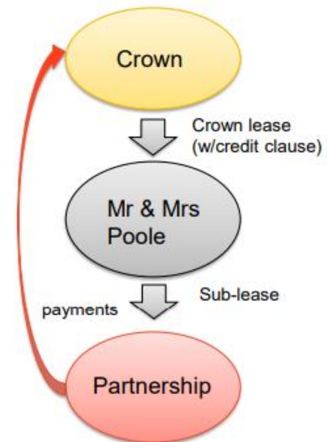
(A) Problem Q Scaffold – Partnerships

- **1. GENERAL LAW PARTNERSHIP VS. TAX LAW PARTNERSHIP**
  - **Definition of "partnership" in s 995-1** – Partnership means an association of persons (other than a company):
    - **(1) Carrying on a business as partners; OR (General law partnership);**
      - Picks up general law meaning – persons carrying on business in common with a view of profit
      - First limb requires that BOTH parties intend to carry on business and that they intend to carry it on TOGETHER (i.e. business 'in common') – need to see evidence that this is in fact occurring.
    - **(2) In receipt of ordinary income or statutory income jointly (Tax law partnership)**
      - When we have a tax law partnership, interest in partnership income can't be based on partnership agreement, because we don't actually have a partnership.
      - Test: Instead, we determine attribution/allocation of income or loss based on partners interest in the asset itself.
  - **McDonald (FCA 1987)**
    - **Facts**: Husband and wife acquired properties as JT's. Had recorded details of their arrangement (investment activities) in writing (and later relied on this as evidence that they had entered into a partnership arrangement). Under agreement, couple determine 75% of profits would go to benefit of wife, and the remainder to the husband. However, if any losses were incurred, these would be solely borne by the husband (the TP). The couple made losses on the investment.
    - **Issue**: Was this a general law partnership or a tax law partnership? What consequences does this have for the TP?
      - **Why does it matter?**
        - TP tried to argue that the arrangement constituted a general law partnership, because this would require looking at partnership agreement to determine who would get the benefit of the loss.
        - If it was merely a tax law partnership, the interest of the partners in the underlying income or loss would be determined by their underlying interest in the property (i.e. 50/50 in this case).
    - **Held:** Beaumont J found that the couple weren't carrying on a business – were just engaged in co-ownership. As a general law partnership requires 'carrying on a business', being engaged in a passive investment activity won't cut it.
      - His Honour observed that there was little active participation by either parties (husband engaged in other full-time work (minor participation), wife was stay-at-home mum and had no commercial expertise).
    - From a legal perspective, the loss was found to be borne 50% by each party as they were JT's of the property, however the husband had

agreed to indemnify his wife against any loss (if there was a loss), or to transfer part of his interest to her such that she would receive 75% profit (if there was a gain).

- **2. ASSESSABLE INCOME OF A PARTNER IN A PARTNERSHIP**
    - **Operative provision – (s 92 ITAA 1936)**
        - **s 92(1) Partnership income** – The assessable income of a partner in a partnership **shall include so much of the individual interest** of the partner in the net income of the partnership of the year of income as is attributable to a period when the partner was a resident (or was not a resident, but is attributable to sources in Australia)
            - **Individual interest** - generally determined by what is stated in the partnership agreement (to the extent one exists)
            - **When is the income derived** – Generally, there is no entitlement to income or loss until the accounts of the partnership are taken (usually done at the end of the year)
        - **s 92(2) Partnership losses** – If a partnership loss is incurred by a partnership in a year of income, a deduction will be allowable to a partner in the partnership in accordance with the individual interest of the partner in the partnership loss as is attributable to a period when the partner was a resident.
        - N.B. s 92 creates a category of statutory income for the PARTNER (not the partnership) (which demonstrates full integration approach) – same concept applies for losses.
    - **Definition of "net income" & "partnership loss" (with respect to a partnership) (s 90 ITAA 1936)**
        - **s 90 – "net income"** in relation to a partnership means the assessable income of the partnership, calculated as if the partnership were a taxpayer who was a resident, less all allowable deductions.
            - N.B., we make an assumption that the partnership is a TP for the purposes of calculating its net income (i.e. this is a legal fiction)
        - **s 90 – "partnership loss"** in relation to a partnership, means the excess (if any) of the allowable deductions… over the assessable income of the partnership, calculated as if the partnership were a TP who was a resident.
    - **Reporting requirements: Partnership (s 91 ITAA 1936)**
        - **s 92(1) Return lodged but no tax paid** – A partnership shall furnish a return of the income of the partnership but shall not be liable to pay tax thereon.
            - **Administrative rule** – partnership lodges a tax return but doesn't pay tax at an 'entity level'.

- **2. TRANSACTIONS BETWEEN PARTNERS**
    - **FCT v Poole & Dight (Walsh J, HCA 1970) – Tax effective arrangements between partners and partnership**



        - **Facts:** Mr. and Mrs. Poole had Crown lease over property. Lease provided that any payments of rent to the Crown were credited towards the ultimate purchase of the freehold.
        - In effect, the couple sub-leased the property to the partnership.
        - Partnership agreed to pay the amounts due for the use of the property directly to the Crown (i.e. not paid by Poole couple in their personal capacity), while government provided credit to Mr. and Mrs. Poole in relation to those payments.
        - **Issue**: Question was whether the rent was deductible to the partnership.
            - Commissioner disallowed deduction for partnership, but deemed payments irrelevant for tax purposes for Poole couple.
        - **Held:** Concluded that the partnership was entitled to a deduction for the rent, however in effect, Mr. Poole had constructively received half of this amount when it had been applied for his benefit to meet his obligations under the Crown lease.
        - Approach taken by Walsh J was that the partnership had effectively derived rent to the Poole couple, whom then paid that amount on to the Crown to meet their obligations under the Crown lease (per s 19 ITAA 1936 constructive receipt rule).
        - Because the payments made by the partnership (i.e. rent paid to Crown) were for the use of the property which related to the grazing business, those payments were deductible as they were akin to rent (focusing on the nature of the benefit derived by the partnership as a result of those outgoings).
        - Court accepted that Mr. and Mrs. Poole had effectively sub-leased the land to the partnership even though they were members of the partnership – demonstrates how partners may give effect to transactions such as this for tax purposes.

    - **Transactions between partners: SALARIES**

        - **Partnership cannot pay a salary to a partner**
            - As the partnership itself does not have a separate legal personality, it cannot be an employer and thus cannot pay a salary.

        - **Partnership can make payments to partners (TR2005/7)**
            - A partnership can pay an amount to a partner, however it wouldn't be recognised as salary and wouldn't be an allowable deduction as such. Commissioner's view in TR2005/7:
                - Not a deductible expense but recognised as a distribution of (anticipated) profits.

- Has the effect of varying the agreement as between the partners (see example 1 from ruling)

Example: Tax consequences of partnership attempting to pay a partner a salary.

- **Facts:** "Anna and Robert formed a partnership under which it was agreed that they share the profits and losses of the partnership equally. The partnership agreement allowed the partners to draw a salary if the partners so agreed. It was agreed at the beginning of the income year that Anna would draw a salary of $20,000, for managing the business, and that the balance of profits and losses would be shared equally. The 2003-2004 year's net profit after paying Anna's salary was $35,000. **[what are the tax consequences to A & R?]"**

- **Tax consequences:** Settled view is that partnerships cannot pay partners salary, so the $20,000 of 'salary' which was expensed, will not be deductible for tax purposes. So, need to add that back to the accounting profits of $35,000. This produces a partnership net income amount of $55,000. Then need to determine what A & R's interest in the partnership is.
- When we look at A's share, we give effect to the partnership agreement. A is entitled to $20,000 + 50% of the balance. R's share is simply 50% of the balance (i.e. of the $35,000).
- Although the amount assessable as income ends up being the same, the character of that income is different. What this means is that the amount A derives as statutory income ($20,000 + 50% of balance) is assessable by virtue of s 92 as a share of the net income of a partnership. It does not mean that the salary of $20,000 is assessable to her under s 6-5.
  - If we had been able to characterise the $20,000 as 'salary' to her, this would be assessable as ordinary income under s 6-5. So, that $20,000 gets re-characterised as statutory income assessable to her under s 92.

- **Transactions between partners: LOANS**
  - **Genuine loan to partnership vs. contribution of working capital**
    - DEBT → Genuine loan – This is where a partner loans money to the partnership in their personal capacity (i.e. not in their capacity as a partner). The amount borrowed will be repayable with interest – thus would be considered a genuine loan.
    - EQUITY → Contribution of working capital – A partner may contribute funds to a partnership in the form of equity. This would be recognised in the partnership agreement as an equity contribution.
  - **FCT v Roberts & Smith → Refinancing in relation to general law partnerships**
    - **Facts**: A partnership of solicitors borrowed from a commercial bank and used the money to pay back capital contributed to the partnership by the five partners, including Smith. The partnership claimed interest deductions on the loan. The Commissioner disallowed the interest deductions and increased the assessable income of each of the partners accordingly.

- The amount the money was paid out of was called a 'partnership capital account'.
- This was effectively a way of refinancing. The partnership was replacing the money contributed by the partners (equity) with debt (the loan money) to fund the operations of the partnership.
- **Issue**: Court had to determine the nature of the partnership capital account – was the amount paid to the partners a refund of contributed capital (and thus deductible) or was it undrawn distributions and profits (and thus not deductible, as loan not drawn for the purposes of carrying on the operations of the partnership)?
- **Held**: Hill J said that interest on a 'borrowing [by a general law partnership] to fund repayment of moneys originally advanced by a partner and used as partnership capital' will be deductible to the extent the partnership capital was employed in a business of the partnership which was carried on for the purpose of producing or gaining assessable income.
    - Hill J said that interest on borrowings to refinance funds employed in the partnership business will be deductible if the funds represent 'partnership capital in the Lord Lindley sense, undrawn profit distributions, advances by the partners or other funds which have actually been invested in the partnership and which the partners were entitled to withdraw'
- However, Hill J made it clear that interest on a borrowing by the partnership is not deductible to the extent that the borrowing is used to make payments to the partners which do not comprise a 'refund of moneys previously invested in the partnership business'. On this basis, interest on borrowings to replace partnership capital which is represented by internally generated goodwill or unrealised revaluation of assets will not be deductible to the partnership.

- **Partner drawing/loan accounts**

    - If a partner of a partnership is in need of funds before the accounts of the partnership are drawn at year end, they can keep account of the amounts drawn from the partnership through a drawing account, and then may offset this amount owing through entitlements they get (i.e. amount they are paid) when the accounts of the partnership are drawn.
    - These accounts may go into either deficit or credit.

- **3. PARTNERSHIPS AND BUSINESS ASSETS**

    - Legal title to an asset used by a partnership may be held by one or more partners, however all partners are deemed to have an equitable interest in the property.

- **Commissioner of State Revenue v Rojoda [2020] – Each partner has a non-specific equitable interest in the assets of the partnership**

  - **Held**: Confirmed that the nature of the interest that each partner has in a partnership is a non-specific equitable interest in relation to all current assets of the partnership.
  - Each partner is recognised as having an equitable interest in each item of partnership property, however it is important to note that it's a non-specific interest:
    - 'the peculiar nature of the fluctuating, unascertained, non-specific interest of partners in relation to partnership assets [39] – the only time when a partners' interest in the partnership will be discerned, is if the partnership is being dissolved.'

- **4. SOME EXPLICIT RULES**

  - **Trading stock – all calculations done at partnership level**
    - Because we assume the partnership is the TP for tax purposes, we also treat trading stock as being owned by the partnership. So, for expenses incurred to acquire trading stock, income derived on the sale of trading stock and working out the opening/closing values of stock on hand, all of these calculations are done at the partnership level.

  - **Depreciating assets – Deemed to be held by the partnership**
    - Like trading stock, we adopt the fiction that depreciating assets are held by the partnership as the TP. In s 40-40, item 7 explicitly states that for the purposes of Div. 40, depreciating assets are deemed to be held by the partnership.

  - **CGT – Each partner has separate cost base for that partners interest in CGT asset**
    (s 106-5, note examples in s 108-5(2))
    - **Test:** Each partners gain/loss is calculated by reference to the partnership agreement, or to partnership law if there is no partnership agreement. Need to look at the partnership agreement, or some indication in arrangements as to the interest that a partner holds in partnership assets. (**s 106-5(1)**)
      - **Definition of CGT asset = (includes) partnerships (s 108-5(2)(c))**
        - **s 108-5(2)(d)** – "CGT asset includes an interest in a partnership not covered by s 108-5(2)(c)" → This means that an interest of a partner in a partnership agreement can itself be treated as a CGT asset, in addition to the interest that the partner has in relation to specific underlying CGT assets.
      - N.B. we're talking about a fiction here as the above result assumes a certain interest of the partners in the partnership assets. Based on Rojoda case [2020], no such interest is capable of being discerned.

(B) Problem Q Scaffold – Companies

Summary of the taxation of company distributions

- **1. COMPANY TAXED AS SEPARATE TAXPAYER (PARTIAL INTEGRATION)**
    - **ss 4-1 and 9-1** - "By virtue of ss 4-1 and 9-1, a company is recognised as a separate TP in accordance with the partial integration basis of taxation. Accordingly, a company will compute income tax liability for the year, lodge returns and be subject to tax on the income it earns."
    - **Consolidation regime (Tax Consolidated Groups)** – By election, (only) an Australian resident head company and wholly owned subsidiaries can be treated as a single entity for income tax purposes – means that you can ignore internal transactions, loans and shares etc.
- **2. TAXATION OF DIVIDENDS PAID TO SHAREHOLDERS**
    - **1. Is there a dividend under s 6 ITAA 1936?**
        - **Definition of "dividend" (s 6)**– includes any distribution made or amount credited by a company to any of its shareholders, whether in money or other property.
        - **Dividend DOES NOT INCLUDE (s 6):**
            - **(a) Moneys (i.e. distribution) debited against the share capital account:**
                - What is the share capital account? (s 975-300) – An account that the company keeps of its share capital.
                - 'Tainted accounts' – An account may become 'tainted' if amounts are transferred in from another account (i.e. from realised profits) into the share capital account – once this has occurred, distributions will be dividends however won't be frankable.
            - **(b) Money's paid to redeem redeemable preference shares**
    - **2. If we have a dividend, is it included in assessable income by virtue of s 44 ITAA 1936?**
        - **Dividends assessable as statutory income** – Dividends are not taxable as ordinary income under s 6-5 ITAA 1997 but are taxed as statutory income by virtue of s 44 ITAA 1936.
        - **Test**
            - (i) Is there an amount paid?
            - (ii) Is the amount paid out of profits?
        - **(i) Is there an amount PAID? (per s 6 ITAA 1936)**
            - **Definition of "paid" (s 6)** – includes 'credited' or 'distributed'.

- **Can be an in-specie distribution** – does not need to be a distribution of cash. If the distribution is of property, then the money value of the property will be treated as the amount of the dividend (**s 21**).

- **When is dividend taken to be paid?** (s 960-120) – A company makes a distribution in the form of a dividend on the day on which it is paid or taken to be paid. This provision creates a cash basis for the taxation of dividends.
    - It is not when an entitlement arises, but when the dividend is actually paid to shareholders that the income by way of dividends is derived.

- **(ii) Is the amount paid "OUT OF PROFITS"? (TR2012/5)**

    - **Definition case**: ***Slater Holdings*** – Defines 'profit' in a broad sense, as including 'gains', even if they would not be income for tax purposes. This means:
        - Capital gains are profits
        - Unrealised gains can also be profits if realised in the accounts of the company.
        - A gift (although not income) may also be considered a profit.

    - **Special issues (disputed cases):**

        - ***Condell*** – **Amount taken to be distributed out of profits if distribution made from retained profits account.**
            - **Facts:** Distribution (in specie/shares) was made from a retained profits account. Issue of Commissioner was that account only reduced by $4b, however market value of shares distributed was $29b.
            - **Held:** Because the amount was distributed out of the retained profits account (i.e. the $4b which was debited out of this account), this was sufficient for a finding that the distribution was made 'out of profits'.

        - ***Uther*** – **Apportionment is possible for distribution that is partially out of profits, and partially not (i.e. if some of the amount is a return of capital through debit to share capital account)**
            - **Facts**: Involved a distribution that was described to shareholders, and in the accounts, as a return of capital. However, distribution was of an amount greater than that shown on the share capital account.
            - **Held**: Dissent of Kitto J is preferred in later cases. He found that it was appropriate to apportion. Kitto J held that only the debit to the share capital account was a return of capital;

the balance being a dividend paid out of profits – he effectively accepted that you could do an apportionment.

- Majority holding in Uther (disallowing apportionment hasn't been explicitly overruled) – would just be a matter of determining whether Uther was distinguishable on its facts in relation to some other circumstances in question.

- **3. Is the distribution made to the shareholder in their capacity as shareholder?**

  - **"Shareholder"** - defined to include member (**s 6**)

- **4. What if we have a return of share capital?** (i.e. a distribution not made out of profits?)

  - **General** – If the amount is not paid out of profits, it probably won't be a dividend, and thus won't be s 44 income.

  - **Two potential CGT events**:

    - **(A) If shares still held by shareholder, but there has been a return of capital** - CGT event G1 reduces the cost base – whatever cost base particular shareholder has in particular shares, it will be reduced by the amount of capital returned. That will in most cases not give rise to any tax consequences. It's only when the shares are later sold, that a greater amount of gain will be realised.

    - **(B) If shares are cancelled or redeemed by shareholder, and some or all of the amount is paid by way of a return of share capital** - one would compare the amount received on cancellation/redemption to the cost, to work out any capital gain or loss, reduce this by any amount assessable by virtue of the event and then claim any available CGT discount which might be important in this particular circumstance.

3. THE IMPUTATION SYSTEM

OVERVIEW

- Once we have determined that the distribution received by a shareholder is a dividend per s 6, and that the dividend should be included in assessable income by virtue of s 44 as statutory income, now we need to look at how the mechanisms of the Tax Act allow for the credit in relation to the tax paid by the company to pass through to shareholders, along with the distribution of profits.

OVERVIEW

- **(A)** Company may choose to pass on to shareholders (members) the credit associated with previous tax it has paid when it makes a distribution of profits – this is called 'franking' a distribution (Div. 202)
  - N.B. To pass on the credit, the distribution must be "frankable".
- **(B)** Company must maintain a franking account to track the amount of tax paid (Div. 205)
- **(C)** The franking credit allocated to a distribution must be specified in a statement provided to recipients – the gross-up and credit rules are found in Div. 207
  - N.B. the benefit of the franking credit is available to companies as well as individuals.
- **(D)** Note on company tax rate changes: Treasury Laws Amendment (Enterprise Tax Plan) Act 2017
  - Rates for the imputation calculation are now based on rate applicable to company, which may be only 27.5% or 30% (30% is used for all entities in this course for simplicity).

- **RULES RE: FRANKING A DISTRIBUTION (Div. 202)**

"To determine the appropriate entries to be made in the company franking account, we must firstly consider whether the rules in Div. 202 surrounding the franking of a distribution are satisfied."

***Important*: Dividend may be assessable, but not frankable**
[We work through ss 6 and 44 to determine whether we have a dividend that must be included as an amount of assessable income by shareholders. The below rules then tell us whether we can attach a franking credit to a particular distribution (dividend). So, the question becomes, if we have a distribution that is assessable, can a shareholder get the benefit of the tax that has been paid by the company on those profits already.]

- **Is the distribution frankable? (s 202-40): 'A distribution is frankable to the extent that it is not unfrankable under s 202-45'**
  - **Unfrankable distributions (s 202-45)**:
    - **(d)** A distribution in respect of a non-equity share;
    - **(e)** Distribution sourced directly or indirectly from share capital account;
      - These amounts would not ordinarily be included in the definition of dividends, except for in circumstances where the share capital account has been tainted. If the share capital account has been tainted, such a distribution will be assessable, not frankable.
    - **(g)** Private company deemed dividends

- **Maximum franking credit that you can attach to a distribution (s 202-60):**

  - **Rule:** Maximum franking credit is worked out by taking the amount of the distribution and multiplying that by (30/70) → The sum of this calculation will give you the maximum amount of credits that you can attach to a distribution of a particular amount.

- **Benchmark rule: All distributions made in the period must be franked to the same extent as the first distribution (anti-streaming rule):**

  - This is to ensure that all distributions made within a 6-month period are franked to the same extent, so that all shareholders benefit the same during that period.

THE COMPANY FRANKING ACCOUNT

- **What is the company franking account? –** The company franking account is a running balance of the tax paid by the company that is kept in order to determine whether there is any credit that can be passed on to shareholders through the franking of dividends (Div. 205)

- **Determining franking credits (s 205-15)** – s 205-15 lists circumstances under which a credit to the company franking credit account arises, the amount of the franking credit and the timing of it (all of the circumstances in the table pick up situations where an amount of tax has been paid by the company, or when a credit has flowed through from another entity).

  - **Circumstances giving rise to a CREDIT to company franking account:**
    - Item 1: Entity pays a PAYG instalment (credit arises on day payment made)
    - Item 2: Entity pays income tax (credit arises on day payment made)
    - Item 3: A franked distribution is made to the entity (credit arises on day distribution is made)

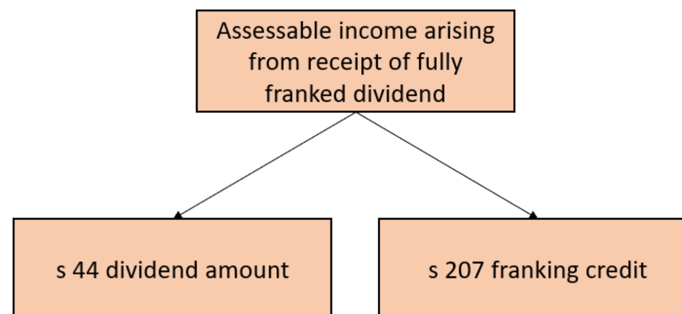
- **Determining franking debits (s 205-30)** – s 205-30 lists circumstances under which a debit to the company franking account arises, the amount of the franking debit and the timing of it (picks up circumstances where company is effectively allocating credits out to shareholders, which is effectively using the franking credits up, so we want to debit the franking account to reflect that).

  - **Circumstances giving rise to a DEBIT to company franking account:**
    - Item 1: Where the entity franks a distribution (debit arises on day distribution is made)
    - Item 2: Where the entity receives a refund of income tax (debit arises on day refund is received)

    - In this situation, we effectively need to reverse the franking.
  - Item 3: Where the entity breaches the benchmark rule (essentially operates as a penalty).

- **OPERATION OF IMPUTATION SYSTEM RE: TAXATION OF DIVIDENDS DISTIRBUTED TO INDIVIDUAL SHAREHOLDERS**

  - **Grossing up assessable income by franking credit (s 207-20(1))** – Where a company makes a distribution of a franked dividend to a shareholder, the shareholder is required to 'gross-up' or include an additional amount in their assessable income to reflect the reflect the franking credit which is attached to the dividend when it is paid.



  - **Shareholder calculates tax payable (see Div. 6AA rates) –** Once an individual shareholder has appropriately grossed-up their assessable income, they would then need to apply the appropriate rates scale to work out the amount of tax payable
    - (would then proceed to deduct tax offset from tax payable per below).

  - **Shareholder's entitlement to tax offset (s 207-20(2)) –** A shareholder who receives a franked dividend is entitled to a tax offset for the income year in which the distribution is made. The tax offset is equal to the franking credit on the distribution.

    - **Tax offset** – This amount is directly deducted from the total tax payable by the shareholder in receipt of the franked dividend.

    - **If tax offset > tax payable** – the excess is refundable to individual shareholders under Div. 67.

- **OPERATION OF IMPUTATION SYSTEM RE: TAXATION OF DIVIDENDS DISTRIBUTED TO COMPANIES**

  - **Normal operation of the gross-up and tax offset rules (s 207-20)** → SEE ABOVE

  - **Gross-up and offset will cancel each other out:** If the same tax rate applies to the company paying the dividend and the company receiving the dividend (which it will in this course), the gross-up and offset rules will result in the dividend not being taxable in the hands of the corporate shareholder (i.e. the gross-up and offset will cancel each other out).
    - N.B. this effectively means that through a chain of companies, credits for tax paid at the corporate level can be passed through the chain to individuals.
  - **If tax offset > tax payable** - If there is any excess franking offset (remainder after tax offset applied to total tax payable), this amount will not be refundable in the same way that it is refundable for individual shareholders (s 67-25).