

i This is a reissue of BR Pub 10/14-10/19. For more information about earlier publications of these Public Rulings see the Commentary to this Ruling.

INCOME TAX — INTEREST DEDUCTIBILITY—*ROBERTS AND SMITH*— BORROWING TO REPLACE AND REPAY AMOUNTS INVESTED IN A BUSINESS OR OTHER INCOME-EARNING ACTIVITY

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

PUBLIC RULING - BR Pub 15/04

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

Taxation Law

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

This Ruling applies in respect of s DB 6.

Specifically, this Ruling applies the replacement and repayment principle in *FC of T v Roberts; FC of T v Smith* 92 ATC 4,380 (the *Roberts and Smith* principle).

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of funds by a partnership where:

- the borrowed funds are used to return capital to a partner who previously invested that capital in the partnership;
- interest is incurred on the borrowed funds at an arm's length rate;
- the partnership derives assessable and/or excluded income, or carries on a business for the purpose of deriving such income;
- the partnership derives the income or carries on the business both at the time the funds are borrowed and when interest is incurred; and
- the interest is not deductible to the partner under s DB 7 (Interest: most companies need no nexus with income).

The Arrangement does not include arrangements where, or to the extent that, the partnership uses the borrowed funds to make a payment to the partner:

- of current year income;
- relating to unrealised asset revaluations; or
- relating to internally generated goodwill.

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

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- The partner can deduct their share of interest incurred on the borrowed funds to the extent that the borrowed funds replace the partner's capital contributions and those capital contributions were:
 - directly used in carrying on the partnership's business for the purpose of deriving income; or
 - directly used in deriving the partnership's income; or
 - used to repay other funds borrowed by the partnership and interest incurred on those funds had been deductible.

This Ruling is subject to subpart FE (Interest apportionment on thin capitalisation). The purpose of subpart FE is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer.

The period for which this Ruling applies

This Ruling will apply for an indefinite period beginning on 24 May 2015.

This Ruling is signed by me on 30 April 2015.

Grant Haley
Manager, OCTC

INTEREST DEDUCTIBILITY—FUNDS BORROWED BY A PARTNERSHIP TO RETURN PAST YEARS' PROFITS TO A PARTNER

PUBLIC RULING - BR Pub 15/05

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

Taxation Law

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

This Ruling applies in respect of s DB 6.

Specifically, this Ruling applies the replacement and repayment principle in *FC of T v Roberts*; *FC of T v Smith* 92 ATC 4,380 (the *Roberts and Smith* principle).

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of funds by a partnership where:

- the borrowed funds are used to pay past years' profits to a partner;
- interest is incurred on the borrowed funds at an arm's length rate;
- the partnership derives assessable and/or excluded income, or carries on a business for the purpose of deriving such income;
- the partnership derives the income or carries on the business both at the time the funds are borrowed and when interest is incurred; and
- the interest is not deductible to the partner under s DB 7 (Interest: most companies need no nexus with income).

The Arrangement does not include arrangements where, or to the extent that, the partnership uses the borrowed funds to make a payment to the partner:

- of current year income;
- relating to unrealised asset revaluations; or
- relating to internally generated goodwill.

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

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- The partner can deduct their share of interest incurred on the borrowed funds to the extent that the borrowed funds are used to pay past years' profits to the partner and the past years' profits were:
 - directly used in carrying on the partnership's business for the purpose of deriving income; or
 - directly used in deriving the partnership's income; or

- used to repay other funds borrowed by the partnership and interest incurred on those funds had been deductible.

This Ruling is subject to subpart FE (Interest apportionment on thin capitalisation). The purpose of subpart FE is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer.

The period for which this Ruling applies

This Ruling will apply for an indefinite period beginning on 24 May 2015.

This Ruling is signed by me on 30 April 2015.

Grant Haley
Manager, OCTC

INTEREST DEDUCTIBILITY—FUNDS BORROWED BY A COMPANY TO REPURCHASE SHARES

PUBLIC RULING - BR Pub 15/06

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

Taxation Law

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

This Ruling applies in respect of s DB 6.

Specifically, this Ruling applies the replacement and repayment principle in *FC of T v Roberts*; *FC of T v Smith* 92 ATC 4,380 (the *Roberts and Smith* principle).

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of funds by a company where:

- the borrowed funds are used to repurchase shares from a shareholder of the company as authorised by the Companies Act 1993;
- interest is incurred on the borrowed funds at an arm's length rate;
- the company derives assessable and/or excluded income, or carries on a business for the purpose of deriving such income;
- the company derives the income or carries on the business both at the time the funds are borrowed and when interest is incurred; and
- the interest is not deductible to the company under s DB 7 (Interest: most companies need no nexus with income).

The Arrangement does not include arrangements where, or to the extent that, the company uses the borrowed funds to make a payment to the shareholder:

- of current year income;
- relating to unrealised asset revaluations; or
- relating to internally generated goodwill.

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

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- The company can deduct interest incurred on the borrowed funds to the extent that the repurchased shares were funded by the shareholder's capital contributions or past years' profits, and those capital contributions or past years' profits were:

- directly used in carrying on the company's business for the purpose of deriving income; or
- directly used in deriving the company's income; or
- used to repay other funds borrowed by the company, and interest incurred on those funds had been deductible.

This Ruling is subject to subpart FE (Interest apportionment on thin capitalisation). The purpose of subpart FE is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer.

The period for which this Ruling applies

This Ruling will apply for an indefinite period beginning on 24 May 2015.

This Ruling is signed by me on 30 April 2015.

Grant Haley
Manager, OCTC

INTEREST DEDUCTIBILITY—FUNDS BORROWED BY A COMPANY TO PAY DIVIDENDS

PUBLIC RULING - BR Pub 15/07

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

Taxation Law

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

This Ruling applies in respect of s DB 6.

Specifically, this Ruling applies the replacement and repayment principle in *FC of T v Roberts*; *FC of T v Smith* 92 ATC 4,380 (the *Roberts and Smith* principle).

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of funds by a company where:

- the borrowed funds are used to pay dividends to a shareholder of the company;
- interest is incurred on the borrowed funds at an arm's length rate;
- the company derives assessable and/or excluded income, or carries on a business for the purpose of deriving such income;
- the company derives the income or carries on the business both at the time the funds are borrowed and when interest is incurred; and
- the interest is not deductible to the company under s DB 7 (Interest: most companies need no nexus with income).

The Arrangement does not include arrangements where, or to the extent that, the company uses the borrowed funds to make a payment to the shareholder:

- of current year income;
- relating to unrealised asset revaluations; or
- relating to internally generated goodwill.

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

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- The company can deduct interest incurred on the borrowed funds to the extent that the dividends were funded by the shareholder's capital contributions or past years' profits, and those capital contributions or past years' profits were:
 - directly used in carrying on the company's business for the purpose of deriving income; or
 - directly used in deriving the company's income; or

- used to repay other funds borrowed by the company, and interest incurred on those funds had been deductible.

This Ruling is subject to subpart FE (Interest apportionment on thin capitalisation). The purpose of subpart FE is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer.

The period for which this Ruling applies

This Ruling will apply for an indefinite period beginning on 24 May 2015.

This Ruling is signed by me on 30 April 2015.

Grant Haley
Manager, OCTC

INTEREST DEDUCTIBILITY—FUNDS BORROWED TO REPAY DEBT

PUBLIC RULING - BR Pub 15/08

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

Taxation Law

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

This Ruling applies in respect of s DB 6.

Specifically, this Ruling applies the replacement and repayment principle in *FC of T v Roberts*; *FC of T v Smith* 92 ATC 4,380 (the *Roberts and Smith* principle).

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of funds by a taxpayer or partnership where:

- the borrowed funds are used to replace and repay existing borrowed funds to the person who invested or lent the existing funds to the taxpayer or partnership;
- interest is incurred on the borrowed funds at an arm's length rate;
- the taxpayer or partnership derives assessable and/or excluded income, or carries on a business for the purpose of deriving such income;
- the taxpayer or partnership derives the income or carries on the business both at the time the funds are borrowed and when interest is incurred; and
- the interest is not deductible under s DB 7 (Interest: most companies need no nexus with income).

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

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Interest incurred on the borrowed funds will be deductible to the extent that the existing funds that are replaced and repaid had been used:
 - directly in deriving a taxpayer's or partnership's income or in carrying on their business for the purpose of deriving income;
 - by a company and the interest was deductible under s DB 7;
 - by a company to purchase shares and the interest was deductible under s DB 8;
 - for one of the Arrangements in BR Pub 15/04–BR Pub 15/07 and met the requirements for interest deductibility in those Rulings;
 - to retain income-earning assets and satisfied the elements in *Public Trustee v CIR* [1938] NZLR 436 as set out in the Commissioner's Interpretation Statement IS0082: "Interest deductibility—*Public Trustee v CIR*", *Tax Information Bulletin* Vol 18, No 6 (July 2006): 9; or

- to repay other borrowed funds (either directly or through a series of borrowings used to repay borrowings) where interest had been deductible.

This Ruling is subject to subpart FE (Interest apportionment on thin capitalisation). The purpose of subpart FE is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer.

The period for which this Ruling applies

This Ruling will apply for an indefinite period beginning on 24 May 2015.

This Ruling is signed by me on 30 April 2015.

Grant Haley
Manager, OCTC

INTEREST DEDUCTIBILITY—FUNDS BORROWED TO MAKE A PAYMENT TO A GROUP COMPANY UNDER SECTION IC 5

PUBLIC RULING - BR Pub 15/09

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

Taxation Law

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

This Ruling applies in respect of s DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of funds by a company to make a payment under s IC 5 (Company B using Company A's tax loss) to another company that has a net loss. Interest is incurred on the borrowed funds and the company is unable to claim a deduction under s DB 7 (Interest: most companies need no nexus with income).

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Interest is not deductible in the circumstances described in the Arrangement.

The period for which this Ruling applies

This Ruling will apply for an indefinite period beginning on 24 May 2015.

This Ruling is signed by me on 30 April 2015.

Grant Haley
Manager, OCTC

COMMENTARY ON PUBLIC RULINGS BR PUB 15/04-15/09

This commentary is not a legally binding statement. It is intended to help readers understand and apply the conclusions in Public Rulings BR Pub 15/04-15/09 (“the Rulings”).

The Rulings and commentary express the Commissioner’s view of the principle set out in the Australian Full Federal Court decision *FC of T v Roberts; FC of T v Smith* 92 ATC 4,380 (the *Roberts and Smith* principle). BR Pub 15/04–15/08 specifically concern deductibility under the *Roberts and Smith* principle and do not purport to be the Commissioner’s view on all aspects of interest deductibility. However, BR Pub 15/09 is of broader application and considers interest deductibility under s DB 6 more generally.

BR Pub 15/04 to 15/08 apply to Arrangements involving the replacement and repayment of existing funding. These Rulings apply to five specific situations where the Commissioner is satisfied that interest incurred on borrowings will be deductible under the *Roberts and Smith* principle. There may be other fact situations not covered by these Rulings where interest may potentially be deductible (either under the *Roberts and Smith* principle or s DB 6 more generally). However, such considerations are outside the scope of these binding Rulings.

Legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this commentary.

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Summary

1. The purpose of the Rulings is to clarify the test for interest deductibility under s DB 6 in specific fact situations where funds are borrowed to replace and repay existing funding. Other than BR Pub 15/09 (subvention payments), the Rulings apply the principle established in *Roberts and Smith* and do not focus on interest deductibility generally.
2. Expenditure incurred by a person is generally deductible where a sufficient nexus exists with deriving income or carrying on a business for the purpose of deriving income. In the interest deductibility context, the Commissioner considers this nexus is established where the borrowed funds are directly used to derive income or are used in carrying on a business for the purpose of deriving income.
3. The *Roberts and Smith* principle provides that a sufficient nexus will also exist where:
 - a partnership or taxpayer incurs interest on borrowed funds;
 - the borrowed funds are used to replace existing funding and to repay that funding to the person who invested or lent the funds; and
 - the existing funding had been used by the partnership or taxpayer to derive income or in carrying on a business for the purpose of deriving income.
4. The nexus is established through the new funding replacing existing funding. The existing funding must have had a sufficient connection with income, or interest must have otherwise been deductible under other provisions (such as ss DB 7 or DB 8).
5. Capital contributions, past years' profits and debt are all forms of existing funding that the Commissioner is satisfied are capable of being replaced. This is not to say that these are the only situations where interest may be deductible, or that interest would not otherwise be deductible under general principles. The Rulings apply the Commissioner's view of how the *Roberts and Smith* principle applies to the specific Arrangements covered by each Ruling.

Background

6. The Rulings are reissues of BR Pub 10/14–10/19, which expire on 23 May 2015. BR Pub 10/14–BR Pub 10/19 were published in *Tax Information Bulletin* Vol 22, No 11 (December 2010) and applied for the period beginning on 23 May 2010 and ending on 23 May 2015.

Scope of the Rulings and commentary

7. The Rulings and commentary are intended to have the same scope and effect as the previous Rulings and commentary in BR Pub 10/14–10/19.

BR Pub 15/04–15/08 apply to a partnership, company or other taxpayer, and consider the deductibility of interest in specific fact situations under s DB 6 and the *Roberts and Smith* principle. BR Pub 15/09 states that interest on borrowed funds used to make a subvention payment to a group company (under s IC 5) is not deductible under s DB 6.

8. The Rulings do not apply to look-through companies. A look through company is generally not a “company” under s YA 1 for tax purposes so BR Pub 15/06, 15/07 and 15/09 will not apply. Additionally, the Rulings relating to partnerships (BR Pub 15/04 and 15/05) will not apply. BR Pub 15/08 could potentially apply to the look through owners, each of whom may be a “taxpayer” (given that look through companies are transparent under s HB 1). Look through companies have not been expressly included in the Rulings because, at the time of publishing the Rulings, the tax rules for closely-held companies and look-through companies were under review. However, the Commissioner has issued specific public items on interest deductibility and look-through companies. These are:
 - QB 11/03: “Income Tax — look-through companies and interest deductibility” *Tax Information Bulletin* Vol 23, No 10 (December 2011): 16.
 - QB 12/08: “Income Tax — look-through companies: interest deductibility on funds borrowed to repay shareholder current accounts” *Tax Information Bulletin* Vol 24, No 6 (July 2012): 70.
 - QB 12/09: “Income Tax — look-through companies: interest deductibility where funds are borrowed to make a payment to shareholders to reflect an asset revaluation” *Tax Information Bulletin* Vol 24, No 6 (July 2012): 72.
9. The Rulings do not apply to arrangements where interest is deductible to a company under s DB 7. This is because s DB 7 provides an automatic deduction for interest incurred by most companies. A company does not need to apply these Rulings if s DB 7 applies. However, some companies cannot apply s DB 7 and so the Rulings are still relevant for those companies.
10. For the avoidance of doubt, the Rulings do not apply to arrangements that are subject to subpart BG. Subpart BG applies to a tax avoidance arrangement, which is void as against the Commissioner for income tax purposes.
11. The deductibility of interest is subject to the thin capitalisation rules in subpart FE. Therefore, the application of the Rulings is also subject to the application of those rules. The application of the thin capitalisation rules is outside the scope of the Rulings and commentary.
12. The Rulings are concerned with the deductibility of interest under the *Roberts and Smith* principle. Understanding the application of the *Roberts and Smith* principle does not require revisiting the reason for the deductibility of interest on the existing funding. Therefore, this commentary does not consider the reasons for the deductibility of the interest on the existing funding in any detail.

Application of the Legislation

13. The purpose of the following analysis is to provide guidance for understanding and applying the conclusions reached in the Rulings.
14. The analysis does not consider general interest deductibility principles in detail. It is intended to provide guidance for certain specific situations (set out in the Arrangements described in BR Pub 15/04 – 15/08) which the Commissioner is satisfied are covered by the *Roberts and Smith* principle.
15. The analysis will first briefly set out the general statutory provisions and case law on interest deductibility in New Zealand. The analysis will then consider the application of *Roberts and Smith* in New Zealand and explain how the *Roberts and Smith* principle applies to the specific Arrangements in the Rulings.

Interest deductibility – relevant provisions

Section DA 1

16. A person is allowed a deduction for expenditure incurred if the expenditure has a sufficient nexus with income. Section DA 1(1) allows a deduction to the extent that expenditure was incurred in deriving assessable and/or excluded income or in the course of carrying on a business for the purpose of deriving such income. Section DA 1(1) is known as the “general permission”.
17. For ease of reference, this commentary refers to the nexus requirement in s DA 1(1) as a sufficient connection with “deriving income” or “carrying on a business”.
18. The general permission is subject to the general limitations in s DA 2. These include limitations for expenditure of a capital or private nature.

Section DB 6

19. The Rulings specifically concern interest deductibility under s DB 6, in certain situations.
20. Section DB 6(1) provides that a person is allowed a deduction for interest incurred. Section DB 6(4) provides that the general permission in s DA 1(1) must be satisfied. However, the capital limitation in s DA 2(1) is overridden.
21. Therefore, a deduction is available where a person incurs interest (whether or not it is of a capital nature) and:
 - the interest was incurred in deriving income or in carrying on a business;
 - the general limitations in s DA 2(2)–(6) do not apply; and
 - the deduction is not denied under s DB 1 (interest on unpaid taxes).

Section DB 7

22. Under s DB 7 certain companies are allowed a deduction for interest incurred.
23. Unlike s DB 6, the company does not need to satisfy the nexus requirement in s DA 1(1). Therefore, most companies will rely on s DB 7

to obtain deductions for interest. Section DB 6 and the *Roberts and Smith* principle will not be relevant for such companies.

24. However, certain companies cannot use s DB 7. Section DB 7 does not apply to:
- Qualifying companies.
 - Companies that derive exempt income or that are part of a wholly-owned group where a company in the group derives exempt income. This does not include exempt income that is dividends, a disposal of a company's own shares or that relates to stake money and a breeding business.
 - Non-resident companies, unless interest is incurred in the course of carrying on a business through a fixed establishment in New Zealand.
 - Interest on unpaid tax under s DB 1.
 - Expenditure related to certain assets under subpart DG (ie, mixed-use assets).
25. Although s DB 7 does not refer to look-through companies, a look-through company is not included in the definition of a "company" in s YA 1 for tax purposes.
26. The effect of s DB 7 is discussed in more detail in a discussion on the Taxation (Taxpayer Assessment and Miscellaneous Provisions) Act 2001 in *Tax Information Bulletin* Vol 13, No 11 (November 2001): 34.

Interest deductibility – general principles

27. The general principles for interest deductibility in New Zealand are established in *Pacific Rendezvous Ltd v CIR* (1986) 8 NZTC 5,146 (CA), *Eggers v CIR* (1988) 10 NZTC 5,153 (CA) and *CIR v Brierley* (1990) 12 NZTC 7,184 (CA). The deductibility of interest requires a sufficient connection between the borrowed funds and deriving income or carrying on a business. In most cases, the test is satisfied when borrowed funds are directly used to derive income, in that the funds are used to acquire income-earning assets.
28. In *Roberts and Smith* and *Public Trustee v CIR* [1938] NZLR 436 (CA), the courts held that interest may be deductible in limited cases where borrowed funds were not directly used in deriving income.
29. *Roberts and Smith* and *Public Trustee* concern situations where borrowed funds were used "in relation to" income-earning assets, but were not "directly used" in deriving income. *Public Trustee* is discussed in IS0082: "Interest Deductibility—*Public Trustee v CIR*" *Tax Information Bulletin* Vol 18, No 6 (July 2006): 9. The *Roberts and Smith* principle is relevant for determining whether interest is deductible when borrowed funds are used to replace and repay existing funding.

The *Roberts and Smith* principle

30. *Roberts and Smith* concerned interest incurred by a partnership. The partnership borrowed funds so it could repay capital contributions to existing partners. This was because new partners were joining the partnership, but the cost of contributing an equal amount of capital was too high. The partners decided to decrease the amount of the existing partners' capital. They did this by borrowing funds and using the funds to

repay the capital contributions to the partners. The Australian Full Federal Court held that the interest incurred on this borrowing was deductible.

31. The case is relevant in New Zealand given the similarity in the wording of the general deductibility provisions. The Australian provision that applied at the time was s 51(1) of the Income Tax Assessment Act 1936. That section provided that losses or outgoings were deductible to the extent that they were incurred in gaining or producing assessable income, or were necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.
32. Hill J considered that interest was deductible irrespective of how the partner used the funds that were repaid to them. This is because the new funding takes on the character of the existing funding that is replaced. The existing funding had been employed in the partnership's business for the purpose of deriving income. Hill J stated at 4,388-4,389:

...let it be assumed that there are undrawn partnership distributions available at any time to be called upon by the partners. The partnership borrows from a bank at interest to fund the repayment to one of the partners who has called up the amount owing to him. That partner uses the moneys so received to purchase a house. A tracing approach, if carried beyond the payment to the partner, encourages the argument raised by the Commissioner in the present case that the funds were used for the private purpose of the partner who received them. But that fact will not preclude the deductibility of the outgoing. **The funds to be withdrawn in such a case were employed in the partnership business; the borrowing replaces those funds and the interest incurred on the borrowing will meet the statutory description of interest incurred in the gaining or production by the partnership of assessable income.**

In principle, such a case is no different from the borrowing from one bank to repay working capital originally borrowed from another; **the character of the refinancing takes on the same character as the original borrowing and gives to the interest incurred the character of a working expense.** Both these cases would equally satisfy the second limb of s. 51(1). In no sense could the interest outgoing in either case be characterised as private or domestic. **Similarly, where moneys are originally advanced by a partner to provide working capital for the partnership, interest on a borrowing made to repay these advances will be deductible, irrespective of the use which the partner repaid makes of the funds.** [Emphasis added]

33. Hill J considered that the deduction was limited to the extent that the borrowed funds replaced the amount of capital actually contributed into the partnership by the partners. Hill J explained this limitation at 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 repayment of capital invested. The partnership assets would remain constant. The goodwill would still be worth \$125,000; it would not have been distributed to the partners, nor could it be.

On those 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 repayment of funds invested in the business, lacks**

the essential connection with the income producing activities of the partnership or, in other words, the partnership business. ...

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

34. Hill J considered that interest was only deductible in circumstances where the borrowed funds were replacing funds invested in the partnership business by a partner. The types of existing funding Hill J considered could be replaced include partnership capital, undrawn profit distributions and advances by the partners. The element of replacement of existing funding invested by the partner is critical. Otherwise, the repayment of funds to the partner would lack the essential connection with the partnership's income producing activities or business.
35. Hill J explained that the principle only applies to the repayment of funds to the person who invested the funds in the business (or other income deriving activity). Types of funding that cannot be said to have been invested by a person include internally generated goodwill and asset revaluations. A payment relating to these types of funding is not a replacement and repayment of funds to the person who invested the funds into the business.
36. This replacement and repayment principle is referred to in this commentary and the Rulings as the "*Roberts and Smith* principle". The *Roberts and Smith* principle applies where:
 - borrowed funds are used to replace existing funding;
 - the existing funding is repaid to the person who invested it; and
 - the existing funding had a sufficient connection with deriving income or carrying on the business.
37. Capital contributions, undrawn profits from previous years and advances are all existing funding that is capable of being replaced.
38. There are two aspects of the *Roberts and Smith* principle that require further discussion. The first concerns the use of the borrowed funds. The second concerns the requirement that the funds replace and repay existing funds to the person who invested those funds.

The use of the borrowed funds

39. The deductibility of interest under s DB 6 generally requires that the borrowed funds are directly used in deriving income or in carrying on a business for the purpose of deriving income. Three questions arise regarding the use of the borrowed funds in the context of the *Roberts and Smith* principle. These are:
 - If borrowed funds are paid directly to a partner, how can this be said to be used in carrying on the partnership's business for the purpose of deriving income?
 - If a partner uses the repaid funds for a private use, how can interest incurred on those funds be deductible to the partner?
 - How can one particular debt, with its own parties, conditions and direct uses, inherit the deductibility status of a different debt?

If borrowed funds are paid directly to a partner, how can this be said to be used in carrying on the partnership's business for the purpose of deriving income?

40. This question concerns situations where the borrowed funds are paid directly to a partner, such as in repayment of a capital contribution.
41. The Commissioner considers that there is a replacement of the existing funding in the partnership's accounts or financial statements. That is, equity is reduced (through reducing the capital contributions) and debt is increased (through the new borrowings replacing those contributions). The new borrowings can be said to replace the capital contributions that were invested into the partnership by the partner, and the capital contributions had been used in the partnership's business.
42. Therefore, the Commissioner considers that, even though borrowed funds may be paid directly to a partner to repay the partner's capital contributions, the borrowed funds replace those contributions in the partnership's accounts and can be said to be used in carrying on the partnership's business for the purpose of deriving income.

If a partner uses the repaid funds for a private use, how can interest incurred on those funds be deductible to the partner?

43. This question relates to the nature of partnerships. A partnership is transparent for tax purposes under s HG 2. This means that the partners deduct their share of the partnership's expenditure.
44. If a partner's capital contributions are repaid through borrowed funds and the partner uses the repaid funds for a private or domestic use, it could be argued that the borrowed funds can be traced to a private use. Therefore, it could be argued that s DA 2(2) could limit the deductibility of private or domestic expenditure in such a case.
45. However, for the purpose of a partner's obligations in their capacity as a partner in a partnership, s HG 2 provides that the partner is treated as carrying on the partnership's activity. The partner is treated as having the partnership's status, intention and purpose. So, it is the use of the borrowings by the partnership that is relevant (and not the partner's secondary use of the funds repaid to them). Further discussion on the nature of partnerships and the ownership of partnership property is set out at [70] to [79] below.
46. The Commissioner considers that, under the *Roberts and Smith* principle, the relevant use of the borrowed funds is to return capital to the partners. Because that capital had been used in carrying on the partnership's business, its replacement is also considered to be used in carrying on the business. The Commissioner considers that the partners' use of the funds paid to them is not relevant for the purposes of determining deductibility under the *Roberts and Smith* principle.

How can one particular debt, with its own parties, conditions and direct uses, inherit the deductibility status of a different debt?

47. This question relates to a basic principle of deductibility, which is that the deductibility of an expense depends on the circumstances in which that expense is incurred. In *Roberts and Smith*, Hill J simply states that interest on a debt that replaces another debt is deductible. However, that statement is not an explanation, and it is not entirely clear that a debt replacing another debt necessarily inherits its deductibility status.

48. A contrary approach was taken in Canada, in *Interior Breweries Ltd v Minister of National Revenue* [1955] CTC 143; 55 DTC 1090. Cameron J of the Exchequer Court held that interest was not deductible where borrowed funds were used to repay 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 148). However, legislation was introduced in Canada to reverse the effect of that decision, and it appears that the decision has not been applied in any later cases.
49. The Commissioner considers it likely that *Interior Breweries* would not be followed by the courts in New Zealand or Australia. Nevertheless, the New Zealand and Australian courts have generally been cautious about allowing deductions relating to indirect uses of borrowed funds (particularly in the lower courts in situations where there has been private use of funds). However, the courts have allowed deductions for certain indirect uses of funds in particular circumstances in cases such as *Roberts and Smith* and *Public Trustee*. *Public Trustee* concerned the deductibility of interest on funds that were borrowed to pay death duties and to avoid a sale of income-earning assets. Nexus with income existed in the particular circumstances through the use of the funds to pay the debts and, therefore, to retain income-earning assets.
50. Cases such as *Public Trustee* and *Roberts and Smith* are examples of the limited situations and particular circumstances where courts have accepted that interest may be deductible when borrowed funds are not directly used to derive income. In the *Roberts and Smith* context, this is when borrowed funds replace and repay existing funding to the person who invested those funds, and the existing funding had the sufficient nexus with income.

The borrowed funds must replace and repay existing funds to the person who invested those funds

51. A further aspect of the *Roberts and Smith* principle is that the borrowed funds must replace existing funding and repay the person who invested those existing funds in the business.
52. Hill J said at 4,390 of *Roberts and Smith*:

The provision of funds to the partners in circumstances where that provision is not a repayment of funds invested in the business, lacks the essential connection with the income producing activities of the partnership or, in other words, the partnership business.
53. Where borrowed funds are used to replace and repay existing funds to the person who invested or lent those funds to the business (or other income-producing activity), the borrowed funds will take on the deductibility status of the existing funds. So, if the existing funds had a sufficient connection with the carrying on of the business or the derivation of income, the borrowed funds that take the place of the existing funds will also take on that connection. The *Roberts and Smith* principle will not apply without this aspect of replacement and repayment to the person who invested or lent funds to the business (or other income-producing activity).
54. This is not to say that interest on other borrowed funds is not otherwise deductible, but such considerations are outside the scope of these Rulings and this commentary. For example, a business might borrow to acquire new income-earning assets. While interest on such borrowings may be deductible under s DB 6, this is under the operation of general interest deductibility principles and not through the application of the *Roberts and*

Smith principle. Similarly, a business might borrow funds to make a nil interest loan, to invest in a company that was barred from making distributions or to pay criminal fines. In such cases, no underlying connection with income exists and so interest would not be deductible under s DB 6 in any circumstance. The *Roberts and Smith* principle would not apply to make such interest deductible.

Sole traders

55. Individuals, who do not operate their business (or otherwise derive income) through a company, partnership or other structure, do not have a separate entity in which to invest their funds. In such a case, no change in the ownership of those funds occurs. The Commissioner considers that the *Roberts and Smith* principle does not apply in these circumstances.
56. Sole traders or individuals may consider that borrowed funds have the effect of returning capital or past years' profits to them. However, it is artificial for a person to describe a transaction with themselves as a "replacement and repayment" of an investment.
57. However, a sole trader or individual can deduct interest on borrowed funds where the borrowed funds replace and repay a debt owed to a third party lender and the debt had been used directly in deriving income or in carrying on a business. The Commissioner considers that, as the funds in such a situation are repaid to a separate person, the *Roberts and Smith* principle can apply.

Relevant New Zealand cases

58. To date, *Roberts and Smith* has not been applied by a New Zealand court. There are two Taxation Review Authority (TRA) cases on similar issues, but these were decided prior to *Roberts and Smith*.
59. The approach of the TRA in *Case P56* (1992) 14 NZTC 4,386 is similar to the Commissioner's interpretation of *Roberts and Smith*. In *Case P56*, partners in a partnership borrowed funds to withdraw more than they had invested in the partnership. Judge Willy concluded that the interest was not deductible. Judge Willy said at 4,396 that if the partners had replaced capital investments they would have been entitled to interest deductions.
60. A different conclusion was reached by the TRA in *Case M127* (1990) 12 NZTC 2,817. In *Case M127*, partners in a partnership required money for personal reasons. The partners had invested \$76,000 of equity into the business. The partnership paid \$70,000 to the partners, putting the partnership account into overdraft. The partnership borrowed to repay the overdraft. The effect on the partnership's balance sheet was that the capital contributed by the partners was replaced by the borrowed funds. The partners argued that the borrowed funds were used in producing income. However, the TRA concluded that the use of the funds was for the partners' private use, and interest was not deductible. It appears that the partners did not argue that the borrowed funds replaced and repaid their equity contributions. It also appears that such a principle was not considered by the TRA.
61. As previously stated, the general test for interest deductibility, as established in cases such as *Pacific Rendezvous*, *Eggers* and *Brierley*, requires borrowed funds to be directly used or "traced" to income. The *Roberts and Smith* principle effectively applies an "indirect" tracing test. That is, the borrowed funds must replace existing funds that were invested

in the business, and those existing funds must have had the sufficient connection with income. However, this principle does not require that the borrowed funds are also traced to the use of the person who was repaid. In *Roberts and Smith*, Hill J said at 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 by the partnership of assessable income.

62. A strict tracing approach was applied by the TRA in *Case M127*. This approach indicated that the loan was used to repay a business overdraft, and the overdraft was traced to private use by the partners. However, under the approach taken in *Roberts and Smith*, the loan could be seen as replacing the overdraft and the overdraft replaced the partners' equity invested in the business. The partners' equity was directly used to fund the partnership's business. Therefore, a sufficient connection with income would exist under this approach. In the absence of such a principle at the time *Case M127* was decided, Judge Bathgate held that the borrowed funds were used for private purposes.
63. The Commissioner considers that a decision of the Full Federal Court of Australia, based on legislation that had similar wording to the New Zealand legislation at the time, would be treated as more persuasive by New Zealand courts. The Commissioner considers that a New Zealand court is likely to follow *Roberts and Smith* rather than *Case M127*.

Conclusion – the application of Roberts and Smith in New Zealand

64. The Commissioner considers that the New Zealand courts would apply the *Roberts and Smith* principle in situations where:
- borrowed funds are used to replace existing funding;
 - the existing funding is repaid to the person who invested it; and
 - the existing funding had a sufficient connection with deriving income or carrying on the business.
65. The *Roberts and Smith* principle provides that, in such situations, interest incurred on the new funding will take on the deductibility status of the existing funding.
66. This commentary will now discuss how this principle applies to the specific Arrangements in BR Pub 15/04—15/08. The commentary will also go on to discuss certain situations including the Arrangement in BR Pub 15/09 where the Commissioner considers that the principle will not apply.

Arrangements to which the *Roberts and Smith* principle applies

67. The following analysis explains the Commissioner's position on interest deductibility under the *Roberts and Smith* principle in the context of the specific Arrangements to which the Rulings apply.

Returns of capital to partners: BR Pub 15/04

68. BR Pub 15/04 applies where borrowed funds are used by a partnership to return capital to a partner who previously invested that capital into the partnership.

69. *Roberts and Smith* specifically concerned this situation. The *Roberts and Smith* principle applies where borrowed funds are used by a partnership to repay capital contributions to partners. Interest is deductible to the extent that the capital that was repaid to partners had been used by the partnership in carrying on its business.
70. An issue that arises concerns ownership of partnership property. For example, it could be argued that a partnership is not able to repay a partner's contributions to the partner. This is on the basis that a partnership is not a legal entity, and the ownership of partnership property already vests in the partners.

Ownership of partnership property

71. A key concept of partnership law is that partners do not have individual rights to partnership property. This point has been made in several cases, including *Hadlee & Sydney Bridge Nominees Ltd v CIR* (1993) 15 NZTC 10,106 (PC), *CIR v Boanas* (2008) 23 NZTC 22,046 (HC) and *Crowe v C of T* (1958) 100 CLR 532 (HCA). It was also confirmed by Webb and Molloy in *Principles of the Law of Partnership* (Butterworths, Wellington, 6th edition, 1996).
72. In *Hadlee* (PC) Lord Jauncey of Tullichettle stated at 10,110:
- ... 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). [Emphasis added]
73. In the Court of Appeal (*Hadlee and Sydney Bridge Nominees Ltd v CIR* (1991) 13 NZTC 8,116 (CA)), Richardson J had referred to a share in a partnership as being a fractional interest in the future profits of the partnership business (at 8,126). In *Boanas*, Dobson J noted at [65] that Richardson J's judgment in *Hadlee* was consistent with s 23(1) of the Partnership Act 1908.
74. Section 23(1) of the Partnership Act 1908 states:
- 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.
75. Section HG 2(1) of the Income Tax Act 2007 provides that partnerships are transparent for income tax purposes (unless the context requires otherwise). This means that, for the purposes of calculating their obligations and liabilities under the Act, the partners 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 party 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.

76. Section HG 2 does not alter the principle that partnership income is derived, and partnership property is owned, jointly by the partners. Section HG 2 applies “[f]or the purposes of a partner’s liabilities and obligations under this Act in their capacity of partner of a partnership”. This makes it clear that s HG 2(1) applies to calculating a partner’s tax obligations and liabilities. Section HG 2 does not affect the partners’ individual rights to partnership property under general law.
77. In summary, partners own an undivided interest in partnership property and do not have individual title to any particular items of partnership property. Therefore, a partnership can validly transfer property to a partner because the nature of the legal ownership would change from joint ownership to ownership by a single person.
78. *Roberts and Smith* specifically applied to partners in a partnership. The above analysis shows that the application of the *Roberts and Smith* principle in a partnership situation would be consistent with the treatment of partnership property in New Zealand.
79. It is noted that a return of capital, whether by a partnership or a company, does not itself have a sufficient connection with deriving income or carrying on a business simply because it is an ordinary part of running a business. A return of capital is generally not part of the income-earning process of the business, but relates to the structure of the business. However, a sufficient connection with deriving income or carrying on a business exists in this Arrangement. This is because borrowing to return capital to partners has the effect of replacing and repaying an amount that was invested into the business by the partner. The initial amount invested into the business had a connection with carrying on the business or deriving income. In these circumstances, the borrowed funds will continue that connection with deriving income or carrying on a business.

Payments of past years’ profits to partners: BR Pub 15/05

80. BR Pub 15/05 applies where borrowed funds are used to repay past years’ partnership profits to partners. Interest is deductible under the *Roberts and Smith* principle to the extent that the borrowed funds are used to repay past years’ profits to partners, and those profits had been used directly in the partnership’s business (or to repay funds borrowed by the partnership where interest had been deductible).
81. In *Roberts and Smith*, Hill J referred to past years’ profits as “undrawn profit distributions”. These can be viewed as amounts contributed by partners to the partnership. Partnership profits are allocated to partners equally or in accordance with the divisions in the partnership agreement. If profits are not withdrawn, the accounting treatment might be to carry profits to the credit of the partners’ 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 into the business.
82. The Commissioner considers that retaining and using past years’ profits in the partnership’s business can be seen as a reinvestment by partners in the partnership. Interest is deductible on borrowings used to repay past years’ profits to partners, to the extent that the profits were used in the partnership’s business.

83. However, BR Pub 15/04 and 15/05 do not apply to the extent that borrowed funds are used to pay current year income to partners. The reasons for this will now be considered.

Why the Ruling does not apply to the payment of current year income to partners

84. The Commissioner's opinion is that the *Roberts and Smith* principle does not extend to borrowings that return current year income to partners. A distinction is made here between current year income and net income or profits that are finally determined. Current year income has generally not been identified as net income or profits of the partnership, which the partners are entitled to withdraw from the partnership.
85. The issue with current year income is whether the partners can be said to have invested the amount back into the partnership. The Commissioner considers that, generally, current year income is not an amount that can be finally determined as being an amount "invested" into the partnership by the partners, and so is not an amount that is "repaid" to partners. The amount can only have been invested in the partnership if someone other than the partnership has had an entitlement to it at some time. Therefore, the issue is whether partners can be said to have become individually entitled to current year income at a point in time before repayment is made.
86. The legal nature of current year partnership income is relevant to answering this question. As previously discussed in this commentary, a distinction exists between partnership property and property of individual partners. If current year partnership income is determined and a share of the net income or profits is allocated to individual partners at any point during the year, it could in theory be said to have been invested by partners in the partnership business (and, therefore, would be "repayable" to the partners).
87. The Partnership Act 1908 is silent on the treatment of current year income. Section 27 provides for the division of profits as follows:

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:

88. Partners are entitled to share in partnership profits (subject to an agreement to the contrary). However, the concept of "profits" is not defined. There is no particular guidance in the Partnership Act 1908 as to when the division and allocation of profits occurs.
89. The amount that forms part of each partner's share of profits from a partnership is ascertained after the partnership accounts have been prepared. In *FC of T v Galland* 86 ATC 4,885, the High Court of Australia held that, in the absence of an agreement otherwise, partnership accounts would be taken each year as at 30 June. A partner's share of the

partnership's profits or net income would be distributed to the partner at that time. Mason and Wilson JJ said at 4,887:

...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 in respect of the relevant period.

90. The High Court of Australia's view is that partners have an individual interest in the net income or profits of the partnership, but not an immediate entitlement to the net income or profits until accounts have been prepared.

91. *Galland* was cited by Hill J in *Roberts and Smith* as authority for the proposition that, in the absence of agreement, a partner's share of the partnership's income is derived by the partner once annual partnership accounts have been prepared. Hill J said at 4,390:

In the absence of agreement, 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 derived by him as at that date: *FC of T v Galland*...

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

"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, viz, 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 being introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the period in question.

93. Profits can be calculated once the total amounts of income and expenses for the relevant fiscal period are known. Although income will come in that may, in due course, form part of the "profits", the finally determined amount cannot be known until the relevant fiscal period has ended and accounts prepared. In the Commissioner's opinion, it follows that a legal entitlement to partnership profits cannot arise until the amount can be finally determined, and this is at the end of the relevant fiscal period (which is generally annual but may depend on the particular facts).

94. Therefore, the Commissioner considers that, generally, a partner does not have an individual entitlement to current year partnership income until the accounts for the relevant fiscal period have been prepared, an amount of profit has been finally determined, and partners are entitled to their share of the resulting profits. Generally, current year income is owned by all of the partners jointly. Individual partners have an ownership interest in that income (in common with the other partners), but the Commissioner considers that no entitlement to an individual share exists until profits have been calculated and allocated for a fiscal period. This means that current year income is generally not an investment that can be "repaid" to partners.

95. The Commissioner's opinion that current year income is not generally an amount that can be repaid to partners is consistent with Hill J's reasoning at 4,389 to 4,390 in *Roberts and Smith*. Hill J considered that amounts

that can be repaid and replaced are funds that have actually been invested in the partnership and that the partners are entitled to withdraw. Hill J listed the types of capital represented in the partnership's accounts. Of these amounts, he considered the types of capital that could be replaced and repaid to an investor. Hill J did not include internally generated goodwill, asset revaluations and profits of the year not yet distributed as amounts able to be replaced and repaid to an investor. Hill J considered that undrawn distributions that have been allocated to partners but not paid (such as past years' profits) can be replaced with borrowings, and the interest relating to such amounts would be deductible.

Summary

96. Past years' profits that remain in the partnership are viewed as an advance from the partners to the partnership, or as new investments of capital. Hill J considered that a partnership's past years' profits could be viewed as amounts invested into the partnership by the partners, and that they could be repaid to the partners. Therefore, interest incurred on funds that are borrowed to repay past years' profits to a partner is deductible under the *Roberts and Smith* principle.
97. It is essential for the application of the *Roberts and Smith* principle that the borrowings replace existing funding, and are repaid to the person who invested that funding. In the Commissioner's opinion, current year income has not been invested by anyone, so the principle does not generally apply.
98. The Commissioner considers that, for the purposes of the *Roberts and Smith* principle, partners do not generally have rights to current year income as it arises during the year. Partnership profits or net income are generally determined at the end of the relevant fiscal period (presumed to be the financial year for the purposes of the relevant Rulings) and, until this happens, the partners are not entitled to a share of the income arising during that year. Although a partner might take drawings out of the current year income during the year, this is generally only an anticipated share of the profits or net income that is finally established at the end of the financial year. Current year income is not an amount that can be seen as being invested into the partnership by the partners. While there may be scope to argue that current year profits are an investment made by partners into the partnership, the Commissioner considers that the nature of such profits is too uncertain to be able to include them within the scope of a binding ruling.
99. Past years' profits can be distinguished from current year income because the partners have become entitled to their share of those past years' profits. The entitlement occurs at a time specified under the partnership agreement or, in the absence of a partnership agreement, when the partnership accounts are taken and the profits notionally allocated to partners.

Share repurchases: BR Pub 15/06

100. BR Pub 15/06 applies where borrowed funds are used by a company to repurchase shares from its shareholders (as authorised by the Companies Act 1993).
101. Note that interest may be deductible to the company under s DB 7. BR Pub 15/06 is only of relevance to companies to which s DB 7 does not apply.

102. The repurchase of a company's shares involves a payment made by the company to its shareholders of amounts previously contributed by the 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 company's payment will reduce the shareholder's capital holding in the company. Therefore, this Arrangement is analogous to a return of capital or past years' profits to partners in a partnership (discussed above).
103. In the Commissioner's view, the *Roberts and Smith* 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 by the company in deriving income or in carrying on its business.

Payments of dividends: BR Pub 15/07

104. BR Pub 15/07 applies where borrowed funds are used by a company to pay dividends to shareholders that relate to past years' profits (ie, retained earnings). As with the previous Arrangement, the interest may be deductible to the company under s DB 7. BR Pub 15/07 is only of relevance to companies in situations where s DB 7 does not apply.
105. There is some conceptual difficulty in bringing a company's retained earnings within the *Roberts and Smith* principle. The difficulty is in equating retained earnings with amounts "invested" into the company by shareholders. This is because, unlike a partnership, a company's profits are not allocated to shareholders at the end of each year. Rather, any retained earnings are added to the company's existing retained earnings. Company directors may or may not decide to distribute some of these retained earnings as a dividend. Therefore, shareholders have no immediate entitlement to retained earnings in the way that partners are entitled to a share in partnership profits.
106. Nevertheless, there are similarities between a partnership's past years' profits and a company's retained earnings, such that comparisons can be drawn (although it is acknowledged that there are differences). For example:
- Both amounts have been finally settled for the year, and the theoretical amount each shareholder or partner is entitled to can be established.
 - In a sense, retained earnings and past years' profits that remain in the business can be seen as an amount that a shareholder or partner has "invested" into the business.
 - Retained earnings and partnership profits are at the disposal of the business until a decision is made to pay them out to the shareholders or partners. Just as partners may not necessarily make an active decision to invest past profits into the partnership, a company's shareholders would not make a decision to invest profits into the company as retained earnings.
107. The Commissioner considers that funds borrowed by a company to pay dividends to shareholders that relate to retained earnings are somewhat analogous to funds borrowed by a partnership to pay past years' profits to

partners. The Commissioner considers that the *Roberts and Smith* principle should apply in such situations.

108. Therefore, the Commissioner considers that interest is deductible on borrowings used by a company to pay dividends to shareholders relating to past years' profits, to the extent that those profits had been used by the company in deriving income or in carrying on its business. If company profits are distributed as bonus issue shares, then, similarly, the amount represented by the shares can be seen as capital that is able to be replaced and repaid.
109. As concluded earlier, the Commissioner considers that the *Roberts and Smith* principle does not generally apply where a partnership uses borrowed funds to pay current year income to partners. Similarly, shareholders in a company do not have an immediate entitlement to the company's current year income, and they cannot be considered to have invested that income into the company. Therefore, the Commissioner considers that the *Roberts and Smith* principle does not apply where borrowed funds are used to pay current year income to a shareholder.

Replacement of debt: BR Pub 15/08

110. The Arrangement considered in BR Pub 15/08 is broader than the previous Arrangements. BR Pub 15/08 applies where borrowed funds are used by a partnership or taxpayer to replace existing debt and to repay the amounts to the person who lent the funds to the taxpayer or partnership.
111. The Commissioner considers that the *Roberts and Smith* principle applies where borrowed funds repay another debt that was directly used in deriving income or in carrying on a business. In *Roberts and Smith*, Hill J considered that there is no difference (for interest deductibility purposes) between repaying one debt with another and borrowing to return capital. Hill J considered that both situations should be similarly treated. Hill J said that where borrowings are used to repay existing debt, and the existing debt had been used in an income-earning business, the refinancing will take on the character of the existing debt.
112. In addition, if new borrowings take on the character of existing debt that is replaced, then logically subsequent refinancing should also inherit that character. Therefore, the Commissioner considers that interest is deductible on borrowings used to repay existing borrowings to the extent that existing borrowings can be traced to a use that gave rise to deductible interest.
113. There are three further issues to consider when borrowed funds are used to replace existing debt. These are:
- whether interest is deductible if the interest on the existing debt was deductible under a provision that did not require nexus with income, such as ss DB 7 and DB 8;
 - whether interest is deductible where the lender's right to be repaid is assigned to another person; and
 - whether direct tracing is required.

Deductibility where no nexus was required

114. The general principle from *Roberts and Smith* is that interest on borrowings may inherit the deductibility status of interest on funds the

borrowings replace and repay. In some situations, the interest incurred on the existing debt may have been deductible under a specific interest deductibility provision, rather than the general permission. Section DB 7 provides for automatic deductions for most companies. Section DB 8 provides for deductions for companies investing in shares in a group company.

115. The Commissioner considers that deductibility status under ss DB 7 and DB 8 should also be inheritable by replacement funding. If it were not, and refinancing meant that interest that had been deductible was no longer deductible (as a matter of law rather than fact), Parliament's intention for ss DB 7 and DB 8 would seem to be defeated.
116. Therefore, the Commissioner considers that the *Roberts and Smith* principle applies when interest on the funding that is replaced had been deductible under ss DB 7 or DB 8.

Deductibility where the lender's right to be repaid is assigned

117. The Commissioner considers that the *Roberts and Smith* principle requires the repaid funds to be returned to the person who invested the funds. However, an exception to this is where the right to receive repayments has been assigned to someone else. The Commissioner considers that interest is still deductible in this situation because there has been a repayment of funds invested. The amounts can be traced back to the original investor through the assignee.

Whether deductibility requires direct tracing

118. In several cases that have considered interest deductibility, the courts held that the funds must be directly used in, or traced to, deriving income: see *Pacific Rendezvous Ltd* and *Brierley*.
119. The Commissioner considers that the *Roberts and Smith* principle is consistent with a tracing approach to interest deductibility. The *Roberts and Smith* principle requires identifying both that the new borrowings replace and repay existing funds, and that the existing funds were used in carrying on a business or in deriving income. The existing funding must have had a sufficient connection with (or be traced to) the derivation of income.
120. In the previous issue of these Rulings, the Commissioner considered the compliance costs that may arise for some taxpayers if tracing is required. It was recognised that, for some taxpayers who have daily changes to their borrowings, the tracing requirement may be difficult to fulfil. Although two potential solutions were canvassed, the Commissioner considered them to be impractical.
121. One approach considered was to allow a deduction in situations where borrowings are taken out and the initial funding repaid at about the same time. However, the Commissioner considers that, in practice, an "about the same time" requirement could not be limited to *Roberts and Smith* situations. This could result in interest on any borrowings qualifying for deductibility. This would be inconsistent with the requirement for a nexus with income under s DB 6.
122. Another approach considered was to accept that all borrowings are a replacement of existing funds, unless used solely for a private or exempt use. However, that would also seem to be too wide as any use of

borrowings could potentially satisfy such a test. Further, this approach would also be inconsistent with the *Roberts and Smith* principle, which requires that funds are returned to those who invested them. Without this element of replacement, insufficient nexus with income exists.

123. Therefore, the Commissioner considers that a tracing approach is required for deductibility in the context of the *Roberts and Smith* principle.
124. Nevertheless, the Commissioner considers that problems regarding tracing are unlikely to arise in most cases. This is because taxpayers with few borrowings should usually be able to trace their funding. Taxpayers with more complicated borrowing practices are, in most cases, likely to be companies that can claim interest deductions under s DB 7.

Arrangements to which s DB 6 and/or the *Roberts and Smith* principle do not apply

125. The following paragraphs discuss the types of arrangements where the Commissioner considers that interest is not deductible under s DB 6 and/or the *Roberts and Smith* principle.

Subvention payments: BR Pub 15/09

126. BR Pub 15/09 applies to an Arrangement where a company borrows funds to make a payment under s IC 5 to another company that has a net loss and is in the same group of companies. This type of payment is commonly referred to as a "subvention payment". The Ruling provides that interest incurred on those borrowed funds will not be deductible under s DB 6.
127. 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 that is paid to shareholders in repayment of amounts they invested in the company. Therefore, the Commissioner considers that the use of borrowed funds to pay a subvention payment does not satisfy the *Roberts and Smith* principle. Interest incurred on borrowed funds used to pay a subvention payment is not deductible under that principle.
128. Unlike the other related Rulings, BR Pub 15/09 is not limited to deductibility under the *Roberts and Smith* principle. BR Pub 15/09 states that interest on borrowed funds used to make a subvention payment will not be deductible under s DB 6.
129. This wider application of BR Pub 15/09 is necessary because the Commissioner considers that a subvention payment will not have a sufficient connection with deriving income or carrying on a business under the general permission. This is because:
 - The relevant payment is made when a company's annual profits have been determined. This occurs after the company has already derived its income for the year, and so the payment cannot be an amount of expenditure incurred in deriving its income.
 - Further, the Commissioner considers that such a payment is not made by the company in the course of carrying on its business for the purpose of deriving income. The payment is made to reduce the overall tax burden of the group, when there are both loss and profit-making companies within that group.

130. Therefore, the Commissioner considers that interest incurred on borrowed funds that are used to make a subvention payment under s IC 5 to a group company will not satisfy the general permission and so will not be deductible under s DB 6.
131. The Commissioner notes that this issue is unlikely to arise in practice. Interest incurred by most companies will be deductible under s DB 7, regardless of the use of the funds. However, BR Pub 15/09 will be relevant in situations where s DB 7 does not apply.
132. The Commissioner acknowledges that the treatment of such borrowings differs between companies that can apply s DB 7 and companies that cannot. However, this is through the operation of the interest deductibility provisions in ss DB 6 and DB 7, and not through the application of the *Roberts and Smith* principle.

Payments relating to internally generated goodwill and asset revaluations

133. The Arrangements described in BR Pub 15/04—15/08 do not include arrangements where, or to the extent that, borrowed funds are used to make a payment that relates to unrealised asset revaluations or internally generated goodwill.
134. 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. This was because it is not an amount that has been invested by the partners into the business. Hill J explained that a payment of goodwill is not a “refund of a pre-existing capital contribution” (at 4,390).
135. Further, Susan Glazebrook and Jan James in *Taxation Implications of Company Law Reform* (1995) 1 NZJTL 132 at 157 explained that goodwill cannot be distributed because, even after any purported distribution, it would still remain in the business.
136. Therefore, the Commissioner considers that internally generated goodwill is not an amount that can be replaced and repaid to partners or shareholders. The Rulings do not apply to such payments.
137. The situation will be different if goodwill is purchased. In that situation, funds (either equity or debt) will be used to purchase the goodwill. These funds can be repaid and replaced with other borrowed funds. Therefore, interest on replacement borrowings would be deductible under the *Roberts and Smith* principle if the existing funding used to purchase that goodwill is repaid to the person who lent or invested those funds. However, if purchased goodwill is revalued internally, the extent of the internal revaluation cannot be said to be an amount invested in the business by a partner or shareholder.
138. Therefore, interest incurred on borrowed funds that are purporting to replace internally generated goodwill will not be deductible under the *Roberts and Smith* principle.
139. For the same reasons, the *Roberts and Smith* principle does not apply to amounts that are attributable to asset revaluations. This is because these amounts do not relate to an amount invested or lent by a person to the business, and they cannot be replaced and repaid to a person who invested those amounts.

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

140. The Australian Taxation Office issued a ruling on its interpretation of *Roberts and Smith*. 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. The Australian Taxation Office's view is similar to the Commissioner's view in these Rulings. 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.
141. A consistent interpretation of *Roberts and Smith* was also applied in TR 2005/12 Income tax: deductibility of interest expenses incurred by trustees on funds borrowed in connection with the payment of distributions to beneficiaries, issued 6 July 2005. TR 2005/12 relates to borrowings used to repay amounts to beneficiaries.

References

Expired Rulings

BR Pub 10/14–10/19 "Interest deductibility — *Roberts and Smith* — Borrowing to replace and repay amounts invested in an income earning activity or business", *Tax Information Bulletin* Vol 22, No 11 (December 2010): 2

Subject references

Interest deductibility

Legislative references

Income Tax Act 2007, ss DA 1, DA 2, DB 1, DB 6, DB 7, DB 8, HG 2, IC 5, definition of "company" in s YA 1
Partnership Act 1908, ss 23, 27

Case references

Case M127 (1990) 12 NZTC 2,817
Case P56 (1992) 14 NZTC 4,386
CIR v Boanas (2008) 23 NZTC 22,046 (HC)
CIR v Brierley (1990) 12 NZTC 7,184 (CA)
Crowe v Commissioner of Taxation (1958) 100 CLR 532 (HCA)
Eggers v CIR (1988) 10 NZTC 5,153 (CA)
FC of T v Galland 86 ATC 4,885 (HCA)
FC of T v Roberts; FC of T v Smith 92 ATC 4,380 (FFedC)
Hadlee & Sydney Bridge Nominees Ltd v CIR (1991) 13 NZTC 8,116 (CA), (1993) 15 NZTC 10,106 (PC)
Interior Breweries Ltd v Minister of National Revenue [1955] CTC 143; 55 DTC 1090 (CAExCt)
Pacific Rendezvous Ltd v CIR (1986) 8 NZTC 5,146 (CA)
Public Trustee v CIR [1938] NZLR 436 (CA)
Re Spanish Prospecting Co. Ltd [1911] 1 Ch 92 (CA)

Other references

ISO082: "Interest Deductibility—*Public Trustee v CIR*" *Tax Information Bulletin* Vol 18, No 6 (July 2006): 9
QB 11/03: "Income Tax – look-through companies and interest deductibility" *Tax Information Bulletin* Vol 23, No 10 (December 2011): 16
QB 12/08: "Income Tax – look-through companies: interest deductibility on funds borrowed to repay shareholder current accounts" *Tax Information Bulletin* Vol 24, No 6 (July 2012): 70
QB 12/09: "Income Tax – look-through companies: interest deductibility where funds are borrowed to make a payment to shareholders to reflect an asset revaluation" *Tax Information Bulletin* Vol 24, No 6 (July 2012): 72
Susan Glazebrook and Jan James *Taxation Implications of Company Law Reform* (1995) 1 NZJTL 132
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
TR 2005/12 Income tax: deductibility of interest expenses incurred by trustees on funds borrowed in connection with the payment of distributions to beneficiaries, issued 6 July 2005
Webb and Molloy *Principles of the Law of Partnership* (Butterworths, Wellington, 6th edition, 1996)

Appendix – Legislation

Income Tax Act 2007

1. Section DA 1 contains the “general permission”:

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.

2. Section DA 2 contains the “general limitations”:

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**.

Employment limitation

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

Withholding tax limitation

- (5) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving non-resident passive income of the kind referred to in section RF 2(3) (Non-resident passive income). This rule is called the **withholding tax limitation**.

Non-residents' foreign-sourced income limitation

- (6) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving non-residents' foreign-sourced income. This rule is called the **non-residents' foreign-sourced income limitation**.

Relationship of general limitations to general permission

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

3. Section DA 3 explains the effect of specific rules on general rules:

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.

4. Section DB 1 contains an exclusion from deductibility for certain amounts of interest:

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;
 - (bb) an amount withheld under section 1471 or 1472 of the Internal Revenue Code of 1986 (USA), as amended from time to time;
 - (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.

5. Section DB 6 allows a deduction for interest incurred:

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.

Conduit financing arrangements

- (3) *[Repealed]*

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.

6. Section DB 7 allows a deduction for interest incurred by companies:

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.

Relationship with subpart DG

- (6B) Subpart DG (Expenditure related to use of certain assets) overrides this section for expenditure to which that subpart relates.

Conduit financing arrangements

- (7) *[Repealed]*

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.

7. Section DB 8 allows a deduction for interest on money borrowed to acquire shares in group companies:

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.

Relationship with subpart DG

- (6B) Subpart DG (Expenditure related to use of certain assets) overrides this section for expenditure to which that subpart relates.

Conduit financing arrangements

- (7) *[Repealed]*

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.

8. Section HG 2 provides that partnerships are transparent for income tax purposes:

HG 2 Partnerships are transparent

Look-through in accordance with share

- (1) For the purposes of a partner's liabilities and obligations under this Act in their capacity of partner of a partnership, unless the context requires otherwise,—
- (a) the partner is treated as carrying on an activity carried on by the partnership, and having a status, intention, and purpose of the partnership, and the partnership is treated as not carrying on the activity or having the status, intention, or purpose:
 - (b) the partner is treated as holding property that a partnership holds, in proportion to the partner's partnership share, and the partnership is treated as not holding the property:
 - (c) the partner is treated as being party to an arrangement to which the partnership is a party, in proportion to the partner's partnership share, and the partnership is treated as not being a party to the arrangement:

- (d) the partner is treated as doing a thing and being entitled to a thing that the partnership does or is entitled to, in proportion to the partner's partnership share, and the partnership is treated as not doing the thing or being entitled to the thing.

No streaming

- (2) Despite subsection (1), for a partner in their capacity of partner of a partnership, the amount of income, tax credit, rebate, gain, expenditure, or loss that they have from a particular source, or of a particular nature, is calculated by multiplying the total income, tax credit, rebate, gain, expenditure, or loss of the partners of the partnership from the particular source or of the particular nature by the partner's partnership share in the partnership's income.

Expenditure or loss previously incurred

- (3) A partner of a partnership may be treated as incurring an expenditure or loss which the partnership incurs ignoring this section, despite the partner not being a partner at the time the expenditure or loss is incurred. This subsection does not allow 2 deductions for 1 expenditure or loss.

Excluded amounts

- (4) Subsection (2) does not apply to the following amounts:
 - (a) expenditure or loss that relates to a person entering a partnership by acquiring partner's interests disposed of by another partner, to the extent to which sections HG 5 to HG 10 do not apply to the partner's interests:
 - (b) supplementary dividends, to the extent to which subpart LP (Tax credits for supplementary dividends) applies:
 - (c) *[Repealed]*
 - (d) imputation credits, to the extent to which section LE 6 (Partners in partnerships) applies:
 - (e) FDP credits, to the extent to which section LF 4 (Partners in partnerships) applies.

9. Section IC 5 provides for when a company may make a subvention payment to another group company:

IC 5 Company B using company A's tax loss

Requirements

- (1) Company A may make a tax loss available to company B to subtract from its net income under section IA 3(2) (Using tax losses in tax year) only if—
 - (a) company A and company B have minimum common ownership for the relevant period as set out in sections IC 2(2) and IC 6; and
 - (b) company A meets the residence requirements of section IC 7; and
 - (c) company A has the required continuity of ownership under section IC 2(1) and, if it applies, section IC 10(2)(a); and
 - (d) the amount falls within the limits set by section IC 8(1) and (2); and
 - (e) the payment and notification requirements of section IC 9 are met.

Method: election or subvention payment

- (2) Having met all the requirements set out in subsection (1), company A may—
 - (a) choose to make a tax loss that it has in a tax year available to company B to use in the tax year, notifying the Commissioner as described in section IC 9; or
 - (b) agree with company B that company B should bear the amount of company A's tax loss, or take a share in it, in return for a payment by company B to company A by the date set out in section IC 9; or
 - (c) apply both paragraphs (a) and (b) in relation to the tax loss.

Amounts used in tax year

- (3) Company B must subtract the amount of the tax loss referred to in subsection (2)(a) or the payment referred to in subsection (2)(b), as applicable, from its net income for the tax year in relation to which company A makes the amount available or receives the payment.

When decisions made

- (4) If company A chooses to make the amount available to company B under subsection (2)(a), the decision is irrevocable.

Nature of payment

- (5) To the extent to which an amount of tax loss is subtracted from net income, a payment from company B to company A under subsection (2)(b) is not a dividend.

Part-year tax losses

- (6) Sections IP 4 and IP 5 (which relate to losses in part-years) modify this section for part-year calculations.

Tax years before 1981–82 and between 1981–82 and 1991–92

- (7) Section IZ 7 (Grouping tax losses for tax years before 1981–82 and between 1981–82 and 1991–92) modifies the requirements of—
- (a) subsection (1)(a) for a tax loss component that arises in tax years between 1981–82 and 1991–92; and
 - (b) subsection (1)(b) for a tax loss component that arises in tax years before the 1991–92 tax year; and
 - (c) subsection (1)(a) for a tax loss component that arises in tax years before the 1981–82 tax year.

Partnership Act 1908

10. Section 23 of the Partnership Act 1908 provides:

23 Partnership property

- (1) All property and rights and interests in property originally brought into the partnership stock, or acquired (whether by purchase or otherwise) on account of the firm or for the purposes and in the course of the partnership business, are called in this Act **partnership property**, and must be held and applied by the partners exclusively for the purposes of the partnership and in accordance with the partnership agreement.
- (2) Provided that the legal estate or interest in any land which belongs to the partnership shall devolve according to the nature and tenure thereof and the general rules of law thereto applicable, but in trust, so far as necessary, for the persons beneficially interested in the land under this section.
- (3) Where co-owners of an estate or interest in any land not being itself partnership property are partners as to profits made by the use of that land or estate, and purchase other land or estate out of the profits to be used in like manner, the land or estate so purchased belongs to them, in the absence of an agreement to the contrary, not as partners, but as co-owners for the same respective estates and interests as are held by them in the land or estate first mentioned at the date of the purchase

11. Section 27 of the Partnership Act 1908 provides:

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:
- (b) the firm must indemnify every partner in respect of payments made and personal liabilities incurred by him—
 - (i) in the ordinary and proper conduct of the business of the firm; or
 - (ii) in or about anything necessarily done for the preservation of the business or property of the firm:
- (c) a partner making, for the purpose of the partnership, any actual payment or advance beyond the amount of capital which he has agreed to subscribe is entitled to interest at the rate of 5% per annum from the date of the payment or advance:

- (d) a partner is not entitled, before the ascertainment of profits, to interest on the capital subscribed by him:
- (e) every partner may take part in the management of the partnership business:
- (f) no partner shall be entitled to remuneration for acting in the partnership business:
- (g) no person may be introduced as a partner without the consent of all existing partners:
- (h) any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners, but no change may be made in the nature of the partnership business without the consent of all existing partners:
- (i) the partnership books are to be kept at the place of business of the partnership (or the principal place if there is more than one), and every partner may when he thinks fit have access to and inspect and copy any of them.