NEW ZEALAND
LAW SOCIETY
NZLS EST 1869

Law Society Building, 26 Waring Taylor Street, Wellington,
DX SP20202, Wellington or PO Box 5041, Lambton Quay,
Wellington 6145, New Zealand

TEL +64 4 472 7837 • FAX +64 4 473 7909
E inquiries@lawsociety.org.nz
www.lawsociety.org.nz • my.lawsociety.org.nz

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Public Consultation
Inland Revenue Department
PO Box 2198
Wellington

By email: public.consultation@ird.govt.nz

PUB0213: Income Tax – Interest Deductibility – Roberts and Smith – Borrowing to replace and repay amounts invested in a business or other income-earning activity

Introduction

The New Zealand Law Society (Law Society) appreciates the opportunity to comment on the above draft public rulings. The Law Society's comments are limited to BR Pub 15/xa *Interest deductibility – Funds Borrowed by a Partnership to Return Capital Contributions to a Partner* and BR Pub 15/xb *Interest deductibility – Funds Borrowed by a Partnership to Return Past Years' Profits to a Partner* (Draft Rulings).

Comments

The Law Society considers the Draft Rulings' position on current year income is unnecessarily restrictive. We set out our submission and analysis below.

The "arrangement" to which the Draft Rulings apply should extend to arrangements where a partnership borrows funds to pay a partner the amount of current year income to which the partner is entitled.

The Draft Rulings correctly recognise:

- the replacement and repayment principle in *FCT of T v Roberts; FCT of T v Smith* 92 ATC 4,380 (the Roberts and Smith Principle) applies to funds borrowed by a partnership to repay an amount invested by a partner in the partnership;
- the amount of undistributed partnership income a partner is entitled to represents an investment by the partner in the partnership;
- a partner's entitlement to undistributed income arises (at paragraph [99] of the Commentary to the Draft Rulings (the Commentary)):

> …at the 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 the partner.

But the Commentary goes on to assume that a partner's entitlement to undistributed income is only determined at the end of each income year, and on this basis concludes (paragraph [98] of the Commentary):

> Current year income is not an amount that can be seen as being invested into the partnership by the partners.

It is wrong to assume a partner's entitlement to undistributed income is only determined at year end. A partner may become entitled to current year income part way through the current year, for example where:

- the partnership agreement provides for partners' entitlements to be determined at any time;
- part-year accounts are prepared recognising the partner's entitlement to year-to-date earnings.

In this circumstance the partner is entitled to current year income, and the amount of their entitlement represents an investment by the partner in the partnership. Applying the Roberts and Smith Principle, interest incurred by the partnership on funds borrowed to pay the partner the amount of this entitlement should be deductible.

Conclusion

This submission was prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further please do not hesitate to contact the committee convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours sincerely

Chris Moore
President