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INLAND REVENUE QBs ON LTCs AND PARTNERSHIPS

1. Inland Revenue has released a number of “Questions We’ve Been Asked” (“QB”) in recent years concerning look-through companies (“LTCs”) and two QBs concerning partnerships.

Interest deductibility by LTCs

2. Inland Revenue Questions We’ve Been Asked QB 11/03, QB 12/08 and QB 12/09 concern the deductibility of interest on money borrowed by LTCs. The situations are:

QB 11/03: Whether interest will still be deductible when:

- A person had previously sold their family home, at market value, to a wholly-owned loss attributing qualifying company (LAQC) as a rental asset, to be rented to a third party on an arm’s length basis; and
- The purchase was funded by a bank loan that the person used to acquire a new family home; and
- The LAQC subsequently became an LTC.

QB: 12/08: Whether interest would be deductible when an LTC borrows money on arm’s length terms to repay current account loans from its shareholders.

QB 12/09: Whether interest would be deductible when 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.

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.

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

4. 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.
5. 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.

6. 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.
7. 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.
8. 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

9. 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.
10. 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.
11. 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

12. 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*.
13. 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.”

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

The replacement and repayment principle

15. 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.

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

17. 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

18. 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.

19. 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.

20. 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

21. 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.

22. 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.
23. 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.”

No longer any limitations on deductions

24. 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. However, the application of these rules to LTCs generally has been repealed with effect from 1 April 2017. They continue to apply only to partnerships and to an LTC in a partnership or a joint venture with another LTC.
25. For an LTC in a partnership, 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.
26. 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.
27. Note that 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.

LTC deducting interest on a loan to acquire a family home to be rented is not tax avoidance

28. **QB 12/11** is concerned with whether the general anti-avoidance rule in s. 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).

29. It is the Commissioner's view that s BG 1 will not apply to this arrangement. 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.

30. 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".

31. 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.

32. 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. "

33. 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.

34. 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)

35. 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.”

36. 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.

Tax avoidance in the context of converting a company into an LTC

37. **QB 14/11** sets out three scenarios on tax avoidance, the second of which involves a look-through company and consists of two questions.
38. The tax advantage, in both cases, concerned making use of the pre-existing ability to convert an ordinary company’s retained earnings into owners’ contributions at the company tax rate of 28%, instead of at the shareholders’ marginal tax rates.
39. This advantage has been removed, effective from 1 April 2017, and a company’s reserves are converted into an LTC’s owner’s funds at the relevant owner’s marginal tax rate.

Tax avoidance and debt capitalisation

40. **QB 15/01** concerned a debt owed by a qualifying company being capitalised in circumstances where the company was unable to repay the debt. The conclusion was that this constituted tax avoidance, however, the new debt remission rules mean that income will not arise to the debtor in the circumstances discussed in the QB, making the discussion on tax avoidance redundant.

Tax avoidance and the use of a limited partnership

41. **QB 15/11** included a scenario concerning the formation of a limited partnership, involving three New Zealand resident companies, as follows:
- (a) Company A, a tax loss company;
 - (b) Profit Co, a wholly-owned subsidiary company of Company A that is operating a profitable business; and
 - (c) Company B, a company that is unassociated with Company A and Profit Co.
42. Under the arrangement:
- (a) Companies A and B establish a limited partnership (LP), registered under the Limited Partnerships Act 2008;
 - (b) Companies A and B make equal contributions to the capital of the partnership and agree to each receive a 50% share of partnership profits and losses; and
 - (c) Profit Co sells its business operations to the LP at the open market value of those operations.
43. The tax effects of the arrangement are that:
- (a) Profit Co no longer derives business income;
 - (b) The LP derives business income;
 - (c) The LP is transparent for tax purposes with Companies A and B each deriving 50% of the LP's income;
 - (d) Company A can offset its share of LP income against its tax losses; and
 - (e) Company A's ability to group tax losses with Profit Co under subpart IC is unaffected.
44. In the Commissioner's opinion, without more, the factual situation in this scenario is not one to which s BG 1 would apply. That is, the arrangement does not have a tax avoidance purpose or effect.

Entry of new partners into a partnership: effect on continuing partners

45. **QB 14/02** concerned when the entry of a new partner into a partnership will have income tax consequences for continuing partners.
46. The answer is that:
- (a) A taxable event is not triggered for continuing partners if a new partner simply "steps into the shoes" of an exiting partner and the continuing partners' interests in the assets of the partnership have not been changed.
 - (b) However, there will be a taxable event for continuing partners if the addition of the new partner changes the continuing partners' interests in the partnership assets.

(c) Where a taxable event arises for a continuing partner, the provisions of ss HG 5 to HG 10 then apply to determine whether the continuing partner needs to account for tax. If there is a disposal, then the partner will need to apply ss HG 5 to HG 10 to determine whether there is any tax payable. These provisions are safe harbour provisions that remove the need for a partner to account for tax when the required adjustment would be below certain thresholds.

Disposal consequences upon an asset being contributed to a partnership

47. **QB 17/09** concerned whether there a full or partial disposal when an asset is contributed to a partnership as a capital contribution.
48. The answer is that there will be a full disposal of the asset with corresponding tax consequences.