Taxation of Partnerships

CPE Supplement – Prog 3: CGT and Partnerships

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Under the general law, a partnership is an association of individuals or entities for the purpose of carrying on a business venture or a business activity in common with a view to profit (also refer to sec 5 of the Partnership Act 1958 (Vic)). Each partner is entitled to take part in the management of the partnership. A partnership is not a separate legal entity, and as such, all the assets of the partnership are owned by the partners jointly. Whilst the income tax laws extend the definition of a partnership to include an association of individuals or entities in receipt of income jointly, this paper deals specifically with general law partnerships.

This paper begins by exploring the treatment of partnership interests under the capital gains tax ("CGT") regime, followed by a CGT analysis of various transactions relating to partnerships such as:

- formation;
- admission of new partners;
- retirement of partners or dissolution of partnership; and
- mergers or takeovers.

The paper concludes with an examination of the CGT concessions available to partners, including the Div 115, Div 152 and rollover relief in Subdiv 122-B of the Income Tax Assessment Act 1997 (Cth) ("ITAA 97").

CGT treatment of partnership interests

There was initially some doubt amongst tax practitioners as to how the CGT provisions apply to partnerships. This is because although a partnership is required to lodge an income tax return, each partner has a fractional interest in each and every asset of the partnership: Federal Commissioner of Taxation v Everett (1980) 143 CLR 440 at 446. Accordingly, there was uncertainty as to whether capital gains and losses under the CGT regime were incurred by the partners themselves or by the partnership.

The Commissioner of Taxation took the position that "even though the partnership itself is treated as a taxpayer for purposes of calculating the net income of the partnership, that net income does not include a net capital gain on the disposal of the partnership asset. Similarly, a capital loss determined… in respect of the disposal of a partnership asset is not a partnership loss; rather, the loss is incurred by the partners in their own right" (refer to paragraph 6 of IT 2540).

Sections 106-5 and 108-5 of the ITAA 97 now specifically exclude the CGT provisions from the calculation of net income or partnership loss of the partnership itself. Section 106-5 also clearly

states that capital gains and losses arising from the disposal of partnership assets, or from the disposal of an interest in partnership assets, are made by the partners individually.

The position is therefore that each partner's fractional interest in a partnership asset constitutes a separate asset for CGT purposes. In addition, sec 108-5(2)(d) provides that so much of a partner's interest in the partnership which cannot be attributed to a specific partnership asset is itself an asset (this would include such interests as the right to income of a partnership arising from Everett assignments, i.e. an assignment of all or part of a partner's interest in the income of the partnership to a third party).

As the tax laws operate to treat each individual partner's share in the partnership as representing a direct fractional interest in each and every asset of the partnership, where a partnership asset is sold each partner is treated as having disposed of their fractional interest in that asset for CGT purposes. For example, if the partners in a partnership each hold a one third interest in the partnership and real estate owned by the partnership is sold, then for CGT purposes the partners each dispose of a one third interest as tenant in common in the real estate. Any gain from the disposal is not included in the partnership income but, rather, directly in the individual partner's income.

This implication of this approach is twofold:

some partners may hold an interest in the partnership property as a pre-CGT asset whereas others may hold it as a post-CGT asset; and

any change in the interests of a partner in partnership will give rise to CGT implications.

Formation of a partnership

Following formation of a partnership, each partner will have a fractional interest in the partnership assets. This means that to the extent that a partner contributes a CGT asset to the partnership, the contributing partner will be deemed to have disposed of part of his or her interest in that asset to the other partners upon formation. The CGT provisions provide that part of, or an interest in, a CGT asset is itself a CGT asset (refer to sec 108-5(2)(a)). Accordingly, the contributing partner's disposal of part of his or her interest in the asset constitutes a CGT event A1 for the contributing partner (refer to sec 104-10). The contributing partner will generate a capital gain from the CGT event where the capital proceeds he or she receives for the disposal of that interest exceeds its cost base (refer to sec 104-10). Conversely, a capital loss will arise where the capital proceeds received from the event is less than the cost base of that interest (refer to sec 104-10(5)).

CASE STUDY 1

Adam commenced an accountancy practice in 1980 as a sole practitioner. In 2000 Adam decided that he would like to admit Bob, a long time employee of his, as an equity participant in the practice and continue operating the practice as a 50-50 partnership. Adam estimates the market value of the goodwill of the practice at that time to be $100,000. It was agreed between the parties that Bob would contribute a building to the partnership valued at $100,000 for use by the business as an office. Bob acquired the building in 1990 for $50,000. On 1 July 2000, Adam and Bob entered into a partnership agreement.

In return for contributing 50% of the business to the partnership, Adam receives 50% of the building. Likewise, in return for contributing 50% of the building, Bob receives 50% of the business. Each of these transactions will have CGT implications for both Adam and Bob.

Contribution of business

Adam is deemed to dispose of 50% of his interest in the business, including goodwill to Bob. As goodwill is a CGT asset (refer to sec 108-5(2)(b)), Adam's disposal of 50% of his interest in the goodwill constitutes a CGT event A1 for Adam (refer to sec 104-10)). Section 116-20(1)(b) provides that where a taxpayer receives property in respect of a CGT event, the capital proceeds the taxpayer receives from that event is the market value of that property. Accordingly, the capital proceeds Adam is deemed to receive from the CGT event is the market value of the building, being $50,000. As Adam's interest in the business has a cost base of nil, the capital gain he generates from contributing the business to the partnership is $50,000. However, as Adam acquired the business prior to the commencement of the CGT regime, the capital gain he generates from the contribution is disregarded (refer to sec 104-10(5)(a)). Accordingly Adam is not required to pay any CGT on the gain.

Bob, on the other hand, will acquire a CGT asset, being a 50% interest in the business. As he "pays" 50% of the building to acquire this interest, Bob's interest in the business has a cost base of $50,000.

Contribution of building

Bob is deemed to dispose of 50% of his interest in the building (a CGT asset) to Adam. This disposal constitutes a CGT event A1 for Bob (refer to sec 104-10)). As Bob acquires 50% of the business from Adam for the disposal, the capital proceeds Bob receives from the CGT event is $50,000 (being the market value of the interest he receives in the business). As the cost base of this interest is $25,000, the capital gain Bob generates from the formation of the partnership is $25,000. Bob acquired his interest in the building after the commencement of the CGT regime. He is therefore required to pay CGT on this gain.

Adam, on the other hand, will acquire a 50% interest in the building. As he "pays" 50% of the business to acquire this interest, Adam's interest in the building has a cost base of $50,000.

Admission of a new partner

If a new partner is admitted to a partnership:

a) the new partner acquires a fractional interest in each of the assets in the partnership; and
b) the existing partners are treated as having disposed of part of their interest in each asset to the extent that the new partner has acquired it (refer to sec 106-5).

To the extent that the partnership owns CGT assets, the new partner will acquire a CGT interest, being a fractional interest in those CGT assets. The cost base of the interest will be equal to the consideration paid for that interest. The CGT implication for each existing partner requires an analysis of the CGT status of each partner's interest in the partnership asset. Whilst each existing partner will experience a CGT event (namely, CGT event A1) to the extent that the partnership owns CGT assets, only those partners whose interests in the partnership asset was acquired after the commencement of the CGT regime will be required to pay CGT.

Under the general partnership law, any change in the membership of a partnership results in a dissolution of that partnership. Notwithstanding this, the Commissioner is of the view that where the business of the partnership is conducted by the continuing partners and any new partner without a break in continuity, there is no dissolution of the partnership but simply a reconstitution (refer to GSTR 2003/13). Accordingly, there is no winding up of the partnership for tax purposes and the partnership retains its ABN and GST registration.

The case study below illustrates the CGT implications of the admission of a new partner. In particular, it highlights the need to determine the CGT status of each existing partner's interest in the partnership in order to determine the CGT liability arising from the admission.

CASE STUDY 2

Amy and Brian run a bookkeeping business in a 50-50 partnership. Amy acquired her interest in the partnership in 1984 for $30,000, whilst Brian acquired his interest in 1995 for $30,000. The goodwill of the bookkeeping business has a market value of $90,000. Apart from the goodwill, the partnership owns no other CGT asset. Amy and Brian wish to admit Charles to the partnership. It is agreed that Charles will pay $30,000 for his one third interest ($15,000 to Amy and $15,000 to Brian). What are the CGT consequences for each of Amy, Brian and Charles?

CGT implications for Amy

Amy will be deemed to dispose of a 16.65% interest in the business to Charles for $15,000. This will constitute a CGT event A1 for her. As this interest has a cost base of $5,000, the capital gain she generates from Charles' admission to the partnership is $10,000. However, as Amy acquired her interest in the partnership before September 1985, the capital gain she generates from the disposal is disregarded (refer to sec 104-10(5)(a)) and she is not required to pay any CGT on that gain.

CGT implications for Bob

Like Amy, Bob will also be deemed to dispose of a 16.65% interest in the business to Charles for $15,000 (a CGT event A1). Whilst Bob will also generate a capital gain of $10,000 for his disposal, unlike Amy, Bob will be required to pay CGT on the disposal as his interest in the partnership is a post-CGT asset.

CGT implications for Charles

Charles will acquire a one third interest in the business for $30,000. As this interest is acquired by him after 1985, this interest in the business is a post-CGT asset.

Alternative scenario

The above case study explores the CGT consequences of the admission of a new partner where both partners sell a fractional interest in the partnership assets to the new partner. However, it is also possible for the new partner to purchase an interest in the partnership from one partner only. In this instance, the only one partner will be disposing of his or her interest in the partnership (and therefore experience a CGT event) whilst the other partners' interest will remain unaffected.

CASE STUDY 3

Rather than disposing 16.5% of her interest to Charles, Amy decides that she does not want her partnership interest diluted. Bob, however, is keen on admitting Charles to the partnership. Accordingly, he decides to dispose of 25% of the partnership interest to Charles for $25,000.

In this instance Bob will be deemed to have disposed of a 25% interest in the business to Charles. As the disposal constitutes a CGT event for Bob, Bob will generate a $10,000 capital gain and is accordingly liable to pay CGT. Charles, however, will acquire a post-CGT asset, being 25% of the interest in the partnership with a cost base of $25,000. Amy's interest in the partnership will remain unaffected. Following the sale, the partnership will constituted by Amy, Charles and Bob in the following proportions:

- Amy has a 50% pre-CGT interest with a cost base of $30,000;
- Bob has a 25% post-CGT interest with a cost base of $15,000; and
- Charles has a 25% post-CGT interest with a cost base of $25,000.

Retirement of a partner or the dissolution of a partnership

Where a partner retires from the partnership, the retiring partner typically relinquishes his or her interest in the partnership to the other partners who continue to operate the business in partnership. This is compared to the situation where the partners resolve to dissolve the partnership. In this instance, the partnership relationship is terminated, with full ownership of all of the partnership assets distributed amongst the partners.

Whilst conceptually different in nature, the CGT consequences of the retirement of a partner and dissolution of a partnership are similar. In both instances, the exiting partner will dispose of his or her interest in the partnership asset or assets to the remaining partners (or partner, whichever the case may be). Where an interest in a CGT asset is disposed of, this disposal will constitute a CGT event A1 for the exiting partner. The acquiring partner, on the other hand, will acquire a new CGT asset. This new CGT asset is separate from the acquiring partner's existing interest in the CGT asset, with a different cost base and acquisition date

CASE STUDY 4 - Retirement

Tony, Graeme and John are equal partners in a law firm. Tony acquired his interest in the partnership in 1980 for $50,000, whilst Graeme and John acquired their respective interests in the partnership in 1990 for $70,000 each. After 15 years in the practice, Graeme decides that it is now time to retire from the legal profession. Tony and John agree to buy Graeme out of the partnership for $100,000 each. What are the CGT consequences arising from Graeme's retirement?

Graeme will be deemed to dispose of his one third interest in all the partnership assets to each of Tony and John for $200,000. As the cost base of Graeme's interest is $70,000, Graeme will generate a capital gain equal to $130,000 (being $200,000 - $70,000). As Graeme acquired his interest in the partnership asset after the commencement of the CGT regime, Graeme will be required to pay CGT on this capital gain.

Tony and John will each acquire half of Graeme's interest in the partnership for $100,000. Following Graeme's retirement, Tony's 50% interest in the partnership can be broken down as follows:

- a 33.3% pre-CGT interest acquired in 1980 with a cost base of $50,000; and
- a 16.7% post-CGT interest acquired upon Graeme's retirement with a cost base of $100,000.

Similarly, John's 50% interest in the partnership can be broken down in the following manner:

- a 33.3% post-CGT asset acquired in 1990 with a cost base of $70,000; and
- a 16.7% post-CGT asset acquired upon Graeme's retirement with a cost base of $100,000.

CASE STUDY 5 - Dissolution

Shortly after Graeme's retirement from the partnership, Tony and John have a partnership dispute. Pursuant to the dispute resolution mechanism in the partnership agreement, Tony makes an offer to purchase John's interest in the partnership for $270,000. John accepts the offer. Following John's exit from the partnership, Tony continues to run the practice as a sole practitioner.

In this instance, Graeme disposes of both his CGT interests in the partnership to Tony for $270,000 (each disposal constitutes CGT event A1). Section 116-40(1) provides that where a taxpayer receives a payment that relates to two CGT events, the capital proceeds from each event are "so much of the payment as is reasonably attributable to that event". Accordingly, Graeme will be required to apportion the $270,000 he receives from Tony between his two interests in calculating the capital gain or loss derived from the dissolution of the partnership. As Graeme acquired both his interests after 1985, he will be required to pay CGT on the capital gain he crystallizes from the disposals.

Tony on the other hand will acquire Graeme's 50% in the partnership. Following the acquisition, Tony will own 100% of the business and, accordingly, the partnership ceases to exist (see the above definition of a partnership). For CGT purposes, Tony's 100% interest in the business is broken down as follows:

- a 33.3% pre-CGT interest acquired in 1980 with a cost base of $50,000;
- a 16.7% post-CGT interest acquired upon Graeme's retirement with a cost base of $100,000; and
- a 50% post-CGT interest acquired upon dissolution of the partnership with a cost base of $270,000.

CGT AND THE MERGER OR TAKEOVER OF PARTNERSHIPS

Where two partnerships merge to form one larger partnership, the partners in each partnership are deemed to have disposed part of their fractional interest in each of the partnership assets to the partners in the other partnership. Accordingly, each partner will experience a CGT event A1 for the disposal of their fractional interest and a corresponding acquisition of an interest in the assets of the other partnership. The result of this is that, following the merger, each partner will have two different interests in the larger partnership, their existing interest and their newly acquired interest. Each partner's interest in the partnership assets will have a different cost base and a different acquisition date.

However, where a partnership is acquired or taken over by another partnership, the partners in the target partnership do not retain an interest in the partnership assets but dispose of the whole of their interests to the partners of the acquiring partnership. The disposing partners will generate a capital gain from the disposal to the extent that the capital proceeds they receive exceed the cost base.

CGT ADVANTAGES AND DISADVANTAFES OF A PARTNERSHIP

As illustrated in the above case studies, the position that each partner owns a fractional interest in each and every asset of the partnership means that any change in interest of a partner will give rise to CGT consequences. As many CGT assets, including business goodwill, are appreciating assets, any change in partnership interest will inevitably result in a capital gain for some of the partners. A further complication to this is that each partner may have both pre- and post-CGT interests in the partnership, with differing cost bases. This means that proper records of changes in partnership assets or constitution of the partnership members need to be kept in order to correctly ascertain the CGT consequences arising from such changes. Given the nature of this, there is very little tax planning strategies available for partners to prevent the crystallization of capital gains in a partnership.

Whilst there is little that partners can do to prevent capital gains, the tax laws provide each partner in a partnership with access to more CGT concessions than that of, say, a company structure, particularly where there are three or more equal equity participants. These concessions include the Div 115 50% general discount, the Div 152 small business concessions and rollover relief under Subdiv 122-B.

Division 115 50% general discount

Upon the sale of the partnership assets (or change in constitution of a partnership), the partners are able to apply the Div 115 50% general CGT discount to reduce by 50% any capital gain created upon disposal of the business, provided that the partners have held the CGT assets of the partnership for more than 12 months. This concession is not available where the business is operated through a company structure, or where the partners are corporate entities.

Division 152 small business CGT concessions

In addition to applying the Div 115 50% discount, the partners are able to apply the Div 152 small business CGT concessions to reduce or eliminate the remaining capital gain. This is provided the relevant CGT asset is an active asset in the sense that it is used in, or forms an integral part of, a business and the net value of the assets held by each partner, entities connected with them and their small business CGT affiliates do not exceed $5 million (refer to Subdiv 152-A).

Briefly, the small business concessions comprise of four concessions:

1. the 15-year exemption under Subdiv 152-B – this is the most valuable of the four concessions as it provides a full CGT exemption on capital gains generated by retirees or incapacitated taxpayers on CGT assets held for at least 15 years;
2. the 50% active asset concession under Subdiv 152-C – this concession is available in addition to the Div 115 50% discount and enables taxpayers to reduce the capital gain generated by them upon the occurrence of a CGT event by a further 50%;
3. the retirement concession under Subdiv 152-D – this is the second most valuable concession as it allows the taxpayer to disregard the remaining capital gain generated from the CGT event provided that the proceeds are used in connection with retirement (note that this concession has a lifetime limit of $500,000 per individual: refer to sec 152-320(1)); and
4. the rollover concession under Subdiv 152-E – this concession provides taxpayers with rollover relief where a CGT asset is disposed of and a replacement asset is acquired within the period commencing 1 year before, and ending 2 years after, the disposal.

The partners in a partnership are prima facie eligible to apply all of these concessions (provided of course that conditions specific to each concessions are met). A corporate entity, on the other hand, faces more hurdles before being able to access the Div 152 small business concessions. While these concessions are prima facie available to companies, to be eligible for the main concessions the company must, at the time of selling the practice, have a controlling individual (refer to sec 152-110(1)(c) and 152-305(2)(b)). This means that there must be a person who holds:

a) shares amounting to at least 50% of the voting power of the company; or
b) the right to receive at least 50% of the dividends or capital distributions of the company (refer to sec 152-55).

Therefore, where a business is operated through a corporate entity and there are three or more equity participants with equal shares in the company, the controlling individual test will not be satisfied and the two most valuable small business CGT concessions will not be available. I note that there is no controlling individual requirement where a small business is conducted via a partnership structure (refer to sec 152-10(2)). This means that, provided that the conditions specific to each concession is met, all partners will be able to access the Div 152 concessions, irrespective of the percentage of their partnership share.

Rollover relief

In addition to the above CGT concessions, the partners in a partnership are also able to dispose of their interests in the partnership assets to a company that they wholly own without paying any CGT on the disposal if they elect to apply the rollover relief in Subdiv 122-B. This provides partners with flexibility in the future should the partners wish to operate through a corporate structure.

CONCLUSION

A partner has fractional interest in all the assets of the partnership. Accordingly, whilst the occurrences of CGT events are inevitable in instances where a partnership is reconstituted (either through retirement, admission, mergers or takeovers) or where partnership assets are disposed of, the capital gain crystallized from such events can be managed by application of the various CGT concessions that are available.

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