

TOPIC FOUR: ‘Taxation of Partnerships’

INTRODUCTION

LEGISLATION: Div 5 Pt III ITAA36; Partnership Act 1958 (VIC) (PA)



OVERVIEW:

- Partnerships are not separate legal entities.
- A partnership can exist for taxation purposes with companies or trusts as the partners.
- In general, partnerships are taxed under the ‘*attribution*’ or ‘*look through*’ model, under which partnerships are not taxpayers. Instead, the partners are assessed on the *net income* of the partnerships.
- The *partnership agreement* stipulates the partners’ rights and duties, and interest in partnership property (the agreement can be in *writing* or *oral*).

Advantages	Disadvantages
<ul style="list-style-type: none">• Losses incurred by a partnership are shared by the partners immediately and can be used to offset the partners’ other assessable income.• Income earned by the partnership retains its character in the hands of the individual partners.	<ul style="list-style-type: none">• Partners retain <i>personal liability</i> for the debts and obligations of the partnership (<i>no limited liability or asset protection</i>).

DEFINITION OF A PARTNERSHIP

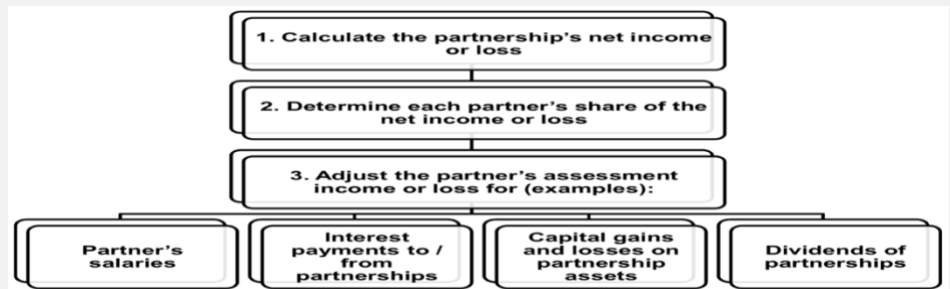
General Law Partnership	<p>s 5 PA</p> <p>TR 94/8</p>	<ul style="list-style-type: none">• <u>Contractual relationship between <i>two or more people</i> who wish to <i>conduct a business</i> in common with a <i>view to profit</i>.</u> <p><u>Requirements of the Definition Criteria:</u></p> <ul style="list-style-type: none">▪ Sufficient activity to constitute a <i>business</i>.▪ Acceptance of liability of each partner for the <i>debts</i> of the partnership.▪ <i>Joint</i> and <i>severable</i> (ie. <u>all</u> partners individual liable for <u>entire</u> obligation; liability not apportioned) liability for the <i>actions</i> of partners.▪ Sharing of <i>net returns</i>. <p><u>Factors considered to ascertain the presence of a partnership:</u></p> <ul style="list-style-type: none">▪ Mutual assent and intentions of parties.▪ Joint ownership of business assets.▪ Registration of business name.▪ Joint business account and power to operate it.▪ Extent to which the parties are involved in the conduct of the business.▪ Extent of capital contributions.▪ Entitlement to a share of net profits.▪ Business records.▪ Trading in join names and public recognition of the partnership. <p>The ATO states that the above list of factors is <i>not exhaustive</i>, and the weight given to each factor will depend on the individual circumstances.</p>
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		However, an 'entitlement to a share of net profits' is <u>essential</u> .
Tax Law Partnership	<p>s 995-1 ITAA97</p> <p><i>FCT v McDonald (1987)</i></p>	<ul style="list-style-type: none"> A partnership at tax law is defined in <u>s 995-1 ITAA97</u>: <ul style="list-style-type: none"> (a) An association of persons (other than company or a limited partnership) <i>carrying on a business as partners</i> (<u>limb one</u> - general law partnership) or <i>in receipt of ordinary or statutory income jointly</i> (<u>limb two</u> - tax law partnership); OR (b) A limited partnership (NOT EXAMINABLE). NOTE, a broader definition is provided under tax law than general law: <ul style="list-style-type: none"> The definition of a <i>tax law partnership</i> (<u>limb two</u>) includes "... receipt of ordinary income or statutory income jointly", therefore, including passive investments (ie. joint bank accounts or jointly owned investment properties even when the parties involved do not conduct a business). Implications of a tax law partnership: Limb Two Partnerships ONLY <ul style="list-style-type: none"> <u>Sharing</u> of profits or losses cannot be varied by agreement. <u>Allocation</u> of profits or losses is based on the partners <i>ownership interests</i> in the underlying property. <div style="border: 1px solid black; padding: 10px; margin-top: 10px;"> <p>CASE: <u>FCT v McDonald (1987)</u></p> <ul style="list-style-type: none"> Husband and wife owned investment properties as joint tenants, Partnership agreement: <ul style="list-style-type: none"> - <u>Wife</u> 75% of profits. - <u>Husband</u> 25% of profits and 100% of losses. Court held: <ul style="list-style-type: none"> - Not a <i>General Law Partnership</i> (not carrying on a business). - Profits and losses split by <i>ownership interest</i> (ie. 50:50) as it was a <i>Tax Law Partnership</i>, not a partnership at general law. </div> <p>NOTE: a partnership tax return is <u>not</u> required to be filed in cases such as the above and husbands and wives are allowed to include the income and deductions in their individual tax returns.</p>
Compliance Obligations	s 91 ITAA36	<ul style="list-style-type: none"> A partnership does <u>not</u> pay tax but must lodge a tax return. <ul style="list-style-type: none"> The tax return, among other things, sets out the <i>net income or loss</i> of the partnership and its <i>attribution to each partner</i>. As a partnership is carrying on a business, it must: <ul style="list-style-type: none"> Obtain a TFN for the partnership (even though it is not a separate legal entity). Obtain an Australian Business Number (ABN). Register for goods and services tax (GST) if required.

TAXATION OF PARTNERSHIPS

Overview

- Partnerships do not pay tax and any partnership income is included in the tax returns of the individual partners, as follows:

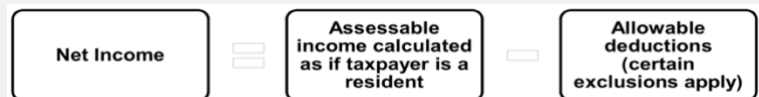


1. Net Income/Loss of a Partnership

'Net Income/Loss of a Partnership'

s 90
ITAA36

"Net Income" of a partnership is broadly:



- A *Capital Gain* is not included in the partnership's assessable income (included in the assessable income of individual partners only).
- Exclusions:
 - s 290-150 ITAA97: personal superannuation contributions (ie. *concessional contributions*)
 - Div. 36: carried forward losses (claimed at partner level – "*non-commercial losses*" rules apply (not part of course))
- "Net Loss" ("*partnership loss*") of a partnership is broadly the excess of eligible allowable deductions over assessable income, calculated as if the partnership taxpayer is a resident.
- Exempt Income* derived by a partnership is attributed to the partners and thus, may affect (reduce) the amount of loss deductions available to the partners.

s 90
ITAA36

s 92 (3)
ITAA36

2. Partner's Share of Net Income

'Partner's Share of Net Income'

s 92 (1)
ITAA36

Attribution / look through model:

- Assessable Income** of the partner includes the individual interest of the partner in the "net income of the partnership" for:
 - So much of the individual interest of the partner in the net income of the partnership as is attributable to a period when the partner was a resident; **AND**
 - So much of the individual interest of the partner in the net income of the partnership as is attributable to a period when the partner was not a resident and is also attributable to sources in Australia
- Deductions** are allowed to partners representing individual's interest in the "partnership loss" for:
 - So much of the individual interest of the partner in the partnership loss as is attributable to a period when the partner was a resident; **AND**
 - So much of the individual interest of the partner in the partnership loss as is attributable to a period when the partner was not a resident and is also attributable to sources in Australia

s 92 (2)
ITAA36

Div 36
ITAA97

NOTE: the loss must be reduced by the amount of *exempt income* derived by the partnership.

3. Treatment of Special Items

Partners' Salaries		<ul style="list-style-type: none"> A partner's salary is not regarded as an expense to the partnership (<i>not a separate legal entity</i>) and <u>not</u> deductible for income tax purposes. Instead, salaries are treated as part of the <i>allocation of profits and losses of a partnership</i> to the partners; partnership split taken <i>after</i> salaries paid. <p><i>Non-deductibility of salaries paid to partners in a partnership established in Re Scott v FCT (2002) (P.605).</i></p>
Interest Payments Between a Partnership and its Partners		<p><u>EQUITY INTEREST</u></p> <ul style="list-style-type: none"> Interest paid to a partner on <u>capital contributions</u> to the partnership are not regarded as an expense and <u>not</u> deductible; treated as part of the allocation of profits of the partnership to the partner. <p><i>Non-deductibility of interest paid on capital contributions paid to partners in a partnership established in FCT v Beville (1953).</i></p> <p><u>DEBT INTEREST</u></p> <ul style="list-style-type: none"> Interest incurred by a partnership on a <u>loan</u> used for <i>working capital</i> <u>is</u> deductible. <ul style="list-style-type: none"> Applies even if the loan is used to <i>repay capital contributions</i> of partners, <i>provided</i> the borrowings are used to refinance funds employed in the partnership <u>business</u> (sufficient nexus to the generation of Assessable Income required). <p><i>Deductibility of interest paid on loans used for working capital established in FCT v Roberts and Smith (1992) & TR 95/25 ('refinancing principle' - applicable to <u>General Law Partnerships</u>).</i></p>
Superannuation for Partners		<ul style="list-style-type: none"> Concessional employer superannuation contributions <i>to partners</i> are <u>not</u> deductible at the partnership level – partners cannot employ themselves. Instead, partners can make concessional contributions at the individual level based on the <i>Superannuation</i> regime. <ul style="list-style-type: none"> <i>Add back</i> deduction for concessional contributions at partnership level. <i>Deduct</i> payment of concessional contributions at individual level.
Dividends Received by a Partnership	s 207-35 ITAA97	<ul style="list-style-type: none"> A partnership <u>includes</u> in Assessable Income the amount of a <i>dividend received</i> plus <i>imputation credit</i>. On distribution as part of the "<i>net income of the partnership</i>", the dividend and imputation credit retain their character. <p>NOTE: unlike a <i>trust</i>, even if a <i>partnership</i> has made a <u>loss</u>, the partners can still share the franking credit attached to the dividend.</p>
Capital Gains Tax	s 106-5 ITAA97	<ul style="list-style-type: none"> <i>Capital gains</i> and <i>capital losses</i> arising from a CGT event in respect of a partnership or one of its CGT assets is made by the partners <u>individually</u> by reference to the partnership agreement (or partnership law if there is no agreement). CGT consequences on <i>new partner admissions</i> and <i>retirement</i>: <ul style="list-style-type: none"> <u>Admissions</u>: existing partners treated as disposing their interest in partnership assets. <u>Retirement</u>: remaining partners treated as acquiring a s share of the departing partner's interest in partnership assets.

VARIATION / DISSOLUTION OF PARTNERSHIPS

- Partnership agreements should be drafted so that the business continues even when *death, retirement or admission of a new partner* takes place – ***otherwise***, a *new partnership* and *tax return* are required.

Item	Income Tax Treatment
<i>Work in Progress</i>	Outgoing partner may sell the WIP to existing partners: <i>Assessable Income</i> under <u>s 15-50 ITAA97</u> (SI). <i>Specific Deduction</i> allowed under <u>s 25-95 ITAA97</u> .
<i>Trading Stock</i>	Deemed to be notionally disposed of at market value, outside the ordinary course of business: <u>s 70-100 ITAA97</u> (see Topic 7).
<i>Depreciating Assets</i>	Roll-over relief provided so that no tax liability arises on a change in the partnership: <u>s 40-340</u> . (NOT EXAMINABLE)

ADDITIONAL INFORMATION

<i>Uncontrolled Partnership Income</i>	<u>s 94 ITAA36</u>	<ul style="list-style-type: none"> A <i>penalty tax rate</i> ('<i>anti-avoidance provision</i>') is imposed on "<i>uncontrolled partnership income</i>" in the hands of the partner. <ul style="list-style-type: none"> "<i>Uncontrolled partnership income</i>" arises when a partner of a partnership has <u><i>no real and effective control</i></u> of his/her share of the net income of the partnership (ie. no actual involvement in the business of the partnership). Penalty tax rate is generally the <i>top marginal tax rate less the average rate of tax of the partner</i>. Does not apply to a partner that is a <i>company, trustee or minor</i>.
<i>Limited Partnerships</i> (NOT EXAMINABLE)	<u>s 995-1 ITAA97</u>	<p><u>Definition:</u></p> <ul style="list-style-type: none"> "<i>an association of persons (other than a company) carrying on businesses as partners ... where the liability of at least one of those persons is limited</i>". <p>Generally taxed as companies: <u>Div 5A Part III ITAA36</u></p>
<i>Note for allocation of partners' share of net income</i>		<ul style="list-style-type: none"> The amount of 'net income' of the partnership available for distribution to partners on a percentage share basis (ie. <i>as per the partnership agreement – for example, a 70.30 split</i>) is <u>reduced</u> by any <i>direct allocations</i> (ie. <i>salary, superannuation</i>) – <i>direct allocations</i> are made from 'net income'.