, then logically, subsequent refinancing should also inherit that character. Therefore, the Commissioner's opinion is that interest is deductible on borrowings used to repay other borrowings, to the extent those other borrowings can be traced to a use that gave rise to deductible interest.

100. Three issues can arise where the borrowed funds are used to repay funds to the person who lent them to the taxpayer or partnership. These issues are whether the *Roberts and Smith* replacement and repayment principle applies:

- where the original, replaced, funds were deductible under a statutory nexus other than the general permission (for example, section DB 7)
- where the lender's right is assigned to another person
- only if there is direct tracing between the original, replaced, funds and the borrowed funds.

These issues are considered in the following paragraphs.

Continuation of a statutory nexus

101. The general rule from *Roberts and Smith* is that borrowings may inherit the deductibility status of funds they repay. In some situations, the repaid funds may be deductible by the operation of a specified statutory nexus,

rather than the general rule that requires as a question of fact a sufficient connection with income. One relevant nexus is in section DB 7, which provides for automatic deductions for most companies, and the other is in section DB 8, which provides for deductions for companies investing in shares in a group company.

102. The nexus in each of these two sections is different in nature from the nexus in *Roberts and Smith*, where the replaced funds achieved the nexus by being used to derive income. Nevertheless, the Commissioner considers that the deductibility status should also be inheritable when deductibility is established through a statutory nexus. If it were not, and refinancing meant interest that had been deductible as a matter of law rather than fact was no longer deductible, Parliament's intention for sections DB 7 and DB 8 would be defeated. Therefore, the Commissioner's opinion is that *Roberts and Smith* applies to replacement and repayment of borrowed funds in respect of which deductibility is established under sections DB 7 and DB 8.

Application of Roberts and Smith where the lender's right is assigned

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

Whether direct tracing is required

104. The replacement and repayment principle requires identifying how the original funds were used, and identifying the use of the new debt to repay those original funds. Therefore, under the principle, the use of funds needs to be identified or "traced".

105. Given the compliance costs that may arise in some circumstances, consideration has been given to whether tracing is essential to the replacement and repayment principle. It is recognised that for some taxpayers, who have daily changes to their borrowings, the requirement may be difficult to fulfil.

106. One approach would be to allow a deduction if the refinancing loan is taken out and the first loan paid back about the same time. However, it seems likely that this "around the same time" requirement would not in practice operate to limit deductibility to arrangements within the principle, and would result in interest on any borrowing qualifying for deductibility.

107. An alternative is that the Commissioner would accept that a loan is a replacement unless it is used solely for a private or exempt use. However, that approach would, in the Commissioner's view, be too wide to be consistent with the statutory requirements, as any use of borrowings would satisfy the test (apart from sole private and exempt uses). The test would not be limited to replacement of funds that are returned to their owners. Without the element of replacement, there would not be a sufficient nexus with income. Uses of funds that would qualify would be those uses that would not seem to be within the intent of the interest

deductibility provision such as nil interest loans to sister companies, investments in companies prohibited from making distributions, and so on.

108. Therefore, the Commissioner takes the view that the replacement and repayment principle requires that borrowings should be traced to replacement of funds that satisfy the statutory nexus for deductibility. Taxpayers with few borrowings should usually be able to trace money. Taxpayers with more complicated borrowing practices will, in most case, be companies, for which interest will be deductible under section DB 7, without the need to satisfy the *Roberts and Smith* principle.

109. It should be remembered that all debt is subject to a tracing test. In several cases that considered the direct test of interest deductibility, the courts have held that the use of funds must be traced: for example, *Pacific Rendezvous Ltd* and *Brierley*.

When interest is not deductible under the Roberts and Smith principle

Introduction

110. Paragraphs 111 – 128 below discuss the situations where interest is not deductible under the *Roberts and Smith* replacement and repayment principle. These paragraphs are organised under the following headings:

- Goodwill and asset revaluations: BR Pub 10/14; BR Pub 10/15; BR Pub 10/16; BR Pub 10/17; BR Pub 10/18
- Subvention payments: BR Pub 10/19
- Sole traders
- Private use.

Goodwill and asset revaluations: BR Pub 10/14; BR Pub 10/15; BR Pub 10/16; BR Pub 10/17; BR Pub 10/18

111. BR Pub 10/14 to BR Pub 10/18 state that interest on borrowed funds will not be deductible under the *Roberts and Smith* replacement and repayment principle to the extent that the borrowed funds are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill.

112. As mentioned in paragraphs 81 and 82 above, in *Roberts and Smith* Hill J singled out internally generated goodwill as an amount in the partnership capital account that could not be replaced and repaid to partners, because it is not an amount that has been invested by someone in the business. Hill J explained that a payment of goodwill is not a "refund of a pre-existing capital contribution" (at p 4,390).

113. Glazebrook and James[6] have explained that goodwill cannot be distributed because after a purported distribution, it would still remain. Therefore, internally generated goodwill is not an amount that can be replaced and

[6] "*Taxation Implications of Company Law Reform*" by Susan Glazebrook and Jan James, New Zealand (1995) 1 NZJTLP 132 at p 157.

repaid to partners or shareholders with borrowed funds with a deductible result.

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

115. If purchased goodwill is revalued internally, the extent of the internal revaluation is not represented by an amount invested in the business that can be replaced and repaid. Therefore, interest on an amount borrowed purporting to replace goodwill to the extent that it is internally generated and to repay it to partners or shareholders, will not be deductible.

116. Similarly, amounts that are attributable to asset revaluations cannot be replaced and repaid and therefore are not within the *Roberts and Smith* principle.

Subvention payments: BR Pub 10/19

117. BR Pub 10/19 applies to interest on borrowed funds used to make a payment under section IC 5 to another company.

118. A company may use borrowed funds to make a payment under section IC 5 to another company that has a net loss and is in the same group of companies. This payment is commonly referred to as a "subvention payment". An issue arises as to whether the interest incurred on borrowed funds used to make subvention payments will be deductible in accordance with the replacement and repayment principle.

119. In many cases, this issue will not arise in practice. Interest incurred by companies is generally deductible under section DB 7. Therefore, interest incurred by a company on borrowed funds used to make a subvention payment will generally be deductible under that section.

120. However, if section DB 7 does not apply, then the application or not of *Roberts and Smith* becomes relevant. The replacement and repayment principle is that interest is deductible on borrowings repaying funds paid into the business or income earning process. A subvention payment is a payment between companies in a group to reduce the overall tax burden of the group. It is not a replacement of an amount previously advanced by the recipient company, or an amount repaid to shareholders for amounts they invested in the paying company.

121. Therefore, in the Commissioner's view, the use of borrowed funds to pay a subvention payment does not satisfy the replacement and repayment principle from *Roberts and Smith*, and interest incurred on borrowed funds used to pay a subvention payment is not deductible under that principle.

122. BR Pub 10/19 states that interest on borrowed funds used to make a subvention payment will not be deductible under the general permission on any basis. In the Commissioner's view, a subvention payment does not have a sufficient connection with the income earning activities of the company making the payment. The payment is made after the derivation of income by the company and when its annual profits are determined. The subvention payment reduces the tax liability of the company, thereby minimising the overall tax liability of the group of companies.

Sole traders

123. The principle in *Roberts and Smith* is that interest is deductible on borrowed funds used to repay funds to investors in an income earning activity or business. This principle applies where an entity—whether a partnership or a company—borrows money and uses it to return amounts invested in the partnership or company. Individuals with an income earning activity or business but who do not operate through a company or any other structure (referred to as a "sole trader"), do not have a separate entity in which to invest their money. If an individual invests money used for private purposes into a business or activity they carry on as a sole trader, there has been no change in ownership of that money. It is artificial to describe a transaction with oneself as a replacement and repayment of funds. Therefore, in the Commissioner's opinion, the replacement and repayment principle cannot apply to sole traders arguing that borrowing funds have the effect of returning their capital or past years' profits.

124. Although a partnership is not a separate legal entity from its partners, as discussed above, there is a distinction between property owned by a partnership and property owned by individual partners. Therefore, in contrast to sole traders, there can be a valid legal transfer of property from a partnership to a partner, and the *Roberts and Smith* principle can apply to partnerships.

125. Professor Parsons raised some arguments that support applying the *Roberts and Smith* principle to individuals in "Roberts and Smith: Principles of Interest Deductibility".[7] He said that separate accounting records may personify a separate entity. Secondly, he argued that the legislation recognises a sole trader in business as separate from the sole trader in a private capacity, because the deductibility provisions distinguish between individuals in business and individuals not in business. However, he considered that these arguments may be tenuous, and that it will be difficult for a sole trader to establish that interest on borrowings used to withdraw capital is not prohibited as private. Also, Professor Parsons considered these arguments in the context of an interpretation of *Roberts and Smith* that is much broader than the interpretation taken by the Commissioner.

126. Although an individual cannot replace capital, an individual can, however, deduct interest incurred in using borrowed funds to replace a debt owed to a third party, where the amount first borrowed was used directly in the individual's income earning activity or business. As the borrowed funds replaced are repaid to a separate entity, the third party lender, the funds are able to be repaid, and so the *Roberts and Smith* principle can apply.

Private use

127. The Commissioner's view is that when borrowings are used to return partners' capital, the interest may be deductible despite the fact that the direct use of the borrowed funds may be for the private use of the taxpayer. The reason is that the borrowed funds are also used for a concurrent income-related use—the replacement of funds used in deriving income.

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[7] See n 2

128. That situation compares with the one where the borrowed funds replace borrowed funds that are being used solely for private use. In that situation, the interest on the replacing funds will not be deductible.

Other Matters

Australian Tax Office's view on Roberts and Smith

129. The Australian Tax Office has issued a ruling on its interpretation of *Roberts and Smith*. The Australian Tax Office's view is similar to the Commissioner's view; see TR 95/25 *Income Tax: deductions for interest under subsection 51(1) of the Income Tax Assessment Act 1936 following FC of T v Roberts; FC of T v Smith*, issued 29 June 1995. Two addenda have been added to TR 95/25, primarily to update the references in the ruling to the Australian Income Tax Assessment Act 1997. A consistent interpretation of *Roberts and Smith* was applied in TR 2005/12 *Income tax: deductibility of interest expenses incurred by trustees on funds borrowed in connection with payments of distributions to beneficiaries*, issued 6 July 2005. TR 2005/12 relates to borrowings used to repay amounts to beneficiaries.

Applicability of Roberts and Smith to the refinancing of investments in QCs, CFCs and FIFs

130. If interest on funds invested in qualifying companies, controlled foreign companies or foreign investment funds is deductible then, applying *Roberts and Smith*, interest on funds used to refinance that investment will be deductible. *Roberts and Smith* is concerned with refinancing of investments, and when it applies, the deductibility status of the initial investment is taken on by the replacing funds. It is not necessary to understand the reasons for the deductibility or otherwise of the initial investment to understand the *Roberts and Smith* principle. Because the deductibility of interest incurred in relation to qualifying companies, controlled foreign companies and foreign investment funds is not relevant to an understanding of how the *Roberts and Smith* case applies, the issue is not dealt with further in this commentary or in the Rulings.