



WEEKLY COMMENT: WEDNESDAY 16 MAY 2012

1. Two exposure drafts of Inland Revenue's Questions We've Been Asked ("the QWBAs") concerning interest deductions by LTCs were released for comment and discussion earlier this year with a deadline for comment of 2 May. QB 11/03 on a similar subject was issued late last year. The Commissioner's view is consistent with the conclusions and discussion in Public Rulings BR Pub 10/14 – 10/19 on the implications for interest deductibility of the decision in *FC of T v Roberts*; *FC of T v Smith* 92 ATC 4.
2. The QWBAs raise two important points. First, it is the use of the funds by the LTC (and not the owner) that determines tax deductibility. Second, and less obvious, careful accounting and record keeping is required for amounts credited to shareholders' current accounts and payments made to shareholder/owners.
3. Regardless of the deduction attributed to them, the interest deduction that can be claimed by LTC owners will be limited by their owners' basis. The 7 February Supplementary Order Paper ("SOP") to the Annual Rates Tax Bill contains amendments to the way in which "secured amounts" that are included in an owner's basis are to be calculated. The amendments are to apply from the commencement of the LTC regime on 1 April 2011.
4. The discussion below is divided into the following sections:
 - What the QWBAs and QB 11/03 are about
 - LTC's use of funds vs the owner's use of the funds
 - Repayment of a shareholder's current account
 - Payment to a shareholder reflecting an asset revaluation
 - Limitations on deductions and the "secured amount" changes

LTC interest deductibility under three scenarios

5. QB 11/03 and the QWBAs concern the deductibility of interest payable by an LTC:
 - (a) On money borrowed, while it was previously an LAQC, to acquire a family home to be rented to a third party; the borrowed money was used by the LTC owner to acquire a new family home (QB 11/03).
 - (b) On money borrowed on arm's length terms to repay current account loans from its shareholders (QWBA).
 - (c) On money borrowed to make payments to shareholders reflecting the increase in the value of an income-earning asset it holds (QWBA).

6. 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.

LTC's use of the funds

7. The Commissioner's stated view is that 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. Under Section HB 1(4) 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 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).
8. 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.
9. 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. 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: *Pacific Rendezvous Ltd v CIR* (1986) 8 NZTC 5,146. 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. In QB 11/03, where the borrowed funds are used by the LTC to acquire an income-earning asset, the answer is straightforward. In the QWBAs the answer depends on the "replacement and repayment principle" from *Roberts and Smith* discussed in the commentary in BR Pub 10/14 – 10/19. This principle is essentially that the borrowed money must replace funds employed in income-earning activities when payments are made to an LTC's owners.

Repayment of a shareholder's current account

11. It is the source of the credit balance in the shareholder's current account that determines interest deductibility, based on the "replacement and repayment principle". The Commissioner's stated view is that a sufficient connection between the interest incurred by an LTC and its assessable income 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*.
12. Providing that is the case, interest will be deductible to the extent the shareholder's current account balance arose from past years' profits or contributed capital. Interest will not be deductible to the extent the shareholder's current account balance represents current year income, or amounts that arose from unrealised asset valuations or internally

generated goodwill. The basis for this distinction is covered in the commentary to BR Pub 10/14 – 10/19 and discussed in the next section below.

13. The commentary to BR Pub 10/14 – 10/19 also covers the question of payments to someone other than the partner (LTC owner, in this case). This issue is not addressed in the draft QWBAs. The same reasoning as in BR Pub 10/14 – 10/19 should apply where an LTC shareholder assigns the right to receive the payment from the current account to the person who lent the shareholder the funds contributed to the LTC. In paragraph 103 of that commentary the Commissioner's stated view is:

"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."

Payment to a shareholder reflecting an asset revaluation

14. The Commissioner's opinion is that interest will not be deductible on money borrowed to make payments to a shareholder reflecting an asset revaluation, internally generated goodwill or current year income. The basis is the decision in *Roberts and Smith* discussed in the commentary to BR Pub 10/14 – 10/19.

15. 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.

16. The commentary to BR Pub 10/14 – 10/19 states, at paragraph 113, that:

"113. Glazebrook and James, in *Taxation Implications of Company Law Reform* by Susan Glazebrook and Jan James, New Zealand (1995) 1 NZJTL 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."

17. 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.

18. 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.

Limitations on deductions and the “secured amount” changes

19. QB 11/03 and the QWBA Exposure Drafts point out that deductions are subject to the deduction limitation rules in sections HB 11 & 12.
20. 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.
21. Borrowing to distribute an asset revaluation will 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.
22. 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. This interpretation is consistent with the discussion in paragraph 103 in the commentary accompanying BR Pub 10/14 – 10/19.
23. An owner’s basis includes “investments” which, in turn, includes “secured amounts”. The SOP contains amendments to the definition of “secured amounts” as well as new definitions of “guarantor”, “owner’s associate” and “recourse property”. There are corresponding amendments that apply to the limited partnerships tax regime.
24. Under the new definition, “secured amounts” for a person will not include amounts lent to an LTC and accounted for as an investment by another person. “Secured amounts” will be the lesser of:
 - (a) LTC debt for which the person is a “guarantor”, *apportioned equally between all guarantors for that secured debt*; and
 - (b) If the guarantee expressly provides recourse to specific property (“recourse property”), the proportion of the market value of the recourse property attributable to the person, *net of higher-ranking calls, whether actual, future or contingent*.
25. A “guarantor” (among all of whom a secured debt must be apportioned) includes:
 - (a) An owner who secures a debt.
 - (b) An owner whose “owner’s associate” (a relative or a trustee associated with the owner) secures the debt.
 - (c) Any other person (who does not have to be an owner) who secures the debt in conjunction with the owner or the owner’s associate.
26. The new definition of an “owner’s associate” means that the debt must be secured by the owner, a relative, or a trustee associated with the owner.



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