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INTEREST DEDUCTIBILITY BY LTCs

IRD answers to questions on LTC interest deductibility discussed in the context of IRD rulings on interest deductibility by partners

QB 11/03: Income tax: look-through companies and interest deductibility

QB 12/08: LTCs borrowings to repay shareholders' current accounts

QB 12/09: LTCs payment to shareholders out of asset revaluation reserve

QB 12/11: Look-through companies, rental properties and avoidance

Public Rulings BR 10/14 – 10/19 *FCT v Roberts and Smith*

1. QB 11/03, 12/08 and 12/09 concern the deductibility of interest on money borrowed by LTCs. The situations are:

   QB 11/03: Whether interest will still be deductible where a loss-attributing qualifying company (LAQC) becomes a look-through company (LTC) if:

   - A person had previously sold their family home, at market value, to a wholly-owned LAQC as a rental asset, to be rented to a third party on an arm's length basis; the purchase was funded by a bank loan that the person used to acquire a new family home; the LAQC has become an LTC.

   QB: 12/08: An LTC borrows money on arm's length terms to repay current account loans from its shareholders.

   QB 12/09: An LTC borrows money and uses it to make payments to shareholders reflecting the increase in the value of an income-earning asset it holds.

2. **QB 12/11** is concerned with whether the general anti-avoidance rule in section BG 1 would apply where:

   - A person who owns 100% of an LTC sells their family home, at market value, to the LTC;
   - The home is used by the LTC as a rental asset and is rented to a third party on an arm's length basis;
   - The LTC borrows from a bank to fund the purchase (and pay the person for the sale);

- The person then uses the funds raised from the sale to purchase a new family home;
- The person, in their capacity as holder of an effective look-through interest in the LTC, is able to deduct the interest incurred by the LTC on the loan (QB 11/03 confirms this).

3. The conclusions on interest deductibility in the QBs are consistent with those in Public Rulings 10/14 – 10/19 and the commentary relating to those rulings, in which *FC of T v Roberts*; *FC of T v Smith* 92 ATC 4 ("*Roberts and Smith*") is discussed.

4. However, underlying the conclusions, and *not necessarily immediately obvious, are the significant accounting and record-keeping requirements that arise in relation to payments by an LTC to its shareholders*.

5. The Commissioner's view as stated in QB 12/11 is that section BG 1 would not apply to the arrangement described. The basis for this is set out in paragraphs 31 to 38 below.

It is the use of the funds by the LTC that is relevant (not the use of funds by the owner)

6. It is the *use of the borrowed funds by the LTC*, attributed under s HB 1(4)(d) to the person (in their capacity as owner) *that is relevant to the issue of interest deductibility*, not the use of the funds by the person in their personal capacity. Section HB 1(4) attributes the actions of the LTC to its owners. This means that the owners are treated as carrying on the activities of the LTC; having the same status, intention and purpose as the LTC; holding property that the LTC holds; being party to any transactions entered into by the LTC; and doing a thing that the LTC does. The LTC is treated as not doing those things or having that status, intention or purpose.

7. The Commissioner is of the view that the use to which the LTC puts the borrowed funds is "a thing" under s HB 1(4)(d). The effect of s HB 1(4) is to treat the LTC's actions as being those of the owner for income tax purposes. Section HB 1(4) does not work in reverse (i.e. the LTC regime does not operate to substitute the owner's actions for those of the LTC). Legislative support for this position can be found in s HB 1(1), which refers to "a person in their capacity of owner of an effective look-through interest". This implies that an owner can have more than one capacity.

8. In paragraphs 36-38 of Rulings BR Pub 10/14 – 10/19 the deductibility of interest on borrowed funds used for two outcomes is discussed. If borrowed funds are used in deriving assessable income, and the sufficient connection is established, it does not matter that the funds are also used to achieve a non-taxable outcome: *Pacific Rendezvous Ltd v CIR* (1986) 8 NZTC 5,146.

9. In those rulings, the Commissioner's opinion is that deductibility will not be affected by a concurrent non-income earning use of the borrowed funds. If the sufficient connection is established through the use of the borrowed funds, that connection is not lost if there is a second, non- income-related outcome. In *Roberts and Smith* the two outcomes were the replacement of funds that had a sufficient connection with the derivation of assessable income, and the use of the funds by partners for non-partnership and possibly private uses.

10. The Commissioner's view is that an owner's use of funds received from an LTC is not relevant to the question of interest deductibility.

Repayment of shareholders' current account loans

11. The LTC must be carrying on an income earning activity or business for the purpose of deriving assessable or excluded income both at the time the funds are borrowed and at the time interest on those funds is payable.

12. Providing that is the case, interest will be deductible to the extent the borrowing replaces past years' profits or contributed capital that was either used directly in the LTC's assessable or excluded income earning activity or business, or used to repay borrowed funds on which interest was deductible. This is subject to the limitations on deductions in ss HB 11 and HB 12 that apply to LTCs.

13. Interest will not be deductible to the extent the borrowed funds are used to replace current year income, or are purported to be used to make a payment out of unrealised asset valuations or internally generated goodwill.

Repayment to the owner

14. The Commissioner's view, as expressed in QB 12/08, is that the interest deductibility test is satisfied where a sufficient connection exists between the interest incurred and the assessable income. A sufficient connection will be established where borrowed funds are used to replace amounts invested in income-earning activities and *to repay those amounts to the persons who invested them*.

15. QB 12/08 refers to the discussion in Public Rulings BR Pub 10/14 – 10/19. In those rulings, the question of deductibility where the lender's (shareholder's, in this case) right is assigned, so as to repay funds to the person who lent them to the lender (shareholder), is discussed as follows:

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

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

16. This issue is not addressed in QB 12/08.

The replacement and repayment principle

17. The commentary in Public Rulings BR 10/14 – 10/19 refers to the principle from *Roberts and Smith* as the "replacement and repayment principle". Capital contributions, undrawn profits and advances are all capable of being replaced.

18. In *Roberts and Smith* current year income, asset revaluations and internally generated goodwill were not included as amounts able to be replaced.

19. In the case of an ordinary company, interest is deductible under section DB 7. However, with an LTC, the deductions are attributed back to the owner and section DB 7 does not apply. Hence it is necessary to trace the source of the payment.

Current year income

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

21. The issue with current year income is whether it is an amount that can be repaid. To be repayable, it must have been paid into the partnership by someone. The amount can only have been paid in if someone other than the partnership has had an entitlement to it at some time. Therefore, the issue is to decide whether partners can be said to have become individually entitled to current year income at some time before any purported replacement.

22. The Commissioner's opinion is that a partner does not have an individual entitlement to current year income. Current year income is owned by all of the partners jointly. Section HG 2(1) does not alter this principle. The words "[f]or the purposes of a partner's liabilities and obligations under the Act" make clear that section HG 2(1) applies only in respect of the calculation of a partner's tax obligations and liabilities. Individual partners have an ownership interest in current year profits in common with the other partners, but not an entitlement to their potential individual share until profits have been calculated and allocated for a fiscal period: *FC of T v Galland* 86 ATC 4885.

Asset revaluations and internally generated goodwill

23. In *Roberts and Smith* Hill J stated that unrealised asset revaluations are not amounts tangibly invested by the partners into the partnership – they are only account entries.

24. The conclusion in QB 12/09 based on *Roberts and Smith* is that because the revaluation has not been realised by sale, the increased value is only an account entry. Consequently, the borrowed funds have not been used to replace and repay amounts tangibly invested in the LTC by the shareholders. Therefore, in accordance with *Roberts and Smith,* no interest deductions would be allowed.

25. The commentary in Public Rulings BR 10/14 – 10/19 deals with internally generated goodwill and purchased goodwill as follows:

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

    113. Glazebrook and James, in "*Taxation Implications of Company Law Reform*" by Susan Glazebrook and Jan James, New Zealand (1995) 1 NZJTLP 132 at p 157 have explained that goodwill cannot be distributed because after a purported distribution, it would still remain.

Therefore, internally generated goodwill is not an amount that can be replaced and repaid to partners or shareholders with borrowed funds with a deductible result.

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

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

Limitations on deductions

26. QB 11/03, QB 12/08 and QB 12/09 point out that deductions are subject to the deduction limitation rules in sections HB 11 & 12.

27. The owner's basis is reduced by distributions. A payment to a shareholder will be a distribution regardless of whether it is a repayment of a current account balance or a payment of an amount that arose from an asset revaluation.

28. Borrowing to distribute an asset revaluation will, therefore, have a double negative effect: no interest deductions will be allowed, and the payment will reduce the owner's basis for claiming other deductible expenditure.

29. An assignment of a shareholder's current account balance to a lender and direct repayment to the lender should be treated as a distribution to the assignor shareholder. The amount to the credit of the shareholder in the current account has already been "paid" to the shareholder in the sense of the definition of "pay" in section YA 1, being an amount that has been credited to the shareholder. The LTC would only make the distribution upon receiving instructions to that effect from the assignor shareholder.

The arrangement described in QB 12/11 is not tax avoidance

30. It is the Commissioner's view that s BG 1 will not apply to the arrangement outlined in QB 12/11 and described in paragraph 2 above. However, if an arrangement were to vary materially from that outlined, or if there are other relevant facts that would materially affect how the arrangement operates, then it is stated in the QB that the Commissioner would need to consider the matter further and a different outcome might apply.

31. The Commissioner refers to the approach set out by the Supreme Court in *Ben Nevis Forestry Ventures Ltd & Ors v CIR; Accent Management Ltd & Ors v CIR* [2008] NZSC 115, (2009) 24 NZTC 23,188, as the "Parliamentary contemplation test". This "is to ask whether the tax outcomes are what Parliament would have intended for the provisions used or circumvented, having regard to the commercial reality and economic effects of the arrangement".

32. The Commissioner states that the first step in this test is to identify the commercial reality and economic effects of the arrangement. In the arrangement outlined in the question above, a LTC borrows from a bank to buy a rental property at market value. The LTC then rents the property to a third party on an arm's length basis. The reality is that interest is

incurred on funds borrowed to purchase a rental property and the arrangement is not structured in a way that allows the person to be reimbursed for the interest paid out.

33. The Commissioner states that the second step is to identify Parliament's purpose for the provisions used:

    "Parliament's purpose for the general deductibility provision was discussed in *Accent Management Limited & Ors* v *CIR* [2007] NZCA 230, (2007) 23 NZTC 21,323. The Court of Appeal said the deductibility provision applies when a person "incurs real economic consequences" of the type contemplated by Parliament when the rules were enacted. "

34. The Commissioner states that Parliament's purpose in enacting the LTC regime was to introduce an income tax treatment for closely-held companies that allows an owner of a company to obtain the benefits of limited liability while permitting that owner to be taxed at their own marginal tax rate. Parliament intended that the LTC regime apply to closely-held companies and that, despite the entity being "transparent" for income tax purposes, the company would be recognised as a separate entity.

35. The Commissioner then sets out the basis for the conclusion that there is no tax avoidance as follows:

    "Putting the two steps of the "Parliamentary contemplation test" together: the reality is that the LTC suffers a real economic cost in incurring interest, and it is incurred in the derivation of income. The shares in the LTC are held by one person so the company is closely-held. This is the type of shareholding that the LTC regime was intended to apply to. Accordingly, the commercial reality and economic effects are within Parliament's purpose for the deductibility provision and the LTC regime.

    The nature of the asset (the house) fundamentally changes for tax purposes. It changes from a private asset (accommodation for the person and their family) to an income-earning asset (a rental property). *This is so, even though the funds borrowed by the LTC are ultimately used by the person to purchase a new family home, and even though, were it not for the existence of the LTC in this case, the interest deductions would not be allowed*." (emphasis added)

36. The Commissioner distinguishes the arrangement outlined in QB 12/11 from the arrangement in Revenue Alert RA 07/01 where a sole shareholder in a LAQC sells the family home to the LAQC and then rents it back at a market rate. It is the Commissioner's view that s BG 1 would apply in this situation:

    "The commercial reality and economic effects of this arrangement is to make private expenses deductible by purporting to engage in a rental activity. The Act does not intend that private expenses should be deductible. Therefore the deductibility provision is not being used as Parliament intended."

37. The Commissioner's view is that the situation in the Revenue Alert is quite different from the facts in QB 12/11 where the person has structured their arrangement in a way that achieves deductibility.