Advanced Income Tax Law

Chapter 3

Partnerships

Overview

Definition of a partnership

Tax law defines a partnership as "an association of persons carrying on a business as partners or in receipt of ordinary income or statutory income jointly, but does not include a company".

Overview

Creation of partnership

For tax purposes the existence of a partnership is a *question of fact* determined according to the facts relevant to each particular circumstance.

A formal written partnership agreement is <u>not</u> a pre-requisite for a partnership to be held to exist for tax purposes.

Overview

Creation of partnership

The following factors are *prima facie* evidence of a partnership:

- joint ownership of business assets
- joint bank accounts
- registration of a business name
- sharing of profits/losses
- evidence of capital invested
- public recognition of the business as a partnership

Income Splitting

A partnership may be formed between family members as a means to split income and therefore reduce the family's overall tax liability.

This is a means of tax minimisation and is a legitimate tax planning technique.

Taxation of a Partnership

A partnership itself does not pay income tax, but it is required to lodge a **Partnership tax return - Form P**

A partnership tax return is **not** necessary where persons are not in a partnership carrying on a business and the only income derived jointly (or in common) with another person was:

- rent from a jointly owned investment property.
- interest from a jointly held account.
- dividends from jointly held shares.

Partners Share of Income

Each partner is individually taxed on their share of partnership net income (PNI).

It must be included as assessable income in the partner’s individual income tax return.

If there is a partnership loss, then each partner's share of the loss is a deduction in their own income tax return.

Partnership Net Income (PNI)

s.90 ITAA36 defines net income as “the balance left after deducting from the partnership assessable income all allowable deductions and allowable losses”.

s.90 PNI is divided between the partners in accordance with their profit/loss sharing ratio.

Partnership Net Income (PNI)

A Partnership tax return requires the completion of a **Statement of Distribution** which shows for each partner:

- name
- Tax File Number and address
- share of s.90 PNI
- share of any dividend franking credit
- share of TFN amount withheld, etc.

Determination of s.90 PNI

Financial dealings with partners in partnership capacity are not considered in determining s.90 PNI.

The following payments to partners are not deductions for the partnership:

- salaries paid to partners
- interest on capital

Alternatively, the following receipts from partners are not assessable income for the partnership:

- interest on drawings

Determination of s.90 PNI

Financial dealings with partners not in partnership capacity are considered in determining s.90 PNI.

- interest expense on a loan (advance) made by a partner to the partnership is a deduction for the partnership.

- interest received from a loan (advance) made by the partnership to a partner is assessable income of the partnership.

Dividend Imputation

Where a partnership receives a franked dividend, the following rules apply:

- the partnership's assessable income is "grossed up" to include the amount of the franking credit.

- the franking credit is then apportioned between the individual partners in accordance with their s.90 PNI share .

Partnership Losses

A partnership cannot carry forward a loss for deduction against income in a future year.

Losses are distributed to the individual partners in the year in which the loss was incurred.

Partnership Capital Gains/Losses

A capital gain or loss is not included in the calculation of s.90 PNI.

Instead, the individual partners are assessed on their respective shares of any capital gain/loss.

Miscellaneous Matters

No Deduction Allowed

A partnership is not allowed a deduction for:

- contributions made to superannuation funds on behalf of the partners.
- premiums paid by the partnership on the life of a partner.

Such payments are instead deductions for the partners individually.

Miscellaneous Matters

Payments to Relatives and Associated Persons

The ATO has the discretion to allow only what they consider “reasonable” as a deduction for payments made to relatives and associated persons and related entities.

Excessive payments which are disallowed need to be added back to net profit so as to determine s.90 PNI.

Uncontrolled Partnership Income (UPI)

s.94 ITAA36 is designed to minimise tax avoidance by imposing a special further tax on any *uncontrolled partnership income.*

It is a penalty tax imposed on partners who do not have *real and effective control* over their share of s.90 PNI.

Partners who are minors are not affected by the UPI provisions.

Uncontrolled Partnership Income (UPI)

Real and effective control

Factors to consider are:

- the constitution of the partnership as per the partnership agreement.
- the control of the partnership as per the actual facts.
- the conduct of the partnership's operations.

Uncontrolled Partnership Income (UPI)

The rate for 2019/20 is 45% reduced by the average rate of ordinary tax (excluding tax offsets and credits) on the taxpayer's taxable income.

Uncontrolled Partnership Income (UPI)

Rate of further tax

The rate of further tax is calculated as follows:

$$45\% \text{ less } \left(\frac{\text{Tax on taxable Income}}{\text{taxable income}} \times 100\%\right)$$

The FCT has the discretionary power not to apply UPI penalty tax where "special circumstances" exist.

Structural Changes to Partnerships

Trading Stock

A change in the ownership of a partnership (e.g. due to formation, admission or dissolution) is treated for tax purposes as a notional disposal of the stock by the old owner(s) to the new owner(s).

Under s.70-90 any profit (loss) upon from revaluation is assessable income (deduction) of the old owner(s).

Structural Changes to Partnerships

Trading Stock Election

As per s.70-100(4) an agreement can be made by the old and new owners that s.70-90 does not apply (i.e. the owners of the new business structure may elect to use the value of trading stock that would have been taken into account if no disposal had occurred.

Under s.70-100 any profit (loss) upon from revaluation is assessable income (deduction) of the new owner(s).

Structural Changes to Partnerships

Trading Stock

The s.70-100(4) agreement can only be made where:

- the old owners retain at least a 25% interest in the new business structure.
- all new owners agree to the election being made.
- the ATO is advised.

Structural Changes to Partnerships

Depreciable assets

If there is a partial change in the holding of a partnership asset, or where an asset becomes a partnership asset (e.g. where a partnership is created, varied or dissolved) an adjustment may be required under the balancing adjustment rules.

This applies where at least one partner who had an interest before the change has an interest after that change.