General and limited partnerships – proposed tax changes

A government discussion document

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First published in June 2006 by the Policy Advice Division of the Inland Revenue Department, P O Box 2198, Wellington.

General and limited partnerships – proposed tax changes: a government discussion document.
ISBN 0-478-27138-7

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Chapter 1

INTRODUCTION

1.1 Greater access to investment capital through the removal of tax and regulatory barriers, and the improvement of international perceptions of New Zealand as an investment destination are key goals for the government.

1.2 For this reason, the government is reviewing the tax treatment of general and limited partnerships. The impetus for these reforms stems, in part, from a separate government initiative to introduce modern limited partnership rules to facilitate venture capital investment. The limited partnership vehicle is an internationally preferred business structure for investing in venture capital.

1.3 Introduction of a new limited partnership vehicle raises some issues around the taxation of entities generally, and partnerships in particular. To resolve these issues, the government proposes to clarify and modernise the tax treatment of partnerships and limited partnerships generally – rather than put in place special rules for venture capital partnerships.

1.4 In undertaking this initiative, the government recalls the work of the Valabh[1] Committee. That committee highlighted many problems associated with the taxation of partnerships. These problems are expected to become more acute as the use of limited partnership structures increases. For this reason, the government has decided to deal with the underlying concerns raised by the Valabh Committee at the same time.

1.5 This discussion document outlines a number of proposals on which the public is invited to comment. The new tax rules will cover a variety of business activities operating in partnership form, including:

- small, closely held businesses;
- small, medium and large professional practices;
- small investment activities;
- widely held investment activities; and
- all sectors, including agriculture, forestry and manufacturing.

1.6 It is impossible to speculate on how these rules might affect these different businesses. It may be desirable to provide minimum threshold rules for all or part of these reforms, or make parts of the reforms elective. However, it is important for the integrity of the tax system to ensure that any exceptions are justified. The government encourages submissions on what, if any, minimum threshold rules would be required in relation to the proposals in this discussion document.

1.7 This discussion document looks only at the income tax side of partnerships. It does not propose any changes to the GST treatment of partnerships.

[1] Consultative Committee on the Taxation of Income from Capital, appointed in 1989 and chaired by Mr Arthur Valabh.

SUMMARY OF PROPOSALS

Except where specifically stated, the proposals in this discussion document would apply to each of the following:

- any partnership under the Partnership Act 1908;
- a limited partnership registered as a "limited partnership" under a future Limited Partnership Bill, which will deal with the regulatory side of limited partnerships;
- any New Zealand-resident partners of foreign general partnerships; and
- any New Zealand-resident partners of a foreign limited partnership (with at least one general partner) that is not publicly traded and does not have separate legal personality.

Partnerships with two to five owners (none of whom have limited liability with respect to the business) may elect either to apply the proposed rules outlined in Chapter 9 or to treat each owner as owning an undivided interest in all assets, liabilities and income of the business.

Tax rules for partnerships

- When apportioning income and expenses, partners would derive income/expenses from each source, in proportion to their profit share.
- Salary and wages paid to a partner would generally not be deductible to the partnership unless they are included in a written contract of service.
- Payments of rent and interest (on amounts over and above the capital contributed to the partnership) received by a partner from a partnership would be deductible to the partnership, provided the payments meet the general test of deductibility and are at market value.
- The current approach of applying the controlled foreign company (CFC) rules to partnerships would be retained.
- The dividend withholding payment and underlying foreign tax credit rules would apply to New Zealand-resident companies that are partners.
- Non-resident partners would be subject to non-resident withholding tax (NRWT) – at the domestic rate or the applicable treaty rate – on any New Zealand-sourced dividends, interest, or royalties derived through the partnership on their behalf.
- A New Zealand-resident company would be eligible for a foreign investor tax credit in relation to a dividend derived by a non-resident partner through the partnership.
- Foreign partners would not be taxed on their proportionate share of foreign-sourced income.
- An interest in a partnership would be treated as a distinct asset (similar to a share in a company).

- The entry and exit of partners would not result in the dissolution of the partnership for income tax purposes.
- Exiting partners may be taxed on taxable gains attributable to underlying partnership assets on disposition subject to a minimum threshold rule.
- The new partner and the partnership may jointly elect, in certain circumstances, to allocate the cost of the new partner's partnership interest over the new partner's share of partnership assets and liabilities.
- The new tax rules would generally apply to all partnership interests (other than special partnership interests unless a special partnership elects for the new rules to apply).
- Two options would be available for the calculation of the opening basis amount for existing partnership interests: the market value option and the historical method option.
- A simple transition from a special partnership to a limited partnership would not generally result in the triggering of income or deductions to the partnership.

Specific rules for limited partnerships

- The introduction of the "partner's basis" concept (basis tracking) to track the tax value of a partner's interest in a partnership.
- The introduction of loss limitation rules to ensure that the net tax losses claimed by a limited partner in relation to a limited partnership interest reflect the actual level of that limited partner's economic loss.

Proposed timeline/application date

1.8 It is proposed that a bill be introduced in 2007, with application from the 2008–2009 income year.

Submission process

1.9 The government welcomes submissions on the proposals in this document. Submissions need not be limited to the suggested submission points.

1.10 Submissions should be addressed to:

Partnerships
C/- The Deputy Commissioner
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON

Or email: policy.webmaster@ird.govt.nz with "Partnerships" in the subject line.

1.11 The closing date for submissions is 11 August 2006.

1.12 Please note that submissions may be the subject of a request under the Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If there is any part of your submission which you consider could be properly withheld under that Act (for example, for reasons of commercial sensitivity), please indicate this clearly in your submission.

Chapter 2

BACKGROUND

2.1 The tax reform of partnerships is being driven in part by the government's proposal to introduce a set of modern limited partnership rules to replace the current special partnership rules. In undertaking this reform it is necessary to take into account the views of the Tax Review 2001 on entity taxation generally, and the findings of the Valabh Committee on the taxation of partnerships in particular.

Replacing special partnerships with a new limited partnership vehicle

2.2 One of the government's principal aims is to raise New Zealand's sustainable rate of economic growth through innovation. Greater access to investment capital has been identified as a means of encouraging innovation and enhancing economic growth. For example, venture capital is a critical source of funding for new and creative businesses attempting to develop innovative and advanced technologies.

2.3 Limited partnerships are an internationally preferred vehicle for investment into a foreign country (particularly in relation to private equity and venture capital investments) for two principal reasons. First, limited partnerships typically allow investors to limit their exposure to liability to the amount of their investment. Second, limited partnerships provide a flow-through tax mechanism for investors in relation to gains and losses. This allows the foreign investor to recognise those gains or losses in their home country.

2.4 New Zealand already has special partnership rules. However, these rules are restrictive and outdated from a regulatory perspective. In particular, the government understands that it is necessary to provide modern limited partnerships with separate legal personality to reinforce the limited liability nature of the partnership interest. This feature addresses a particular concern which is that, in the absence of a separate legal personality, a limited partner could be held personally liable for liabilities of the limited partnership by a foreign court – particularly in relation to actions of negligence.

2.5 Therefore the government plans to replace the special partnership legislation with more modern limited partnership rules. This new limited partnership vehicle will have separate legal entity status.

Tax implications of a modern limited partnership

2.6 Without any change to the tax legislation, a limited partnership with separate legal entity status would be characterised as a company for income tax purposes. This would not be acceptable for venture capital investors and could inhibit the flow of foreign venture capital into New Zealand.

2.7 One option would be to introduce special venture-capital limited partnership rules similar to the venture-capital limited partnership rules (VCLPs) in Australia. However, there are problems associated with providing special tax treatments for different industry groups. Accordingly, the government has decided to take this opportunity to review the tax treatment of partnerships and limited partnerships generally.

2.8 In undertaking this review, the government has taken into account the work of two consultative committees. First, it has considered the observations made by the Tax Review 2001[2] on the broad subject of entity taxation. Second, it has taken account of the findings and recommendations of the Valabh Committee[3] on the taxation of partnerships.

Tax Review 2001

2.9 According to the Tax Review 2001, the income of all entities ideally should be taxed at the marginal rate of their owners. However, this would involve high administrative and compliance costs in allocating income and identifying the marginal tax rates of owners for widely held vehicles. The Tax Review 2001 advocated treating widely held vehicles as companies and closely held vehicles (fewer than six members) as partnerships. It recommended that future legislative reform should head in this direction.

2.10 There is merit in the simplicity of the Tax Review's "first principle" approach. However, international trends suggest that to facilitate both domestic and foreign investment, countries need to provide entities that offer "flow-through" tax treatment as well as entities that offer company tax treatment. Indeed, the United States, through its check-the-box rules, has gone as far as to make the tax treatment elective for entities that have a mix of corporate and partnership characteristics.

2.11 The government also agrees with other key observations of Tax Review 2001 on entity taxation. Its *Issues Paper* examined the relevant economic efficiency considerations relating to the taxation of entities. It observed that differences in the taxation of entities create incentives to shop among different sets of rules ("entity shopping"). It also identified the following types of efficiency costs:

- conducting business in an organisational structure that differs from the form that would have been chosen in the absence of tax differences;
- searching for, designing and complying with tax-effective entity regimes and structures; and
- lobbying to procure the favourable features of other tax rules on the basis of consistency and fairness.

[2] The Tax Review 2001 was an independent review commissioned to undertake a broad review of the tax system and to develop proposals to guide the future direction of New Zealand tax policy.
[3] The first task the Valabh Committee undertook was to look at the simplification and rationalisation of existing tax rules.

2.12 The Tax Review 2001 also said that one of the primary goals of tax policy is to minimise compliance costs. With this in mind, it recommended the following principles for the taxation of entities:

- Minimising the number of different general entity treatments. When specific rules are necessary to deal with a special characteristic they should be attached to a general treatment rather than cause a separate holistic treatment of the particular entity.
- The boundaries between different entity-specific tax rules should be drawn so that business structures falling on either side of a boundary are not closely substitutable.
- Equity or debt instruments that are issued by an entity and that are substitutable for each other should have a uniform tax treatment.
- The tax rate applying to an entity should be aligned with the highest personal marginal tax rate, where possible.

2.13 New Zealand already has comprehensive company and trust (partial flow-through) tax treatments on its statute books. If the proposals outlined in this discussion document go ahead, New Zealand will have a new flow-through treatment for partnerships and limited partnerships with separate legal personalities. These new tax rules will complement the existing company and trust alternatives. Taxpayers will then be able to choose between these four different vehicles for their general business and investment undertakings.

2.14 The introduction of new partnership flow-through rules does raise the question of whether it is necessary to retain similar tax treatments offered by the qualifying company (QC) and loss attributing qualifying company (LAQC) rules. It is inconsistent with the Tax Review's principles to proliferate our laws with a variety of flow-through treatments.[4] Submissions are invited on this issue.

2.15 Finally, although the government does not propose to adopt the Tax Review's proposal to restrict flow-through treatment to entities with fewer than six members, such treatment should not be available for publicly listed vehicles.

[4] However, a review of the various flow-through treatments in the Act would not encroach on the proposed portfolio investment entities, the subject of a bill currently before Parliament.

Valabh Committee findings

2.16 In 1991 the Valabh Committee[5] undertook a review of the taxation of partnerships and identified six shortcomings of the tax law applicable to partnerships. These were:

- The taxation treatment for the entry and exit of partners to or from the partnership (or, more properly, the dissolution and creation of new partnerships as a consequence of these events). In particular, it was noted that the reallocation of interests within a partnership is uncertain and inconsistent.
- The allocation to partners of income from different sources or of different types. Specifically, the treatment of partnerships with non-resident partners or in receipt of foreign-sourced income is uncertain.
- The treatment of particular transactions (such as the payment of interest on capital and current accounts) and the treatment of asset transfers between partners and the partnership is uncertain.
- The allocation of balance dates to a partnership that may differ from individual partners, and the resulting impact on returning income and losses is uncertain.
- The treatment of certain payments made to or by partnerships with both resident and non-resident partners is unclear.
- The definition of what constitutes a "partnership" for tax purposes is unclear.

2.17 Following consultation, the Valabh Committee recommended that a comprehensive review of the tax treatment of partnerships should be undertaken by officials with a view to developing tax rules that are:

- clear in meaning and application;
- consistent in approach to the taxation of partners and partnerships, and also with economically equivalent entities; and
- able to redress or correct the various problems identified above.

2.18 The Valabh Committee also identified several issues to be considered in a more in-depth review of the taxation of partnerships. Specifically, it recommended that the following areas be reviewed in depth:

- the allocation of income between partners;
- transactions between partners and the partnership, especially the difference between the treatment of interest on capital accounts and the treatment of interest on current accounts;

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[5] *Key Reforms to the Scheme of Tax Legislation*, (The Valabh Committee), October 1991, p.90.

- payments made to or by partnerships, especially looking at how the flows are apportioned between resident and non-resident partners; and
- the status of "special partnerships".

2.19 The proposed partnership tax rules aim to deal with these concerns.

Chapter 3

FRAMEWORK FOR TAXING INCOME FROM PARTNERSHIPS

Summary of proposals

- The aggregate approach would prevail in connection with the allocation of income/loss to the partners.
- In relation to the entry and exit of partners and the disposal of partnership interests, the government proposes moving towards an entity approach.

3.1 There are generally two conceptual approaches to considering the tax treatment for partnerships – the "aggregate" approach and the "entity" approach.

Aggregate approach

3.2 Under a strict aggregate approach, each partner is treated as an owner of a fraction of all the assets of the partnership for tax purposes. The partnership does not exist independently from the partners. There is no calculation of the partnership income at the partnership level. Partners are apportioned their share of each item of income and expenditure from the partnership and the tax consequences are determined for each individual partner at the partner level. When partners sell their interest in the partnership, they are treated as selling a share in each of the underlying assets of the partnership. This may trigger tax adjustments for all of the partners (such as tax depreciation recovery calculations on any disposal of depreciable property).

Entity approach

3.3 The entity approach views the partnership as an entity separate from its partners. Each partner owns an interest in the partnership (akin to a shareholder in a company). The income is therefore determined at the partnership level and then apportioned to the partners. It is the net result (income less deductions) that is flowed through to the partners. Partners then include their share of the net result in their own tax return. When a partner disposes of an interest in the partnership it is similar to the sale of a share in a company. Under this framework, complicated tax adjustments are not generally required.

International experience

3.4 Strict adherence to either of the approaches outlined above provides logical coherence, but can result in undesirable practical consequences. In reality, many countries adopt a hybrid approach that combines elements of both the aggregate and entity approaches.

3.5 The United States uses aspects of both the entity and aggregate concepts and has developed a comprehensive scheme for the taxation of partnerships. The aggregate concept prevails in connection with the taxation of partnership income of individual partners. By contrast, the entity approach largely prevails when transferring partnership interests. However, a number of special rules and elections have the effect of providing an aggregate treatment to the transfer of partnership interests.

3.6 Australia differentiates general partnerships from limited partnerships. Limited partnerships are taxed as companies in Australia, not as partnerships.[6] In the case of general partnerships,[7] the taxation of partnership income follows an entity-type of approach. The net income of a partnership is calculated as if the partnership is a taxpayer in its own right. Each partner then derives a share of the net partnership income, which becomes assessable income in the hands of any resident partner. When there is a change in the membership of a partnership, Australia adopts more of an aggregate approach, and the partnership is dissolved and a new partnership is formed.

3.7 In the United Kingdom the profits of the partnership are determined at the partnership level and each partner is apportioned a share of the partnership profits (or losses). However, unlike Australia (which follows an aggregate approach), it is only when there is a complete change in the composition of the partnership that the partnership ceases to exist. When someone joins a partnership, the new partner is treated as if he or she had set up and started their own business at that time. If a partner leaves the partnership, his or her business is treated as ceasing on the date of exit. Therefore it appears that the United Kingdom imports more entity concepts into its partnership tax law.

3.8 Currently, New Zealand (while adopting a hybrid approach) is more closely aligned with the aggregate approach. Even though a partnership is defined as "a person" in the Income Tax Act 2004, the Act does not impose income tax on a partnership.[8] Accordingly, when calculating tax payable in respect of a partnership business (which involves identifying the income and allowable deductions applicable to each partner), this is not calculated at the partnership level. Partners must file their own income tax returns, including the share of the income and expenditure apportioned to them by the partnership.

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[6] However, venture capital limited partnerships (VCLPs) are taxed as partnerships in Australia.
[7] And VCLPs.
[8] Section HD 1(1)(b) of the Income Tax Act 2004. The partnership does have limited obligations as a taxpayer under the PAYE rules and the RWT rules.

3.9 The problems with our existing tax laws, as identified by the Valabh Committee, are largely as a result of the aggregate approach. As discussed in Chapter 9, this is especially true when partners enter and exit the partnership.

3.10 The current practice is to allow deviations from the purely aggregate approach for administrative and compliance simplicity. Accordingly, some partnerships may take different approaches for tax purposes, depending on their circumstances, and this can result in uncertainty. This uncertainty and the mix of approaches is unsatisfactory.

3.11 In this discussion document the government proposes to codify the tax rules for the purposes of certainty and to provide a reasonable balance between the integrity and accuracy of the "flow-through" mechanism afforded by the aggregate approach and the administrative and compliance convenience of the entity approach.

3.12 The government also proposes a change to New Zealand's framework for taxing partnerships. This change is similar to the approach adopted in the United States. The aggregate approach will prevail in connection with the allocation of income/loss to the partners, and the rules for doing this will be codified in the Income Tax Act. However, in relation to the entry and exit of partners and the disposal of partnership interests, the government proposes moving towards an entity approach although, as in the United States, some aspects of the aggregate approach will remain.

Chapter 4

SCOPE AND APPLICATION OF NEW RULES TO GENERAL AND LIMITED PARTNERSHIPS

Summary of proposals

Except when specifically stated, the proposals in this discussion document would apply to each of the following:

- any partnership under the Partnership Act 1908;
- a limited partnership registered as a "limited partnership" under the proposed Limited Partnership Bill;
- any New Zealand-resident partners of foreign general partnerships; and
- any New Zealand-resident partners of a foreign limited partnership (that has at least one general partner) that is not publicly traded and does not have a separate legal personality.

The generic nature of this reform means that the new rules will apply across a wide range of business activities and investment. It is impossible to anticipate all the administrative and compliance issues that might arise. A comprehensive discussion of these issues will be an important part of the consultation on the proposals in this document.

Application of new tax rules to a "partnership"

4.1 There is no general definition of "partnership" in the Income Tax Act.[9] The current partnership tax rules in that Act apply to an arrangement that constitutes a "partnership" under the Partnership Act 1908.

4.2 The Partnership Act 1908 defines a "partnership" as "…the relation which subsists between persons carrying on a business in common with a view to profit…", but does not include a company.[10]

4.3 A partnership is one relationship in which two or more persons can carry on a business together. Each partner will contribute something to the business (often capital) in return for a share in the profit or loss of the partnership. Each partner is also jointly and severally liable for any obligations of the partnership.

[9] While not a general definition, section NF 10(6) of the Income Tax Act 2004 currently refers to the definition of "partnership" in the Partnership Act 1908.
[10] Partnership Act 1908 (NZ), section 4.

4.4 The law recognises that when individuals carry on business together in partnership, certain expectations will arise. Legislation provides for a minimum standard of protection of those expectations, subject to modification by explicit or implicit agreement by the partners.

4.5 A partnership is not a legal entity. A partnership consists of a collection of rights and obligations between the partners. Ownership of partnership assets is vested in the partners, not the partnership. Consequently, the partnership does not own property on its own account. Rather, each partner is treated as jointly owning a share of each of the partnership's assets.

4.6 As outlined above, whether or not a partnership exists for tax purposes is a question of fact, determined by consideration of all the surrounding factors. New Zealand tax law will generally recognise the existence of a partnership if it exists under general or common law.[11]

Application of the new rules to joint ventures

4.7 The current approach of applying partnership tax rules to those partnerships that are found to exist under general partnership law will be retained. This means that those arrangements that do not constitute a "partnership" under general law will not come within the scope of these reforms.[12] The most common example of an investment relationship that does not constitute a partnership is a joint venture.

4.8 The term "joint venture" generally refers to an arrangement that is something less than a partnership.[13] For example, in a contractual joint venture the parties usually carry on separate businesses, although the parties will collaborate on a specific joint-venture activity. Accordingly, the parties will have a different set of rights and obligations as part of the joint-venture activity than would be the case if the parties were in partnership. Common law has attempted to differentiate when a joint venture is not a partnership.[14] The typical features of a joint venture are:

- Each party can generally assign its rights in the joint venture without the need for the consent of the other parties.
- A party can dispose of its share of the joint venture in any way it chooses.
- A party is not responsible for the acts or liabilities of the other parties.
- A party is not prevented from competing with the other business participants in business operations outside the joint venture.

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[11] It should be noted that the existence of a formal written agreement is not conclusive evidence that a partnership exists. Similarly, the absence of such a written agreement is not evidence of a partnership not being in existence.

[12] Section 5 of the Partnership Act 1908, outlines rules for determining the existence of a partnership. For example, joint tenancy, tenancy in common, joint property or part ownership do not themselves create a partnership, nor does the sharing of gross returns.

[13] The Partnership Act 1908 does not apply to "joint ventures" that do not of themselves qualify as partnerships.

[14] *United Dominions Corporation Limited v Brian Pty Ltd* (1985) 157 CLR 1; *Aotearoa International Limited v Paper Reclaim Limited HC Auckland Registry* (CP No 117/01), 19 March 2004; *Commerce Commission v Fletcher Challenge Ltd* [1989] 2 NZLR 554.

- Each party retains its own autonomy and control.
- Each party to the joint venture may contribute the use of its assets in the joint venture activities but will retain ownership of them.
- Each party may be entitled to a share of the output from a joint venture.

4.9 Joint ventures will continue to be taxed as they are currently. However, it may be desirable that some co-owned businesses, with six or more members (that are not partnerships under New Zealand law), are treated as partnerships for tax purposes. Submissions are welcomed on whether the proposals in this discussion document should apply to any form of joint ownership which is not a trust or a company for tax purposes.

Inserting a definition of "partnership" in the Income Tax Act

4.10 The Valabh Committee was in favour of inserting into the income tax legislation the definition of what constitutes a partnership according to general partnership law.

4.11 Having a definition of "partnership" that applies to the whole of the Income Tax Act would provide certainty and remove the need for users to refer to the Partnership Act. It would also be consistent with other business entities that are currently defined in the Income Tax Act, such as a "company".[15]

4.12 A minimalist approach would be to clarify in the Income Tax Act that the meaning of "partnership" is a partnership as defined in the Partnership Act. This would clarify that the definition in the Partnership Act and relevant interpretation in case law would be conclusive for the purposes of the Income Tax Act.

Application of new tax rules to limited partnerships

4.13 Currently, New Zealand taxes special partnerships (a form of limited partnerships) as partnerships. This contrasts with Australia, where limited partnerships are taxed as companies – with an exception for venture capital limited partnerships.

4.14 It is proposed to continue to tax the proposed limited partnerships as partnerships.[16] As the liability of limited partners is limited to their capital contribution, however, some special tax rules will be required.

[15] The Companies Act 1993 goes into more detail as to what is required to constitute a company under the Companies Act 1993. However, both the Companies Act 1993 and the Income Tax Act 2004, state that a "company" has a separate legal personality.
[16] However, if the limited partnership interests are publicly traded the limited partnership would be taxed as a company, as it would be impractical to apply partnership treatment when ownership interests are frequently traded.

New limited partnership legislation

4.15 As explained in Chapter 2, the government plans to replace the special partnership regulatory rules with modern limited-partnership rules. Unlike the current special partnership structure, limited partnerships will be separate legal entities. In the absence of changes to tax law, these limited partnerships would be taxed as companies, although international practice is to allow a flow-through tax treatment for limited partnerships.

4.16 This flow-through tax treatment will require a change to the definition of "company" in the Income Tax Act. The definition of "company" will have to expressly exclude New Zealand-registered limited partnerships. A limited partnership and its partners would be taxed subject to the proposals included in this discussion document.

Comparison between general partnerships and limited partnerships

4.17 Most New Zealand taxpayers are less familiar with the limited partnership/special partnership form. To date it has been mainly used for speculative investment undertakings because of the ability to flow through tax losses. The proposed new regulatory reforms may make it a more popular business vehicle.

4.18 There are four key characteristics of an ordinary partnership that a limited partnership does not have. These differences are highlighted in the following table:

General partnership	Limited partnership
All partners are jointly and severally liable for the debts and obligations of the partnership.	The liability of limited partners is limited to the amount of their contribution to the partnership. General partners are jointly and severally liable for the debts and obligations of the partnership in the same way as partners in a general partnership would be.
There is implied authority for each partner to bind the firm (and the other partners) in all matters within the ordinary course of business.	Only general partners have implied authority to bind the firm. Limited partners have no power to bind the firm.
Each partner has the right, subject to what the partners have agreed in the partnership agreement, to participate in the management of the firm.	Limited partners are specifically prohibited from taking part in the management of the firm, at the risk of losing their limited liability status. However, certain activities ("safe harbours") are not considered to be activities in the nature of management.
A general partnership is formed by the agreement of the partners, which is usually set out in a partnership agreement and in certain circumstances a business arrangement may be deemed a partnership by a court.	A limited partnership is formed by statute, upon registration with the appropriate authority.

Minimum threshold rules for partnerships and limited partnerships

4.19 Following the recommendations of the Tax Review 2001, outlined in Chapter 3, the government has opted for a uniform flow-through tax treatment for all partnerships and limited partnerships. It is recognised, however, that the new tax rules will cover a variety of business activities operating as partnership structures, including:

- small, closely held businesses;
- small, medium and large professional practices;
- small investment activities;
- widely held investment activities; and
- all sectors, including agriculture, forestry and manufacturing.

4.20 Although it may be desirable to provide minimum threshold exemptions from all or part of these reforms, or make parts of these reforms elective, it will be important for the integrity of the tax law to ensure that any exceptions are justified. Submitters are encouraged to consider what, if any, minimum threshold rules will be required in relation to the proposals in this discussion document.

Application of the new rules to foreign general partnerships and foreign limited partnerships

4.21 The New Zealand-resident partners of a foreign general partnership will be taxed in New Zealand in accordance with the proposals contained in this discussion document.

4.22 However, the treatment of New Zealand-resident partners of a foreign limited partnership would depend on whether the limited partnership is a separate legal entity. New Zealand-resident partners of foreign limited partnerships – without separate legal personality – will be taxed in New Zealand in accordance with the proposals contained in this discussion document (provided there is at least one general partner and the partnership is not publicly traded). New Zealand-resident partners of a foreign limited partnership with separate legal personality would be taxed in accordance with the foreign hybrids legislation. The Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act 2006 introduced new rules to clarify that a foreign hybrid (an entity that has a flow-through tax treatment but is a separate legal entity) will be treated as a company under the Income Tax Act.

Chapter 5

PROPOSED "FLOW-THROUGH" OF INCOME AND EXPENDITURE

Summary of proposals

This chapter codifies the tax treatment of apportioning income and deductions to partners by proposing that partners will derive income/expenses from each source, in proportion to their profit share.

5.1 The principal aim of these proposals is to create a set of tax rules that gives clear guidance to taxpayers. At the same time it is important to maintain the integrity of the tax system, and the principle of tax neutrality between different business structures.

5.2 This chapter explains how the proposed framework for taxing income from partnerships (as outlined in Chapter 3) will apply in practice. It outlines the proposed tax rules for flowing through the income and expenditure of a partnership.

Apportioning income and deductions

5.3 Section HD 1(1)(b) of the Income Tax Act contains a general rule requiring partners to "take into account their share of the income that they jointly derive from the firm". In addition, the Partnership Act 1908 provides that in the absence of an express or implied agreement, the partners share equally in the profits and losses of the partnership.[17] Accordingly, each partner's "share" of partnership income is the amount apportioned in accordance with the partnership agreement or the Partnership Act 1908.

5.4 The reference to "income" in section HD 1(1)(b) is to a gross amount. Partners can claim allowable deductions against income attributed to them from the partnership for expenses that satisfy the general deductibility rules – that is, when there is sufficient nexus between expenses and income derived through the partnership. This includes:

- expenses jointly incurred by the partnership; or
- expenses of the partner in relation to his or her investment in the partnership.

[17] Partnership Act 1908, s 27(a).

5.5 Proportionate allocation of costs is not explicitly required by the current tax rules. However, the practice appears to be that partners apportion expenses and deductions in the same proportion that their gross profits are apportioned.

5.6 The key issue is the extent to which partnerships should be able to apportion income from different sources to different partners. The Valabh Committee[18] noted that:

> As a general principle, profits cannot be allocated to one partner for tax purposes while allocating losses to another partner. However, where a partnership derives income from different sources and of different kinds, there appear to be no restrictions on the method by which such income is allocated.

5.7 Example 1 illustrates the effect of apportioning different sources of income to different partners.

Example 1

Assume there is a partnership consisting of four partners. Partner 1 is a New Zealand charity, partner 2 is non-resident, partner 3 is a New Zealand taxpayer, partner 4 is also a New Zealand taxpayer but is in a loss position. The partnership has assets comprising a building, foreign shares and New Zealand shares.

The partners agree to split the items of income in the following way. Partner 1 would receive all the rental income. Partner 2 would receive all the foreign dividends. Partner 3 would receive the capital gain on the sale of the building. Partner 4 would receive the dividends from the New Zealand shares. They agree to share equally the expenses jointly incurred by the partnership.

At the end of the year the partnership has income of $NZ440 rent, $NZ360 foreign dividends, and $NZ400 of unimputed dividends. The partnership deductions consist of depreciation of $NZ100 and interest paid on the building mortgage of $100. At the end of the year, one of the buildings is sold for a capital gain of $400. If the partnership is able to apportion the income and the deductions as provided for in the agreement, it will minimise the partners' tax liability overall.

	Partner 1 (charity)	**Partner 2 (non-resident)**	**Partner 3 (NZ taxpayer)**	**Partner 4 (NZ taxpayer in loss)**
Income				
Rent	$440			
Foreign dividends		$360		
Capital gains			$400	
Dividends				$400
Total	**$440**	**$360**	**$400**	**$400**
Deductions				
Depreciation	$25	$25	$25	$25
Interest on loan	$25	$25	$25	$25

[18] In the discussion document, *Key reforms to the scheme of tax legislation*, (1991) p. 94.

5.8 The Valabh Committee initially recommended that partners be deemed to derive income from each source in proportion to their profit shares.

5.9 The Valabh Committee also made some critical observations in its final report.[19] First, it noted that the major areas of concern were that:

- Taxed and non-taxed income may be allocated between partners with different tax rates (income splitting).
- Income from different sources may be allocated to resident and non-resident partners, depending upon the tax treatment afforded to that income.
- Tax credits may be streamed to those partners most able to use them.

5.10 Following consultation, the Valabh Committee indicated that there was a mixture of views on whether it was possible to apportion different streams of income or whether it was only possible to allocate different income streams proportionately:

> There is a degree of uncertainty about the ability of a partnership to allocate income from different sources to different partners (as opposed to allocating profit shares based on the income streams received by the partnership from specific sources).[20]

5.11 The Valabh Committee decided not to propose a statutory formula for deeming partners to receive income from differing sources on a pro rata basis at that time – noting that there was uncertainty about whether the manipulation of income was causing a problem in practice. However, it concluded that the entire subject should be given careful attention as part of a comprehensive review of the taxation of partnerships.

Proposed approach

5.12 The approach suggested by the Valabh Committee for several reasons will be adopted. First, it is important to have certainty on the allocation of income and expenditure for income tax purposes – particularly given the expected increase in use of partnerships and limited partnerships as a result of the regulatory reform. Second, this approach seems to be most consistent with the notion that a partnership, like a company, is a vehicle whereby investors pool assets and are jointly liable. Third, it prevents the streaming of income and expenditure designed to take advantage of the different tax circumstances of the partners. Fourth, it is broadly in line with international practice.[21]

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[19] *Final report of the consultative committee on the taxation of income from capital,* The Valabh Committee (October 1992) p.46.

[20] *Final report of the consultative committee on the taxation of income from capital,* The Valabh Committee (October 1992) p.46.

[21] Australia and Canada allocate "net income". An allocation of net income (being a blending of income and deductions from all sources) gives the same result as the proportionate approach to the allocation of income and expenses proposed in this discussion document. The possibility of allocating net income has been considered as an option but there are difficulties reconciling this approach with the core provisions in the Income Tax Act. The United States also allocates net income to partners but allows special allocations of income and expenditure to specific partners. However, those special allocations will not be respected if they do not have "substantial economic effect" and are simply done to achieve a tax benefit.

5.13 The current law already contains anti-streaming rules for the allocation of imputation credits among partners to ensure that the imputed dividends are not apportioned to the partner best able to use them. Adoption of this proportionate approach is consistent with this specific anti-streaming rule.

Proposed flow-through treatment of partnership income and deductions to partners

5.14 Assessable income derived and expenditure incurred through the partnership will be apportioned by the partnership to an income year in accordance with the existing provisions of the Income Tax Act as though the partnership were itself a taxpayer. Generally, rules relevant to the character of receipts and timing of the apportionment of income to a particular income year will be applied at the partnership level rather than at partner level. For instance, in determining whether the sale of an asset of the partnership business is on capital or revenue account, the tests would be applied as if the partnership were a taxpayer disposing of the asset. This approach accords with the commercial reality of the partnership as a business vehicle and brings the law into line with current practice.

5.15 Under the proposed new rules, assessable income, excluded income, exempt income or a non-resident's foreign-sourced income in the hands of the partners would be apportioned by the partnership to each partner in accordance with each partner's profit share ("the proportionate rule").[22] Each item will retain its character in the hands of the partner. Partners will then individually, include these amounts in the appropriate income year.

5.16 Capital gains or capital losses would also be apportioned by the partnership to each partner in accordance with each partner's profit share.

5.17 Expenses jointly incurred by the partners in relation to income through the partnership would also be apportioned to the partners in the same proportions. Again, the tax treatment of expenses jointly incurred by the partners will generally be determined at the partnership level, unless the tax status or position of the partner is important for determining deductibility – for example, interest that is subject to the thin capitalisation rules. Accordingly, the partnership will determine whether there is a nexus between the expenditure and assessable income or excluded income, or whether the expense was incurred in deriving an amount even if that item would be exempt income in the hands of the partners.

[22] However, if a new partner has made an election to adjust his or her tax book value in the assets (see Chapter 9) this may alter the allocation of certain items (for example, a depreciation allowance) between the partners.

5.18 Individual partners will then return these items as part of their own tax return based on the relevant information provided by the partnership. Specifically, amounts that are assessable income will be included and aggregated with a partner's other income to determine that partner's annual gross income. Expenses incurred that have a nexus with amounts that are either assessable income or excluded income of the partner will constitute a deduction apportioned to that income year. These deductions will then be aggregated with the partner's annual allowable deductions although, as discussed in Chapter 8, some amounts may need to be carried forward by limited partners in line with the proposed loss limitation rules.

5.19 The tax treatment of expenses that a partner incurs separately to invest in the partnership will be determined at the partner level. This is because the expenses are incurred by the partner acting in an individual capacity rather than jointly incurred by the partners in the carrying out of the partnership business.

5.20 Any credits attached to an amount that flows through to a partner will be apportioned proportionately with the partner's profit share. For example, imputation credits attached to a dividend will be apportioned to each of the partners according to their respective partnership profit shares – regardless of which partner is allocated the dividend in the partnership agreement.[23] Similarly, resident withholding tax credits will be apportioned in accordance with the proportionate rule.[24] These credits can then be used to offset a partner's income tax liability.

Example 2: Proposed flow-through approach

Under the proposed flow-through approach, the same partnership in Example 1 will have to apportion the income and expenses so that each partner receives a proportionate amount of each item of income as follows:

	Partner 1 (charity)	**Partner 2 (non-resident)**	**Partner 3 (NZ taxpayer)**	**Partner 4 (NZ taxpayer in loss)**
Income				
Rent	$121	$99	$110	$110
Foreign dividends	$99	$81	$90	$90
Capital gains	$110	$90	$100	$100
Dividends	$110	$90	$100	$100
Total	**$440**	**$360**	**$400**	**$400**
Deductions				
Depreciation	$27.50	$22.50	$25	$25
Interest on loan	$27.50	$22.50	$25	$25

[23] This is consistent with section LB 1(4) of the Income Tax Act 2004.
[24] This is consistent with section LB 1(4) of the Income Tax Act 2004.

Partner 1 (the charity) will receive the same amount of income. Partner 1 will also receive $55 of expenses connected with that income which it cannot deduct. Partner 2 (the non-resident partner) will have $189 of New Zealand-sourced income and $45 of deductions which can be used to offset his annual gross income. Partner 3 (the New Zealand partner) will have $300 of income to aggregate with her other assessable income, and $50 of deductions to aggregate with her other allowable deductions. Partner 4 (the New Zealand partner in a loss position) will have $300 of income to aggregate with his other assessable income, and $50 of deductions to aggregate with his other allowable deductions. However, as Partner 4 is in a loss position overall, it is unlikely that he will have an income tax liability.

Similarly, each partner will be apportioned a proportionate share of the foreign tax paid. The amount of the credit is the lesser of the amount of foreign tax paid or the New Zealand tax in respect of that income. In accordance with the existing rules, any excess foreign tax credits cannot be carried forward or refunded.[25]

As outlined in Example 1, the partnership has $NZ360 of foreign dividends. The partnership has paid $NZ54[26] in foreign tax on these dividends. Therefore, under the proposed approach, the partnership will advise each partner that in relation to the proportion of foreign dividends received, the following amount of foreign tax has been paid:

	Foreign dividend received (NZ$)	**Foreign tax paid (NZ$)**
Partner 1 (charity)	$99	$14.85
Partner 2 (non-resident)	$81	$12.15
Partner 3 (NZ-resident)	$90	$13.50
Partner 4 (NZ-resident in loss)	$90	$13.50

Individual partners will then have to calculate the foreign tax credit they are entitled to.

As Partner 1 is a charity it cannot use a foreign tax credit. Similarly, as Partner 2 is a non-resident he will not be taxed on the foreign dividend and therefore cannot receive a foreign tax credit.[27] Partner 3 is the only partner who can use the foreign tax credit because Partner 4 is in loss.

Non-standard balance dates

5.21 The correct allocation to a partner's income year of that partner's share in the income and expenditure of the partnership is a relatively simple exercise when the balance dates of all the partners and the partnership are aligned. However, this process can become more complex in the case of non-standard balance dates – such as when the partnership has a balance date other than 31 March. The Commissioner's balance date policy, as set out in *Tax Information Bulletin* Vol 3, No 9 (June 1992) and confirmed in *Tax Information Bulletin* Vol 5, No 11 (April 1994) currently addresses this situation. However, submissions on this issue are welcomed.

[25] Except controlled foreign company tax credits which may be carried forward (as happens under current rules).
[26] This is assuming that the dividend is received from a treaty country. The country from which the dividend is received also has the same treaty rate with the country the non-resident partner is from.
[27] The non-resident may be able to receive a tax credit for the tax paid in their country of residence.

Calculation of income and expenditure for new and exiting partners

5.22 Under current tax law, the expenditure incurred by the partners of an existing partnership is generally not deductible to incoming partners. Expenditure incurred from the time of entry will generally be deductible to a new partner if that expenditure meets the deductibility tests under the Income Tax Act. However, a problem arises when trying to determine the amount of expenditure relating to a part-year for tax purposes. Similarly, a problem also arises when determining the amount of taxable income that can be attributed to partners for the part-year before an existing partner exits the partnership, or the part-year from when a new partner joins a partnership.

5.23 Two approaches are proposed to deal with these quantification and apportionment issues and the associated compliance costs:

- the close-off approach; and
- the simplified apportionment approach.

5.24 It is intended that these approaches would be chosen at the discretion of the partnership through a joint election.

Close-off approach

5.25 Under this approach, the income and expenditure attributable to the existing partners would be calculated (and apportioned to them) up to the time a new partner enters the partnership (and/or the time an existing partner exits a partnership). This option would most probably involve the preparation of financial and tax accounts for the appropriate part-year period, but would ensure that all taxable income derived and deductible expenditure incurred by existing partners is factored into their net income/loss allocations for the period before the new partner joined (or the exiting partner left). Under this approach, the apportioned income for that period would not be taxable to the incoming partner, nor would the apportioned deductions be deductible to that partner. Instead, these amounts would be apportioned to the partners that existed at the time of exit or entry for inclusion in their individual income tax returns.

5.26 This option is likely to be accurate in determining the appropriate amount of taxable income and deductible expenditure attributable to existing partners, exiting partners and incoming partners. However, it may be more compliance-intensive as a result of the associated accounting and tax activities required. Accordingly, a less compliance-intensive option could be considered. To this end, an alternative "simplified apportionment approach" is proposed.

Simplified apportionment approach

5.27 This option would involve calculating a weighted average of the level of an exiting partner's partnership interest for the part-year period of which he or she was a partner. A portion of the taxable income and deductible expenditure would then be allocated to the exiting partner on this basis. Example 3 helps illustrate this approach in relation to deductible expenditure.

Example 3

Partnership X comprises four partners, each with a 25% interest in the partnership as at 31 March 2009 (the balance date of the partnership and each of the partners). Partner A (a general partner) had an interest of 10% for the period 1 April 2008 until 30 June 2008. From 1 July 2008, the level of Partner A's interest increased to 25%, and it remained at this level until 31 December 2008, the time of Partner A's exit from the partnership. Deductible expenditure of $50,000 had been incurred by the partnership in relation to the lease of partnership business premises for the period 1 April 2008 to 31 March 2009. Under this method, Partner A would be entitled to a deduction calculated as follows:

$$\frac{91\text{ days}}{365\text{ days}} \times 10\% \times \$50{,}000 = \$1{,}246.58$$

Plus: $$\frac{184}{365} \times 25\% \times \$50{,}000 = \$6{,}301.37$$

The total deduction for Partner A would be: $7,547.95.

5.28 While this option would be less accurate than the close-off approach, it could constitute a simplified and less costly alternative, particularly for larger (for example, professional) partnerships.

Chapter 6

TRANSACTIONS BETWEEN PARTNERS AND PARTNERSHIPS

Summary of proposals

- Salary and wages paid to a partner would generally not be deductible to the partnership unless performed as part of a written contract of service.
- Rent and interest (on amounts over and above the capital contributed to the partnership) received by a partner from a partnership would be deductible to the partnership provided the payments meet the general test of deductibility.
- All transactions between partners and partnerships must occur at market value for tax purposes.

Salaries and wages paid to a partner

6.1 Under current tax law, any remuneration paid by a partnership to a partner is generally seen as drawings – not as salary or wages. Therefore a partnership cannot generally claim a deduction for income tax purposes for salary paid to a partner (*Case F123* (1984) 6 NZTC 60,157, *Case L28* (1989) 11 NZTC 1,172). This follows the principle under general partnership law that a partner cannot employ him or herself. However, there are two exceptions to this rule.

6.2 First, section DC 4 of the Income Tax Act allows the members of a partnership to receive a deduction for their share of any payment made by the partnership to a partner for services performed for the partnership under a written contract of service. The recipient partner must personally and actively perform any duties that are required to be performed in carrying on the partnership business. The contract must also specify the amount payable to the partner for the services he or she performs in carrying out the partnership business. It is implicit that the fee must be at arm's length. However, no deduction is allowed if the partnership is engaged principally in the investment of money or the holding of or dealing in shares, securities, estates or interests in land.

6.3 Second, section DC 3 of the Income Tax Act allows a tax deduction for pensions (that are of a reasonable amount) paid to a former partner or the surviving spouse or civil union partner, of a former partner.[28]

[28] However, this section does not apply to partnerships that are principally engaged in the investment of money or the holding of or dealing in shares, securities, estates or interests in land.

6.4 Under the proposed rules, this treatment would be maintained as it is consistent with general partnership law and international practices.[29] However, submissions on the matter are welcomed.

Rent transactions

6.5 Under the general deductibility provision[30] and section GD 10 of the Income Tax Act, a partnership that leases property from one of its partners is allowed a deduction for the rent payable. The rental income received by the partner is treated as assessable income to that partner. Similarly, if a partnership leases any property to a partner, the rental income received is considered as assessable income to the partnership. It follows that the partner incurring the leasing expenditure is allowed a deduction for the rent paid, provided the requirements of the general deductibility test are met.

6.6 The deduction is subject to an anti-avoidance provision that ensures the amount of rent paid is "adequate rent". "Adequate rent" is defined as "the amount of rent that the Commissioner determines to be adequate for that property during the period in respect of which the determination is made".[31] This is generally a market value rent.

6.7 This treatment would be maintained as it is consistent with the general deductibility rule and with international practice.[32] However, submissions on the matter are welcomed.

Interest paid to a partner

6.8 Under existing law, a tax deduction is not allowed for interest paid to a partner in respect of his or her capital contribution to the partnership.[33] The interest is treated as a distribution of the partnership profits.

6.9 Nevertheless, if a partner provides a loan to the partnership that is an amount over and above his or her capital contribution, any interest paid by the partnership to the partner in relation to this loan will be deductible to the partners of the partnership under sections DA 1 and DB 6 of the Income Tax Act. The interest paid to the partner constitutes assessable interest income in the hands of the recipient partner.

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[29] In Australia and the United Kingdom (except Scotland) salaries are not deductible to the partnership. They are seen as a means of distributing partnership income. In the United States, if the partner is acting in his or her capacity as such, the salary is treated as part of the partner's distributive share and is not deductible to the partnership. However, if the partner is acting at arm's length with the partnership or receives a fixed or "guaranteed payment" for services, the payment is treated as ordinary income to the partner and is deductible to the partnership.

[30] Income Tax Act 2004, s DA 1.

[31] Income Tax Act 2004, s GD 10(4).

[32] In the United States rent paid by a partnership to a partner is deductible to the partnership and is income to the partner. This is also subject to an anti-avoidance rule – "substantial economic effect".

[33] Section 27 of the Partnership Act 1908 states that a partner is entitled to interest only on any actual payment or advance beyond the capital which he or she has agreed to subscribe.

6.10 The Partnership Act 1908 states that a partner is entitled to interest at 5 percent a year on any amount over and above his or her capital contribution. However, the rate is not limited to this amount because it can be modified by a partnership agreement.

6.11 This treatment would be maintained, subject to the market value rule discussed below, as it is consistent with the general deductibility rule and with international practice.[34] However, submissions on the matter are welcomed.

Market value rule

6.12 The existing rule on rent transactions requires the transaction to be made at market value for tax purposes. The requirement for arm's-length transactions is implicit in the requirements of section DC 4, in relation to contracts for services. It will be clarified that, in all cases, transactions between partners and partnerships must be at market value to qualify for the relevant tax treatment of being deductible to the partnership and taxable to the partner.

Partnership asset sold to a partner

6.13 When a partnership asset is sold to a partner for that partner's own private ownership and use, the partnership will be required to recognise any gain or loss on disposition in accordance with general tax principles.[35] For example, in the case of the disposal of depreciable property to a partner, this would involve the calculation of any amount of depreciation recovery or depreciation loss on sale of the asset. The consideration derived for the disposal of the asset will be deemed to be at market value for tax purposes.

Introduction of property by a partner

6.14 The introduction of property into a partnership by a partner would constitute a disposal of the property by the partner to the partnership for income tax purposes. The partner disposing of the property would be required to recognise any gain or loss on disposition in accordance with general tax principles. For example, if the partner was disposing of revenue account property to the partnership, the proceeds would constitute assessable income to the partner and the cost of the property would be an allowable deduction to the partner.

[34] The United States adopts a similar approach to that of New Zealand. Interest is also deductible in Australia if the money lent to the partnership is used by the partnership in producing income.
[35] This is consistent with the approach under existing legislation.

Submissions

6.15 Submissions are welcomed on whether and how the approaches discussed in this chapter might give rise to legitimate business concerns. Specific examples illustrating any concerns would be helpful. In addition, submitters should consider whether these concerns arise specifically for general partnerships, limited partnerships, or both.

Chapter 7

FLOW-THROUGH TREATMENT: INTERNATIONAL AND CROSS-BORDER ISSUES

Summary of proposals

- The current approach of applying the controlled foreign company (CFC) rules to partnerships would be retained.
- The dividend withholding payment and underlying foreign tax credit rules would apply to New Zealand-resident companies that are partners.
- Non-resident partners would be subject to non-resident withholding tax (NRWT) – at the domestic rate or the applicable treaty rate – on any New Zealand-sourced dividends, interest or royalties.
- A New Zealand-resident company would be eligible for a foreign investor tax credit in relation to a dividend derived by a non-resident partner.
- Foreign partners would not be taxed on their proportionate share of foreign-sourced income.

Application of controlled foreign company (CFC) rules

7.1 The current CFC rules fit reasonably well with the partnership flow-through treatment discussed in Chapter 5. This is because the rules generally apply at the New Zealand partner level, although the interests of other partners are taken into account through the associated person test for certain purposes. The government proposes to retain the current approach for both partnerships and limited partnerships.

7.2 Under the current rules, when a partnership holds an interest in a foreign company, individual partners are required to take the full partnership interest into account for the purposes of determining their own control interest and whether or not that foreign company is a CFC. (However, an interest may be counted only once in determining whether a foreign company is a CFC.) Specifically, the control interest test for a CFC applies to New Zealand residents (see section EX 1). Section EX 3(b) provides that a New Zealand-resident's control interest in a foreign company includes:

> …any direct control interests in the company held by persons associated with the New Zealand resident.

7.3 A partnership and any person who is a partner (or associated with a partner) in the partnership is an associated person (see section OD 8(3)(e) and (f)). This associated person rule is also relevant in the partnership context for the purposes of determining whether the partner has an income interest in the CFC of 10% or more and is therefore required to return the attributed CFC income or loss for the CFC.

7.4 For the purpose of determining the income interest of each partner, each partner is treated as holding a share of anything held by the partnership, according to the partner's proportionate interest in the partnership. (See section EX 13 of the Income Tax Act.)

7.5 Under the proposed rules, individual partners can claim a foreign tax credit against their attributed CFC income. They will be able to establish their branch equivalent tax account (BETA) to record credits to offset income tax or dividend withholding payment (DWP) liability on foreign dividends.

Foreign dividends, interest and royalties

7.6 New Zealand-resident individual partners will be liable for income tax on their proportionate share of any foreign dividends earned by the partnership. They will be entitled to a foreign tax credit (FTC) for any foreign non-resident withholding tax (NRWT) imposed on the dividend. They can also offset their tax liability with BETA credits.

7.7 New Zealand-resident companies that are partners will be liable to make a dividend withholding payment on their proportionate share of foreign dividends. If the corporate partner has the requisite voting interest, market value interest (where relevant) or income interest of 10% or more in a foreign company, it will be eligible for an underlying foreign tax credit (UFTC) in accordance with the UFTC rules. If the foreign company is resident in one of the eight "grey list" countries, the corporate partner may be entitled to a deemed UFTC.

7.8 New Zealand-resident partners are taxed on their proportionate shares of foreign interest and royalties at their marginal rates. They will be entitled to a FTC for foreign NRWT imposed on their proportionate share of that income.

7.9 New Zealand-resident partners will be liable for income tax on their proportionate share of the income of the foreign branch. A FTC will be provided for income tax imposed on the branch by the host country.

Taxation of non-resident partners on New Zealand income

7.10 The source rules will generally apply to determine whether income derived by the partnership from its activities or investments has a New Zealand source.

7.11 A non-resident partner will be taxed on their proportionate share of business income derived by the partnership from a business carried on in New Zealand. This income will continue to be taxable under the treaty if the business carried on by the partnership constitutes a permanent establishment for the purposes of the business profits article in the treaty. Paragraph 19.1 of the Commentary to Article 5 in the OECD *Model Tax Convention on Income and on Capital*[36] clarifies that the activities of a transparent entity may constitute a permanent establishment for its non-resident members.

7.12 A non-resident partner's proportionate share of New Zealand-sourced interest derived from the partnership will be subject to NRWT at the relevant domestic or treaty rate. If, however, the partnership includes a New Zealand-resident partner the interest payment is currently subject to withholding tax at resident withholding tax rates (section NG 2(1)(ab) of the Income Tax Act). This is because the interest income is derived jointly by residents and non-residents. Partners who are residents of treaty countries are, however, entitled to obtain a refund from the Commissioner for the over-deducted tax. One option would be to enable the partnership to apply for a certificate of exemption from resident withholding tax and then require the partnership to withhold at the appropriate NRWT rate. The partnership would also be required to withhold RWT with respect to its resident partners who do not hold certificates of exemption. Changes to existing legislation would be required to achieve this result.

7.13 A non-resident partner's proportionate share of dividends derived by the New Zealand partnership from shares in a New Zealand company would also be subject to NRWT at the relevant domestic or treaty rate. A New Zealand company is also eligible for a foreign investor tax credit (FITC) in relation to a dividend derived by a non-resident partner. As a practical matter, the partnership would need to provide the company with information about the residence of its members to enable the company to comply with the imputation, FITC and NRWT rules. The government is interested to know whether there are any difficulties in relation to the way these rules operate in practice.

7.14 A non-resident partner's proportionate share of royalties earned by the partnership would be subject to NRWT at the relevant domestic or treaty rate. Again, the payer of the royalty would need to know the residence of the partner to withhold at the correct rate.

7.15 Non-resident partners would not be taxed in New Zealand on their proportionate share of foreign-sourced income derived by the partnership.

7.16 Neither foreign nor New Zealand partners would be taxed on their proportionate share of capital gains derived by the partnership. The general law that determines whether gains are of a capital nature will apply in this regard (see paragraph 5.14).

[36] Paragraph 19.1 states: "… If the period of time spent on the site by the partners and the employees of the partnership exceeds twelve month(s), the enterprise carried on by the partnership will therefore be considered to have a permanent establishment. Each partner will thus be considered to have a permanent establishment for purposes of the taxation of his share of the business profits derived by the partnership regardless of the time spent by himself on the site."

Issue for submissions

Nominee companies are known to advise the company/payer of the dividend or royalty with the relevant information concerning the beneficial owners of the nominee company. Submissions are welcomed on whether or not this approach would be suitable for partnerships.

Residence of partnerships and source rules

7.17 New Zealand partnerships currently are not "resident" for New Zealand tax purposes. Nor are they generally regarded as resident for the purposes of our tax treaties because:

- they are not resident under our domestic law; or
- are not "liable to tax" because they are fiscally transparent.

7.18 The result is that treaty benefits should be conferred on partnerships when the partners are resident in New Zealand.[37] The approach adopted for the taxation of partnerships is not expected to affect the application of treaties.

7.19 The Valabh Committee did, however, identify some particular issues arising from the lack of residence status. For example, the source rules in section OE 4[38] deem certain types of income to have a New Zealand source if:

- for interest and redemption payments, the money is lent outside New Zealand to a person who is resident in New Zealand;
- royalty payments are made by a resident in New Zealand; and
- payments for the use of personal property are paid by a resident in New Zealand.

7.20 When the partnership is comprised of New Zealand partners it is clear that payments of interest, royalties and rents have a New Zealand source. The more difficult issue is how to deal with payments by New Zealand partnerships that comprise New Zealand and non-resident partners. As noted by the Valabh Committee, theoretically at least, payments of interest, royalties or rent by a New Zealand partnership made to a non-resident should have a New Zealand source when the partners are New Zealand-resident. Ideally, the payment would be apportioned in some way to determine the amount that has a New Zealand source. One option would be to adopt the Valabh Committee proposal and deem partnerships with 50 percent or more New Zealand-resident partners to be New Zealand-resident for the purposes of the source rules only. Submissions on this issue are welcomed.

[37] Although it is important to examine each treaty to determine the application of treaty protection in a given case.
[38] Income Tax Act 2004.

Chapter 8

LIMITATION OF LIMITED PARTNERS' TAX LOSSES

Summary of proposals

The proposed rules in this chapter apply only to limited partners. They include:

- the introduction of loss limitation rules to ensure that the net limited partnership loss claimed by a limited partner in relation to a limited partnership interest reflects the actual level of that limited partner's economic loss; and
- the introduction of the "partner's basis" concept (basis tracking) to determine the extent of the application of the loss limitation rules – limited partners would be required to track the amount of their basis.

Limiting tax losses allowed to limited partners

8.1 Limited partnerships are different from general partnerships in one important respect. Partners in a general partnership have unlimited liability with respect to their business dealings through the partnership. When general partners incur a loss through a general partnership, it generally will be an economic loss, as their liability for loss is not restricted to the level of their investment in the general partnership. In contrast, limited partners are not exposed to any risk of loss greater than the amount of their limited partnership investment. This feature of a limited partnership will be even more entrenched with the proposed separate legal personality.

8.2 The rationale behind restricting a limited partner's net tax losses in any given year is to ensure that the net tax losses claimed by a limited partner reflect the actual level of that partner's economic loss in relation to the limited partnership interest. It is an appropriate policy result to allow taxpayers to offset, for tax purposes, only those net tax losses they have actually borne. The absence of loss limitation rules is likely to distort efficient risk-bearing decision-making and efficient resource allocation by encouraging investors to enter arrangements or schemes whereby small amounts of capital are invested to get access to larger net tax losses. This could result in abuse of the limited partnership rules and in actions that are contrary to their intent. This may potentially create large fiscal costs to the government.

8.3 The loss limitation rules proposed in this chapter are consistent with the treatment provided by other countries.[39] Introduction by New Zealand of rules consistent with internationally accepted practice should not deter foreign investors.

[39] For instance, the United States and Australia (for venture capital limited partnerships) have similar loss limitation rules.

Proposed tax loss limitation rules

8.4 Special tax loss limitation rules would prevent the flow-through of losses in excess of the actual investment of the limited partner in any income year. Therefore the rules would limit the loss allowed to be utilised in that year up to the amount of the limited partner's economic loss.

8.5 To apply these rules, limited partners would be required to calculate their net income or loss from the limited partnership as a separate calculation from their other income. This is referred to as "net limited partnership income" and "net limited partnership loss".

8.6 A limited partner's share in the net limited partnership loss disallowed in any year would be allowed to be carried forward to future years. It would effectively flow through only when the limited partner had sufficient taxable income from the limited partnership available to offset the losses, or sufficient equity/investment at risk in the limited partnership.

8.7 The existing deferred deduction rule may potentially apply to limit the loss that flows through to limited (and general) partners. However, the deferred deduction rule does not address the more general issue of limiting the losses available to limited partners to the amount of their economic loss. Therefore, a broader mechanism will be required in the context of limited partnerships.

8.8 Under existing tax legislation,[40] special partners will forfeit any tax losses incurred in an income year if they do not derive any New Zealand assessable income in that income year. Non-residents therefore cannot carry forward any losses that arise from investing in New Zealand special partnerships if they have no other New Zealand-sourced income. Non-residents may then be taxed in a later year when they derive income from the partnership. This rule may arguably overtax non-resident investors in special partnerships and may discourage some non-resident investment into special partnerships. Accordingly, it is proposed to repeal these rules and replace them with tax loss limitation and carry-forward rules for limited partners. Such rules better reflect the economic consequences to the limited partner and are more consistent with international practice. This proposal may make investment by non-residents into New Zealand limited partnerships more attractive than under the current law applying to special partners.

Partner's basis

8.9 A partner's adjusted investment in a partnership would be referred to as the partner's "basis". For limited partnerships, it will be necessary to implement basis rules for the purpose of the proposed loss limitation rules. Basis rules may also be required to ensure income tax is appropriately accounted for on an exit from a partnership.

[40] Section IE 1(2B) of the Income Tax Act.

8.10 A process of "basis tracking" would allow partners to maintain a running balance of their basis in a partnership, and would determine whether the loss limitation rules apply to a limited partner in an income year. "Basis tracking" would provide limited partners with an amount against which the quantity of losses from a limited partnership (or the amount of losses limited and carried forward) would be measured in any given year.

8.11 The next section explains two potential basis mechanisms and how they would operate to determine whether the tax losses of a limited partner are limited (and carried forward) in any given income year and the extent of any such tax loss limitation.

Calculation of a partner's basis

8.12 A partner's basis would be calculated in any income year in the following manner:

original investment + value of additional contractual guarantees and indemnities provided + share of net limited partnership income previously recognised + prior equity injections – share of net limited partnership loss previously recognised – prior distributions

Original investment

The original investment would be the partner's initial investment contribution to the partnership. The original investment would be calculated by reference to the market value of net assets (or services) contributed to the partnership or paid to an existing partner for the partnership interest. The market values would be required to be calculated on an arm's-length basis.

Value of additional contractual guarantees and indemnities provided

Should a partner provide any guarantees or indemnities in addition to the amount of original investment, the value of any such guarantees or indemnities would be added to the amount of that partner's basis. These guarantees or indemnities would have to be contractual in nature and enforceable by non-associated third parties before any adjustment to that partner's basis would be allowed. The amount of any guarantees or indemnities that expire, or that are cancelled or subsequently rescinded, would be subtracted from this amount.

Share of net limited partnership income previously recognised

This amount would be the partner's share of the net limited partnership income (being the excess of the partner's income over deductions) generated by the partnership (that has been recognised by the partner in earlier periods) as calculated under the relevant provisions of the Income Tax Act.

Prior equity injections

This comprises capital injections (new amounts of capital in addition to the original investment capital) provided to the partnership by a partner over the period the partner holds the partnership interest.

Share of net limited partnership loss previously recognised

This amount would be the partner's share of the net limited partnership loss (being the excess of the partner's deductions over income) previously "flowed through" to a partner in a partnership and deducted by the partner.

Prior distributions

Prior distributions are effectively withdrawals of equity or capital by a partner or distributions of income to a partner over the period the partner holds a partnership interest.

Example 1

On 1 April 2008 limited Partner B contributes equity of $100,000 to Partnership X. Partnership X comprises four partners. Each partner shares equally in the net income and loss of the partnership. All partners (including Partner B) have the same March balance date as the partnership. Partnership X derives net income of $40,000 for the income year ended 31 March 2009. The basis calculation for Partner B would be calculated as follows:

Original investment	$	100,000
+ Prior net income	$	10,000
Partner B's basis – 31/3/2009	**$**	**110,000**

On 1 June 2009, Partner B receives a distribution from the partnership of $5,000. For the income year ended 31 March 2010, the partnership makes a loss of $460,000.

Basis calculation for Partner B:

Original investment	$	100,000
Prior net limited partnership income	$	10,000
Additional guarantees/indemnities	$	0
Prior equity injections	$	0
Prior net limited partnership losses	$	(0)
Prior distributions	$	(5,000)
Partner B's basis – 31/3/2010	**$**	**105,000**

Basis of Partner B	$	105,000
Partner B's share of tax loss	$	(115,000)
Allowable tax loss to Partner B – 2010	$	(105,000)

Apply the loss limitation rule

Disallowed tax loss	$	(10,000)

The disallowed tax loss (from the limited partnership) cannot be included in the limited partner's annual tax calculation as an annual total deduction. In other words, it cannot be offset against any other income of the limited partner. It can be carried forward by Partner B to a future year if Partner B has sufficient basis in the partnership to offset against the loss.

8.13 The loss limitation rules apply only to limited partners. The basis of limited partners would generally not fall below zero, as they could not deduct a net limited partnership tax loss greater than the amount of their basis.[41]

8.14 If a limited partner disposes of his or her partnership interest, and at the time of disposal that limited partner has tax losses carried forward, the limited partner's tax losses would be extinguished because they could not be used. However, they could be used to reduce a revenue account adjustment, if any, as discussed in Chapter 9.

Alternative partner's basis calculation

8.15 A possible alternative calculation mechanism for the determination of a partner's basis can be illustrated by the following formula:

Partner's basis = OI + AGI + TI + RCG + PEI – TL – RCL – PD

Where:

OI	=	original investment
AGI	=	value of any additional guarantees or indemnities provided
TI	=	share of net limited partnership income previously recognised
RCG	=	share of realised capital gains previously recognised (reduced by any amount of taxable income in relation to capital dispositions that are included in TI, such as a depreciation recovery arising from the disposition of a business asset)
PEI	=	prior equity injections
TL	=	share of net limited partnership losses previously recognised
RCL	=	share of realised capital losses previously recognised (reduced by any amount of tax losses in relation to capital dispositions that are included in TL, such as a tax loss arising from the disposition of a business asset)
PD	=	prior distributions

8.16 While similar to the partner's basis calculation mechanism previously described, this alternative mechanism differs by including adjustments in respect of a partner's share of realised capital gains derived, and realised capital losses incurred, from the partnership. The reasons for allowing such adjustments include the need to:

- accurately reflect a partner's net investment in the partnership that is at risk; and
- decrease the disparity between the tax treatment applying to a partner investing through a partnership vehicle and an individual investing directly.

[41] Limited partners' basis may fall below zero if their distributions exceed their bases.

8.17 This is illustrated in simplified form in Example 2.[42]

Example 2

Direct investor (and sole proprietor) P purchases an asset for $50,000 and uses the asset in a business for the purposes of producing taxable income. The $50,000 represents the extent of P's capital investment in the business. P then sells the asset for $70,000, deriving a non-taxable capital gain of $20,000 (assume no tax depreciation recovery). P then uses the $70,000 for other business expenses which are deductible. Assuming that P derives no taxable income during the year, P would be entitled to a tax deduction for the full amount of $70,000 (which could be used to offset against other taxable income sources P has).

However, if P was a limited partner in a partnership, under the original partner's basis calculation mechanism outlined earlier, P would only be entitled to deduct $50,000 for income tax purposes – being the amount of P's basis in that year. Under the alternative basis calculation mechanism, net limited partnership losses arising from the tax deductions of $70,000 would flow through to P (that is, not be limited to $50,000 in that year). Accordingly, this alternative basis calculation mechanism provides a tax result closer to that of a direct investor.

8.18 The alternative basis calculation mechanism may increase a partner's basis and therefore may be more advantageous, from a tax perspective, for many taxpayers deriving realised non-taxable capital gains through partnership vehicles. For a limited partner, the increased basis may result in the flow through of net limited partnership losses, in a particular income year, when they would otherwise have been required to be carried forward under the proposed loss limitation rules. However, it would be necessary to include appropriate rules to combat manipulation and avoidance of the proposals through artificial and temporary increases in partners' bases (for example, by way of transactions with related parties that are not on arm's-length terms).

8.19 The basis of a limited partner would likely only fall below zero in circumstances where a capital loss is incurred. A negative basis would be allowed in these situations because a capital loss would not be able to flow through to a limited partner to be offset against other sources of income.

8.20 Under this alternative mechanism, if a limited partner incurs a loss and derives a realised capital gain in the same period, a question would arise as to which amount to take into account first. Example 3 illustrates the ordering problem.

[42] The following examples assume the partners and the partnership have income years that are aligned for income tax purposes.

Example 3

Partner A becomes a limited partner in Partnership Y and enters the partnership at the beginning of year one with an original capital investment of $100. Year one is a bad year in terms of business performance and at the end of that year A's share of the net limited partnership loss is $120. In addition, the partnership realised a capital gain during year one on the disposal of shares (that were held on capital account). A's share of this realised capital gain is $50.

Capital gain added to basis first		**Tax loss subtracted from basis first**	
Particulars	***$***	***Particulars***	***$***
Original investment	100	Original investment	100
Capital gain	50	Tax loss	(120)
Adjusted basis	150	Adjusted basis	0[43]
Tax loss	(120)	Capital gain	50
Adjusted basis	30	Adjusted basis	50
Losses allowed to flow through	(120)	Losses allowed to flow through	(100)
Losses limited and carried forward	0	Losses limited and carried forward	(20)

8.21 As the example shows, the ordering in which losses and realised capital gain amounts are taken into account in determining a limited partner's basis can influence the application of the loss limitation rules.

8.22 Under the proposed rules, the basis adjustments in relation to realised capital gains and realised capital losses would take place on the last day of the partnership's income year – before the flow-through of any net limited partnership income or net limited partnership losses to the partners. Alternatively, capital gains and losses could be taken into account when the gains and losses are realised, while any income derived by the partnership would be taken into account on the last day of the partnership tax year. Either of these approaches may provide a tax advantage to partners if realised capital gains are derived by allowing each partner's basis to be increased by the amount of any realised capital gains before the partnership attributes any net limited partnership income or net limited partnership loss to the partners. As seen in Example 3, such an increase to the basis of limited partners could increase the likelihood of net limited partnership losses flowing through to them.

8.23 Under this alternative mechanism, it should be acknowledged that a tax disadvantage could potentially arise in circumstances where a limited partner incurs a net limited partnership loss and a realised capital loss in the same period (if, under this alternative basis calculation mechanism, the realised capital loss amount is taken into account first). This possibility is illustrated in Example 4.

[43] The basis would be $0 as under these proposals a limited partner would generally only have a negative basis if the negative amount arises from a capital loss.

Example 4

Partner A becomes a limited partner in Partnership Y and enters the partnership at the beginning of year one with an original capital investment of $100. Year one is a bad year in terms of business performance and at the end of that year A's share of the net limited partnership loss is $40. In addition, the partnership incurred a realised capital loss during year one on the disposal of shares (that were held on capital account). A's share of this realised capital loss is $100.

Tax loss subtracted from basis first		**Capital loss subtracted from basis first**	
Particulars	***$***	***Particulars***	***$***
Original investment	100	Original investment	100
Tax loss	(40)	Capital loss	(100)
Capital loss	(100)	Tax loss	(40)
Adjusted basis	(40)	Adjusted basis	0
Losses allowed to flow through	40	Losses allowed to flow through	0
Losses limited and carried forward	0	Losses limited and carried forward	(40)

8.24 Example 4 highlights that the flow-through of net limited partnership losses to a limited partner may be restricted under the alternative basis calculation mechanism – resulting in the deferral of recognition of these losses. In addition, this alternative basis calculation mechanism would involve more complexity than the first basis calculation mechanism described earlier (as a result of additional adjustments and ordering rules being required).

8.25 Submissions on the appropriate basis calculation mechanism and workable design features are welcomed.

Change of partner status

8.26 Under the proposed limited partnership regulatory reforms, general partners would be able to become limited partners and vice versa. When a general partner becomes a limited partner, he or she will need to begin basis tracking. When a general partner changes status to that of a limited partner, the loss limitation rules will apply to that partner from that time. The loss limitation rules would cease to apply when a limited partner changes status to a general partner.

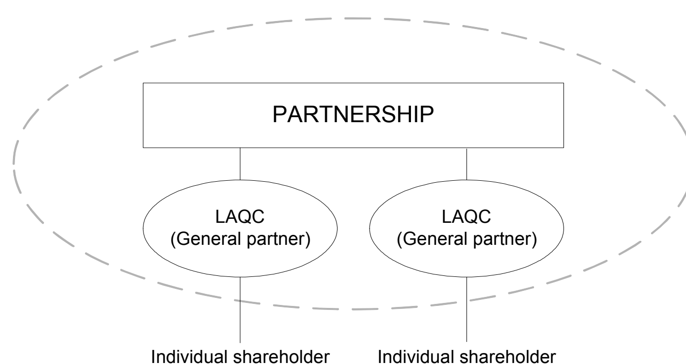
8.27 Anti-avoidance rules would be required to prevent the abuse of status changes to circumvent the loss limitation rules (such as switching from a limited partner to a general partner – and back again – to get access to tax losses in an income year when the limited partner has insufficient basis).

Limited liability entities and the flow-through of tax losses

8.28 While the proposed loss limitation rules would restrict tax losses to a limited partner in a partnership (up to the amount of that limited partner's investment), taxpayers could structure their affairs (through the use of other business and investment vehicles) in such a way that the proposed rules would not apply. For example, using structures involving loss attributing qualifying companies (LAQCs) as general partners in partnerships, net tax losses in excess of the capital invested through the LAQC could conceivably still flow through to shareholder individuals – even though the LAQC vehicle serves to provide limited liability to these shareholders. This is illustrated in Example 5.

Example 5

Partnership A has two general partners – both of which are LAQCs, each having one shareholder that is a natural person. This structure is represented below:



8.29 Under this structure, the proposed loss limitation rules would not apply because neither of the LAQCs will be limited partners. However, as each partner is a corporate entity – each partner will have limited liability. In addition, by virtue of its LAQC status for tax purposes, each LAQC general partner will be able to flow through net tax losses to its individual natural person shareholder.

8.30 The government recognises that these structures could be used to circumvent the policy intent behind the proposed loss limitation rules. This issue may be considered further in a future review of the LAQC rules.

Chapter 9

ENTRY AND EXIT OF PARTNERS AND CHANGES TO PARTNERSHIP INTERESTS

Summary of proposals

- An interest in a partnership would be treated as a distinct asset (similar to a share in a company).
- The entry and exit of partners would not result in the dissolution of the partnership for income tax purposes.
- Exiting partners may be taxed on taxable gains attributable to underlying partnership assets on disposition, subject to a minimum threshold.
- The new partner and the partnership may jointly elect, in certain circumstances, to allocate the cost of the new partner's partnership interest over the new partner's share of partnership assets and liabilities.
- Partnerships with two to five owners (none of whom have limited liability with respect to the business) may elect either to apply the proposed rules outlined in this chapter or to treat each owner as owning an undivided interest in all assets, liabilities and income of the business.

Existing law and practice

9.1 Under general partnership law, both the entry and exit of partners results in a technical dissolution of the partnership and the creation of a new partnership. The effect of the change to individual profit/loss shares amongst existing partners is less clear, although it is generally understood that such an alteration in shares does not result in the dissolution of a partnership under general partnership law.

9.2 Technically, a "dissolution" can trigger the operation of tax provisions relating to the disposal of an interest in the property of the partnership for all partners in the partnership. The Valabh Committee noted that it is unclear whether the disposal is in the nature of a transfer of assets from the "old" to the "new" partnership, or a transfer of assets between the existing partners and the partner who is entering or exiting the partnership. Notably, the existing provisions relating to trading stock and depreciation are consistent with the latter approach.

9.3 In any event, a disposal of assets for tax purposes can result in tax liabilities being crystallised on the transfer of assets for all partners, even when only minor changes in partnership interests have occurred. This potentially results in significant compliance costs for the partners, who must make various complex tax adjustments.

9.4 In practice, the tax treatment adopted in relation to the entry and exit from partnerships may depart from the technical legal position. Some partnerships treat themselves for tax purposes in a manner similar to companies, in which changes in the interests of partners are treated similarly to changes in the interests of shareholders. As noted by the Valabh Committee, the uncertainty created by this disparity between the technical legal position and common practice is unsatisfactory. Moreover, the problems associated with such uncertainty will only become more pronounced as use of the limited partnership structure increases.

Proposals

The entity approach

9.5 In relation to the income tax treatment applying on the entry and exit of partners, a move towards an "entity" approach is proposed. Under this proposal, interests in a partnership would be treated as a distinct asset (similar to a share in a company) and, generally, partnership assets would be treated as being held by the partnership and not by the partners. For instance, the entry and exit of partners would not result in the dissolution of the partnership for income tax purposes, and would not generally trigger tax adjustments for the existing partners (for example, in relation to their partnership interest or their interest in the underlying partnership assets).[44] However, exiting partners may sometimes be required to recognise all or part of any gain on disposition for tax purposes.

9.6 The entity approach should clarify and reduce the complexity of the tax rules applying to partnerships and the compliance costs associated with the entry and exit of partners.

9.7 Smaller joint businesses may prefer to account for their tax position under a pure aggregate approach. Therefore partnerships with two to five owners (none of whom have limited liability with respect to the business) would be able to elect either to apply the proposed rules outlined in this chapter or to treat each owner as owning an undivided interest in all assets, liabilities and income of the business.[45] That election would simply be done by filing a tax return prepared under the set of rules chosen by the partnership.

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[44] However, partnership interests themselves could be held on revenue account (for example, if actively traded), thereby crystallising potential tax liabilities on disposal of these interests.

[45] This would essentially mean following existing tax rules modified for the flow-through rules discussed in Chapter 5.

Tax implications when a partner exits or disposes of a part-interest

General

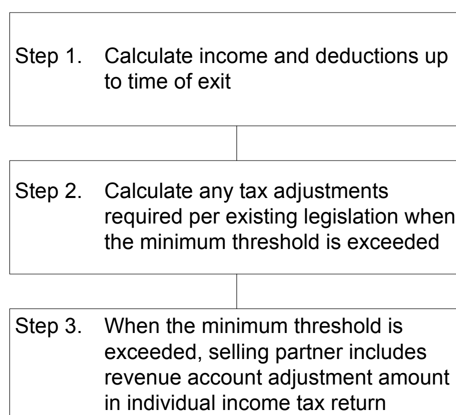
9.8 Under the entity approach, the exit of a partner from a partnership would be viewed for tax purposes as a sale of the partnership interest itself, as opposed to a sale of the partner's share of the underlying partnership assets. If a partnership interest is held on revenue account, the entire gain on the interest would be taxable to the exiting partner.

9.9 Disposal of a partnership interest that is a capital asset would result in tax consequences to the exiting partner if the partnership interest is sold for a gain and the partnership has significantly appreciated assets. The partner's share of the assets may be deemed to be realised at market value for tax purposes, and the resulting assessable income (or allowable deduction) may flow through to the partner (the "revenue account adjustments" amount).

9.10 The revenue account adjustments proposal is the main exception to the entity approach. The reason for it and its proposed operation are discussed in detail later.

9.11 The tax treatment applying on the exit of a partner (or sale of a part-interest in a partnership) will be determined according to the steps illustrated in figure 1.

Figure 1



Calculation of income and deductions up to the time of exit

9.12 Income and expenditure from the business activity of the partnership would generally be flowed through to the exiting partner before his or her exit, in accordance with the proportionate rule, as outlined in Chapter 5. However, when a partner leaves during an income year, a part-year apportionment of income and expenditure may be performed. Part-year allocation methods for exiting partners have been discussed in Chapter 5. If an exiting limited partner has a suspended loss carry-forward amount, it may be applied against net income which flows through from the partnership.

9.13 If the partnership is flowing through a net loss, limited partners must calculate their basis to determine if loss limitation applies. If a basis has increased because of guarantees of partnership debt, and the partner is released from the debt as a consequence of leaving the partnership, the basis must be adjusted down to reflect the fact that the limited partner is no longer liable for the partnership's debt.

Revenue account adjustments where minimum thresholds are exceeded

9.14 Under a purely aggregate approach, an exiting partner would be deemed to have sold his or her share of partnership assets and revenue gains and losses would be recognised. Technically, this is how the law now stands, although the degree to which this law is applied in practice is mixed.

9.15 Under the entity approach, the exit of a partner will be treated as the disposition of his or her interest in the partnership for tax purposes. However, if the interest in the partnership is held on capital account, and the partnership has appreciated assets, the following tax issues arise:

- The exiting partner has crystallised his or her share of the appreciated assets through the sale of the partnership interest (which is a capital asset), thereby deferring recognition of the revenue gain until the partnership sells the assets.
- The potential gain remains in the partnership to be realised, and the new partner, who has already paid for the appreciation on the assets through the price of the partnership interest, will be taxable on the allocated share of that appreciation (the "last man standing" issue[46]).

9.16 Revenue account adjustments (as defined in paragraph 9.9) will be required to ensure that the component of the sale price that is referrable to appreciation in assets is taxed to the correct partner – the one who was the partner when those gains accrued to the asset.

The minimum threshold

9.17 Implementing this approach may give rise to considerable administrative and compliance costs. For this reason, the rules should not apply when the amount of income tax at stake is insignificant relative to the potential compliance and administration costs of calculating the revenue account adjustment.

9.18 Designing a minimum threshold that makes this "trade-off" is very difficult because every case is unique and facts specific. Also, the more complex the minimum threshold rule, the more difficult it is for taxpayers to determine whether or not it applies, which defeats the rationale for having a minimum threshold rule in the first place.

[46] This issue may be dealt with commercially by the new partner reducing the price for the partnership interest to take into account the inherent tax liability. The government welcomes submissions on whether this is, in fact, a problem or not.

9.19 At this stage, a monetary threshold is the simplest and least compliance-intensive option. Therefore revenue account adjustments would not be required by a partner on the disposal of his or her partnership interest (or part-interest) if the amount of the disposal proceeds for the interest does not exceed the total of the net tax book values[47] of the partner's share of partnership property by more than $20,000.

9.20 Specific anti-avoidance rules would be required for partial sale of partnership interests through a series of connected contracts, or by testing the minimum threshold cumulatively with respect to interests in the same partnership sold by a partner.

9.21 The minimum threshold rule will be an important issue for consultation. Submissions on the workability of this rule and any suitable amendments or alternatives are welcomed.

9.22 The calculation would also be allowable by election by both the exiting partner and the partnership. If the gain is below the minimum threshold, the calculations would not be required. However, the exiting partner and the partnership could still elect to perform the calculation and take the consequences into account. An election may be advantageous when purchasing partners want to adjust their cost base in their share of the underlying assets (which is discussed later in this chapter), or when exiting partners would make a loss on the disposal of their share in partnership assets and would like this loss to flow through.

Calculating the revenue account adjustment

9.23 The amount realised upon the sale of the partnership assets would be allocated to the exiting partner's share of partnership assets and liabilities in proportion to their market values, (as if they were sold directly to the new partner. All revenue account assets and liabilities would be deemed disposed of, such as:

- financial arrangements;
- trading stock; and
- depreciable assets.

9.24 The net realised gain or loss would be the revenue account adjustment amount.

[47] Net tax book value of assets means the gross tax book value of assets less the gross tax book value of liabilities.

Treatment of losses carried forward on disposal of partnership interest

9.25 If an exiting limited partner has an amount of tax loss carry-forward at the time of disposal, it would first be applied to any business income flowing through from the partnership to the partner in that year. If a tax loss was flowed through to the partner in the year of exit, the tax loss carry-forward amount would be increased by the current year's tax loss. If an amount of tax loss carry-forward remains on exit, any remaining tax loss carry-forward is applied to reduce any income arising from revenue account adjustments. Any residual loss carried forward will be extinguished on exit.

Accounting for income tax on revenue account adjustments

9.26 Under Step 3 in figure 1, the selling partner would account for income tax on any amount of income arising under revenue account adjustments if the minimum threshold rule is exceeded or the calculation is performed electively.

9.27 If a deduction arises under revenue account adjustments on disposal of a partnership interest (or part-interest), the selling partner would be entitled to a deduction. This could occur, for example, when the amount of consideration attributable to depreciable property was less than the adjusted tax value of that property.[48]

9.28 Examples 6 and 7 illustrate the tax implications of an exit from a partnership or disposal of a part-interest under the proposed rules.

[48] However, a deduction for an amount of depreciation loss would not generally be allowed in the event of a loss incurred on disposal of a building.

Example 6: No revenue account adjustments

Partnership X comprises two general partners, each having a 50 percent share. The partnership has only two partnership assets – a depreciable building (Partner A's share of the original cost is $500,000) and revenue account property (Partner A's share of the original cost is $5,000 and the market value at the time of disposal is $10,000).

Partner A is allocated a depreciation deduction of $15,000 in year one, based on the 3% straight-line depreciation method. There is no income from business activities in year one. On the first day of year two, Partner A sells her entire partnership interest at her share of market value, which is $507,000.

Partner A's net tax book value calculation is represented below:

Share of building – building at cost	$500,000
Share of tax depreciation	($15,000)
Share of adjusted tax book value of building	$485,000
Share of revenue account property	$5,000
Net tax book value	$490,000
Partnership interest sale proceeds	$507,000

Determining the tax treatment for Partner A on exit:

Step 1: There is no income to apportion from the partnership's business activities.

Step 2: No revenue account adjustments are required as the minimum threshold is not exceeded.

The sale proceeds exceed the total tax book value of Partner A's share of assets by $17,000, which is less than $20,000.

Step 3: As the minimum threshold is not exceeded, there is no revenue account adjustment amount. Accordingly, Partner A is not required to account for income tax in relation to the disposal of her interest in the underlying partnership assets.

Example 7: Revenue account adjustments

Partnership Z is a professional partnership that has two general partners, each having a 50 percent share. The partnership has only two partnership assets – a depreciable building (Partner A's share of the original cost is $500,000) and revenue account property (Partner A's share of the original cost is $50,000; the market value at time of disposal is $100,000).

Partner A is allocated a depreciation deduction of $15,000 in the current year, based on the 3% straight-line depreciation method. There is no income from business activities in year one. On the first day of year two, Partner A sells his entire partnership interest at his share of market value, which is $700,000. Partner A's net tax book value calculation is represented below:

Share of building – building at cost	$500,000
Share of tax depreciation	($15,000)
Share of adjusted tax book value of building	$485,000
Share of revenue account property	$50,000
Net tax book value	$535,000
Partnership interest sale proceeds	$700,000

Step 1: There is no income to apportion from the partnership business activities.

Step 2: Revenue account adjustments are required as the minimum threshold is exceeded.

The sale proceeds exceed the total tax book value of Partner A's share of assets by $165,000, which is more than $20,000.

Revenue account adjustments are:

- assessable tax depreciation recovery income: $15,000; and
- assessable income on disposal of interest in revenue account property: $50,000.

The total revenue account adjustment amount is therefore $65,000.

Step 3: Because the minimum threshold has been exceeded, Partner A would include $65,000 as assessable income (in respect of the partnership interest) in the income year of disposition.

"In-substance" transfer of partnership assets

9.29 The Valabh Committee noted that, under the entity approach, significant in-substance asset transfers could result through the transfer of partnership interests (or part-interests). This could in turn result in the significant deferral of tax liabilities. The Valabh Committee suggested that this could be addressed by the introduction of special rules that trigger revenue account adjustments (such as deeming a disposal of assets to third parties for tax purposes), in the event of major changes in partnership interests in a single transaction (or a series of transactions having the same effect within a short period of time). While the proposals in relation to the disposal of partnership interests (or part-interests) serve to reduce this risk to the tax base, an additional, broader rule would provide greater protection. Accordingly, it is proposed that when interests in a partnership exceeding 50 percent in aggregate are sold (or altered as between partners) in any 12-month period, a deemed disposal of all partnership property would arise for tax purposes.[49] The rule attempts to balance the need to protect the tax base with the desire for flexibility with respect to changes in the composition of partnerships, and reduce compliance costs.

9.30 Submissions on these proposals are welcomed.

Tax implications when a new partner enters an existing partnership

9.31 Consistent with the entity approach, when a new partner joins a partnership, he or she is considered to have acquired a partnership interest in exchange for property or services. The new partner could have either acquired the partnership interest from existing partners through the partial sale of their partnership interests, from an exiting partner, or by contributing new capital to the partnership.

Cost base of partnership interest to new partner

9.32 For an incoming partner, the main tax implication of following an entity approach is the need to establish a cost base for the partnership interest. Under the proposed rules, the cost base of an incoming partner's interest in a partnership would generally be equal to the market value of the consideration provided by that partner for that interest. Accordingly, the cost base for an incoming partner's interest would be the sum of the market values of assets contributed to the partnership by that partner. This includes the value of any introduction of capital by way of services to the partnership. The partner's cost base for the contribution of capital by way of services would be equal to the assessable income recognised by the partner for performing the services.

[49] The United States has a similar rule.

9.33 The sum of these amounts represents the opening value of the incoming partner's cost base. According to existing tax law, the contribution of business assets to a partnership by a new partner, constitutes a disposal by that partner of those assets.[50] As a consequence, various tax provisions of the Income Tax Act may be triggered in relation to that partner's entry into the partnership.

Existing partners

9.34 Overall, no tax consequences would arise for continuing partners in relation to the entry or exit of other partners, provided the interests of the continuing partners remain unchanged and their partnership cost base remains the same. Depending on what the new partner contributes to the partnership, an existing partner's share of the underlying partnership assets may change. While under current law this may have been a disposition of assets by the existing partner, under the proposed rules there would be no tax consequences to the remaining partners under the entity approach. If, however, the existing partners are selling part of their partnership interest their cost base would reduce and the revenue account adjustment rules that are relevant to exiting partners would apply accordingly.

Cost base of assets to incoming partner

9.35 Consistent with the entity approach, the purchase of partnership interests from existing partners would generally not affect the adjusted tax book value of assets held by the partnership. However, there would sometimes be a mismatch between the cost base of the partnership interest held by the new partner, and the new partner's share of the net cost base (adjusted tax book value) of the partnership's assets and liabilities. This is known as a difference between the "outside" cost base (the basis of the partnership interest itself) and the "inside" cost base (the partner's share of the net adjusted tax book value of the assets and liabilities of the partnership).

9.36 For example, assume three people form a partnership by contributing $100 each and the partnership buys a $300 revenue account asset. A year later, the value of the asset has appreciated to $450. The costs and market values of the partnership's and the partners' interests are illustrated below:

	Partnership	**Partner 1**	**Partner 2**	**Partner 3**
Contributed Capital	$300	$100	$100	$100
Asset: Cost	$300	$100	$100	$100
Asset: MV	$450	$150	$150	$150

[50] Technically, under current law it may be that a new partner is deemed to sell only a portion of assets contributed to a partnership (in relation to the portion attributable to the other partners' interests). The government proposes to take a pure entity approach and deem each asset to be sold in its entirety to the partnership as an entity.

9.37 At this time, Partner 3 sells her partnership interest to a new partner, Partner 4. Partner 4 pays the market value of the partnership interest, which is $150.[51] The respective interests of the partnership and the partners can be illustrated as follows:

	Partnership	Partner 1	Partner 2	Partner 4
Contributed Capital	$300	$100	$100	$100
Asset: Cost	$300	$100	$100	$100
Asset: MV	$450	$150	$150	$150

9.38 The consequences are that although Partner 4 has paid $150 for his share of the revenue account asset, his share of the asset on the books of the partnership would be $100. If the partnership sold the asset, it would recognise a gain of $150. Partner 4's share of the $50 of gain would be allocated to him even though, in substance, he has not realised any gain. This is the "last man standing" issue.

9.39 Additionally, if Partner 3 had recognised revenue account adjustments as described earlier, she would have recognised $50 of income from a deemed disposal of the asset. When the asset is sold by the partnership, the same gain would be recognised a second time and be allocated to Partner 4.

Cost base allocation election

9.40 To resolve this problem, the new partner and the partnership will be able to elect jointly, in certain circumstances, to allocate the cost of the new partner's partnership interest over the new partner's share of partnership assets and liabilities. The election would be allowed only if:

- the exiting partner had recognised revenue account adjustments (either mandatory or by election); or
- all of the gain on disposal of the partnership interest had been recognised because the interest was held on revenue account.

9.41 In addition, if the exiting partner had elected to recognise revenue account adjustments, and the adjustments resulted in a recognised loss to the exiting partner, the cost base allocation by the new partner would be mandatory. Effectively, three parties would have to agree to an election to recognise a revenue account adjustment loss in conjunction with the new partner allocating cost base – the exiting partner, the new partner, and the partnership.

[51] Disregarding potential tax liability adjustments for purposes of the illustration.

9.42 If the exiting partner had performed a revenue account adjustment, the allocations used in allocating cost base for the new partner would have to be the same. The effect would be to change the partnership balance sheet. The new partner would have a different underlying balance sheet from the other partners.

9.43 This would complicate calculating partnership income and losses, which is a reason the partnership must be a party to the election. The new partner would have a different depreciation calculation from the other partners, as well as different accrual income and expenditure calculations and different calculations on the disposal of trading stock and other revenue account assets.

9.44 For example, in the preceding illustration, the interests of the partnership and the partners would resemble the following:

	Partnership	**Partner 1**	**Partner 2**	**Partner 4**
Contributed Capital	\$350	\$100	\$100	\$150
Asset: Cost	\$350	\$100	\$100	\$150
Asset: MV	\$450	\$150	\$150	\$150

9.45 When the asset is sold, the partnership would recognise a total gain of \$100 (\$450 sales price less \$350 cost). However, \$50 of the gain would be allocated to both Partner 1 and Partner 2. No gain would be allocated to Partner 4.

9.46 The proposal is complex, but it attempts to balance the simplicity of the entity approach with the "last man standing" issue and resulting potential over-taxation if an exiting partner has recognised revenue account adjustments.

9.47 Submissions on all proposals in this chapter are welcomed.

Chapter 10

DISTRIBUTIONS AND DISSOLUTION OF A PARTNERSHIP

Summary of proposals

This chapter provides proposals in relation to the applicable tax treatment on distributions from a partnership and partnership dissolutions. It is proposed that:

- Generally, a distribution to a partner would not be deductible to that partner nor assessable income to that partner (as is currently the case).
- Dissolutions of partnerships would be subject to the proposals discussed in Chapter 9 for dispositions of partnership interests.

Distributions

10.1 A distribution from a partnership to a partner (in contrast to an allocation of income) is typically regarded as a "withdrawal" of capital or income[52] by that partner. Generally, withdrawals of partnership capital or previously taxed retained income amounts are not deductible to the partners or subject to income tax in the hands of the recipient partners. This is the treatment under existing rules and it will not change.

10.2 Under the system of basis tracking discussed in Chapter 8, a distribution to a limited partner would reduce that partner's basis by the amount of the distribution. For example, a withdrawal (distribution) of $10,000 cash from a limited partner's partnership capital account would reduce that partner's basis by the corresponding amount of $10,000. The distribution to a limited partner of an asset that constitutes partnership property would also reduce that recipient partner's basis. The amount of the basis reduction for tax purposes would be equivalent to the market value of the asset distributed on the day of distribution.[53]

10.3 If a limited partner's basis has been calculated by taking into account limited partner guarantees of partnership debt, and that guarantee is later revoked or the maximum liability is reduced, the reduction of guarantee would be treated as equivalent to a distribution of that amount to the partner. This would, in turn, be reflected as a reduction in that limited partner's basis.

[52] Allocations of income to a partner that are retained in the partnership by that partner.
[53] The distribution of an asset in this manner may also trigger tax adjustments on disposal of the asset.

Dissolution of partnership

10.4 Under general partnership law, the dissolution of a partnership may occur in a number of ways. These may include bankruptcy or the death of a partner (in the absence of provisions to the contrary in any partnership agreement). Under the proposed entity approach to partnership taxation previously discussed, the death or bankruptcy of a partner would not generally result in the dissolution of a partnership for the purposes of income tax.[54] However, the dissolution of a partnership could occur for income tax purposes (and in general law) in a number of ways. For example, dissolution could occur through an order of a court, or by unanimous agreement between the relevant partners.

10.5 In relation to the dissolution of a partnership, an entity approach is proposed. When the dissolution of a partnership occurs for income tax purposes, each partner's partnership interest will be deemed to have been disposed of for an amount equal to the market value of the partner's share in the residual net assets of the partnership at the date of dissolution. As the dissolution of a partnership is conceptually similar to a disposal of a partnership interest, it is proposed that the proposals in relation to disposals of partnership interests would apply.

10.6 If a partnership becomes insolvent and dissolves without making any distribution, each partner is deemed to have disposed of his or her interest in exchange for nil consideration.

10.7 Submissions on these proposals are welcomed.

[54] This would generally be the case unless the partners had provided for dissolution in these circumstances in any partnership agreement.

Chapter 11

TRANSITIONAL ISSUES

Summary of proposals

- The new tax rules would generally apply to all partnership interests (other than special partnership interests, unless a special partnership elects for the new rules to apply).
- Two options would be available for the calculation of the opening basis amount for existing partnership interests – the market value option and the historical method option.
- A simple transition from a special partnership to a limited partnership would not generally result in the triggering of income tax provisions to the partners.

11.1 The proposed new tax rules for partnerships raise a number of issues in relation to transitioning from the current partnerships tax rules. First, in applying the new rules to existing partners, there is a need to establish an opening basis value for those existing partners. Second, under the proposed new rules, special partnerships will continue to exist until their expiry. As a consequence, the tax treatment applying to continuing special partnerships and the newly created limited partnerships will need to be made clear. Third, the transition from a special partnership to a limited partnership can result in the triggering of various tax adjustments that will need to be dealt with.

New tax rules apply to all partnership interests from the effective date

11.2 The new tax rules will apply to all partnership interests from the effective date (with the exception of jointly owned businesses with five or fewer owners that elect to remain under the existing tax rules). However, special partnerships could elect to apply either set of tax rules until their cessation.[55]

11.3 Partnership interests in existence at the time the new tax rules come into effect will need to calculate an opening basis amount.

Opening basis amount

11.4 Partnerships formed after the enactment of the proposals will calculate each limited partner's basis from the beginning of the partnership, based largely on subsequent events for which information will be readily available.

[55] Generally, a special partnership would cease at the earlier of the statutory seven-year period, or such shorter period for which the special partnership was formed.

11.5 The identification of an opening basis amount for partnerships that are in existence at the time of the enactment of the new tax rules may be more problematic. Two options are proposed for calculating the opening basis in these circumstances: the "market value option" and the "historical method option".

Market value option

11.6 Under this option, individual partners would calculate their opening basis amount based on their share in the market value of the net partnership assets at the effective date of the new tax rules. If a partner's share of the value of net assets was a negative amount, the opening basis would be deemed to be zero so that excess tax losses taken before the effective date will not count against the partnership basis. This option would be the least compliance-intensive of the two options for the partners, but may incur valuation costs if a professional valuer is used.

Historical method option

11.7 This method involves the calculation of a partner's basis as if the partnership and the partners had always been subject to the new basis rules. If this calculation resulted in an opening basis of less than zero, the opening basis would be deemed to be zero. This method would rely heavily on the availability of full information to enable basis calculations to be performed and tracked from the time the partnership first began. It is anticipated that this method would be more compliance-intensive – particularly for larger partnerships that have been in existence for a number of years.

11.8 Providing the option for taxpayers to choose between the two methods provides a reasonable balance between policy accuracy and compliance costs for taxpayers.

Special partnerships continuing after enactment of the new rules

11.9 Under the proposed rules, special partnerships will continue until their expiry. Accordingly, some special partnerships may continue to exist after the enactment of the proposed new tax rules.

11.10 One option would be for the proposed rules contained in this discussion document to apply to special partnerships that continue to exist. However, this may involve large compliance costs for special partnerships that do not plan to register as limited partnerships in the future. Therefore one option would be to "grand-parent" existing special partnership interests. Under this proposal, only the new income and deduction flow-through tax rules (outlined in Chapters 5, 6 and 7) would apply to existing special partnership interests. The remaining tax proposals in this discussion document would not apply.

11.11 Another option is to allow special partnerships to elect which set of tax rules will apply to them until their cessation (with the proviso that the flow-through proposals would be mandatory). This option is preferable as it allows greater flexibility for special partnerships.

11.12 Under the proposed regulatory reforms, a special partnership would have the opportunity to register as a limited partnership. If a special partnership does not register as a limited partnership upon its expiry, it will cease to exist. In the event a cessation occurs, this will constitute a dissolution at law and for tax purposes. This will then trigger the tax rules applying on dissolution as outlined in Chapter 9.

Transitioning from special partnership to limited partnership

11.13 When a special partnership transitions to a limited partnership, the special partnership ceases to exist and a new limited partnership person with separate legal personality is created. This event can involve the transfer of assets, rights, and obligations from the special partnership to the newly created limited partnership person. This can, in turn, result in the triggering of various income tax adjustments, such as depreciation recoveries and base price adjustments under the financial arrangements rules and, potentially, the breaching of the shareholder continuity rules. The transitional event may also have other tax implications, such as the triggering of gift duty liabilities and goods and services tax liabilities in respect of the transfer of assets.

11.14 To ensure a smooth transition to the new tax rules, it is proposed to include provisions that would ensure that no undue tax liabilities arose on the transition from a special partnership to a limited partnership. These provisions would follow a "same person" concept, in that a simple transition from a special partnership to a limited partnership, all other things held equal, would not trigger tax adjustments (and resulting tax liabilities) when these adjustments and liabilities would not have arisen in absence of the transition. For the purposes of the transition of a special partnership to a limited partnership, this outcome would be achieved by deeming the limited partnership always to have been the holder of the relevant assets, rights and obligations for income tax purposes.

11.15 If the special partnership has not been subject to the new rules, the limited partnership would be subject to them. The partners will be considered to contribute their share of the partnership net assets to the limited partnership to determine their opening basis. However, there will be no other tax consequences.

11.16 This treatment would provide certainty and significantly reduce any potential compliance and administrative costs associated with these reforms.

Submissions

11.17 Submissions are welcomed on the suitability of these proposals and on any other specific transitional issues that submitters may consider are important for these reforms. Specific examples illustrating any such additional measures and the benefits to be obtained from them would be particularly helpful.