

Limited Partnerships Bill

Commentary on Parts 5 and 6 of the Bill
– associated tax changes

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OVERVIEW

New regulatory rules for limited partnerships are being introduced to improve the ability of New Zealand firms to access investment capital.

Limited partnerships are a form of partnership involving general partners, who are liable for all of the debts and liabilities of the partnership, and limited partners, who are liable only for their contribution to the partnership. Limited partnerships are an internationally preferred structure for investing in venture capital.

In a highly competitive international venture capital market, New Zealand is disadvantaged by size and distance. This makes it particularly important for New Zealand to adopt a limited partnership structure which is consistent with international norms and which provides a legal and tax structure that is recognised and accepted by investors.

Currently, New Zealand has a statutory form of limited partnership called the “special partnership”, as described in Part 2 of the Partnerships Act 1908. However, because the legislation is outdated, it does not have all of the features preferred by foreign venture capital investors and the local venture capital industry has been unable to make use of the existing special partnership rules. These rules are being updated and replaced.

At the same time, the bill introduces new tax rules for limited partnerships and updates the tax rules related to general partnerships. This commentary deals with the tax changes. Information on the regulatory side of the bill can be found at <http://www.med.govt.nz/>.

New limited partnership structure

Parts 1 to 4 of the Limited Partnership Bill introduce a new limited partnership vehicle with the following key features:

- Limited partners’ liability will be limited to the amount of their contribution to the partnership.
- Limited partners should be able to undertake certain activities (“safe harbours”) that allow them to have a say in how the partnership is run, without being treated as participating in the management of the partnership and consequently losing their limited liability status.
- A limited partnership should be a separate legal entity to further protect the liability of limited partners – for example, to allow the partnership itself to own property.

Changes to the partnership tax rules

Parts 5 and 6 of the bill introduce new tax rules for limited partnerships and general partnerships.

Under the proposed rules, the limited partnership vehicle will have separate legal entity status. If the proposed regulatory rules were to be introduced without any change to the tax legislation, a limited partnership would be characterised as a “company” for income tax purposes. As a result, income and expenses would not flow through the partnership to be taxed at partner level but would instead be taxed at company level. The bill will ensure that the limited partnership will not be taxed. Instead, each partner will be taxed individually.

The introduction of a new limited partnership vehicle also highlights some problems around the current taxation of general partnerships. To resolve these problems, the bill clarifies and modernises the tax treatment of partnerships generally. This will improve certainty and reduce compliance costs for investors.

The proposed new partnership rules will amend the Income Tax Act 2004 in the following ways:

- Income and expenses will flow through to partners on the basis of their partnership agreement. However, to prevent streaming, income, expenditure and other items from different sources will generally be allocated to the partners in the same proportion.
- Transactions between partners and partnerships (except salary payments) will be treated as being at arm’s length.
- Partners will be required to account for tax upon their exit from a partnership in certain circumstances, to address revenue concerns. There are, however, several exceptions to this requirement including when compliance costs outweigh the fiscal risks. A new exception is that partners will generally not need to account for tax upon exit if their profit is \$50,000 or under. They will also not need to comply with the requirement in relation to:
 - trading stock, if the trading partnership has a turnover of under \$3 million;
 - certain types of depreciable tangible property, if the historical cost of any depreciable tangible asset held by the partnership is less than \$200,000;
 - certain types of financial arrangements, if the financial arrangement has been entered into as a necessary and incidental purpose of the business (for example, a loan to provide working capital for the business); and
 - certain excepted financial arrangements.
- When an exiting partner accounts for tax, the partnership and the incoming partner must take on a cost base in the partnership’s assets and liabilities. The cost base must be equal to the amount that the exiting partner was deemed to dispose of them for, in accordance with the disposal provisions.

- If an exiting partner has performed a revenue account adjustment on livestock, the incoming partner will be allowed to deduct the amount of that adjustment on a straight-line basis over a five-year period. This will reduce any compliance costs as separate tax books for livestock will not need to be maintained.
- The new entry and exit rules will be elective for partnerships of five or fewer partners provided no partner has limited liability for the debts of the partnership business.

An amendment applying to limited partnerships will ensure that a limited partner's loss will be restricted in any year to the limited partner's level of economic loss.

Amendments to the Tax Administration Act 1994 will clarify and simplify the record-keeping and filing requirements for partnerships.

Policy changes

SCOPE AND APPLICATION OF THE NEW RULES

(Clauses 119 and 121)

Summary of proposed amendments

The bill introduces a new definition of “partnership” and clarifies which partnership arrangements are covered by the new rules.

The rules also clarify when the source taxation rules will apply to partnership income.

Application date

The changes will apply to income years beginning on or after 1 April 2008.

Key features

Section OB 1 of the Income Tax Act 1994 is being amended to ensure that the new rules will apply to:

- any partnership under the Partnership Act 1908;
- a limited partnership registered as a “limited partnership” under the Limited Partnership Bill;
- any New Zealand-resident partners of a foreign general partnership;
- 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 separate legal personality;
- joint ventures whose members choose to be treated as a partnership for the purposes of the Inland Revenue Acts; and
- co-owners of property (not being a company or a trust) where all the co-owners choose to be treated as a partnership for the purposes of the Inland Revenue Acts.

Definition of partnership

The definition of “partnership” in the Income Tax Act will be based on the definition contained in the Partnership Act 1908. That means a partnership will be a group of two or more persons who have, between themselves, the relationship described in section 4(1) of the Partnership Act 1908.

Income source rules

The changes will modify the income source rules in section OE 4 when:

- the partnership is a limited partnership registered under the Limited Partnership Act; or
- 50 percent or more of the partnership capital is owned by partners who are resident in New Zealand; or
- the centre of partnership management is in New Zealand.

In these situations, any New Zealand residence requirement in the income source rules will be considered to be satisfied.

Background

There is currently no general definition of “partnership” in the Income Tax Act. In clarifying the partnership rules, the bill introduces a new definition of “partnership” and explains which forms of co-ownership are covered by the partnership rules.

In its 1991 review, the Valabh Committee¹ noted that the tax treatment of partnerships that have non-resident partners or that receive foreign-sourced income is uncertain. The proposed rules deal with these situations by making it clear when the partners of a partnership are treated as New Zealand-resident for the purposes of the source taxation rules.

¹ *Key reforms to the scheme of tax legislation*, the Consultative Committee on the Taxation of Income from Capital (“Valabh Committee”), 1991.

FLOW-THROUGH OF INCOME, EXPENSES AND OTHER ITEMS

(Clause 116)

Summary of proposed amendments

The Income Tax Act will be amended to allow income, expenses, tax credits, rebates, gains and losses to flow through to individual partners.

Income, tax credits, rebates, gains, expenditure or loss will generally be allocated to the partners in proportion to each partner share in the partnership's income.

A partner will be able to deduct partnership expenditure incurred by the partnership before he or she became a member, subject to the other deductibility tests in the Income Tax Act.

Application date

The changes will apply to income years beginning on or after 1 April 2008.

Key features

New section HD 2 of the Income Tax Act will clarify that the income, tax credits, rebates, gains, expenditure or loss allocated to a partner in an income year will generally be allocated in proportion to each partner's share in the partnership's income under the partnership agreement. In the absence of a partnership agreement, these items will be apportioned to partners under the Partnership Act 1908 or whichever law determines their right to a share in the partnership's income.

The proportionate approach prevents streaming of these items to specific partners, by requiring them to be allocated to the partners in the same proportion as their respective shares in the partnership's income.

Under the proposed rules, it will be clear that expenditure apportioned to new partners who were not partners when the expenditure was originally incurred will generally be deductible, subject to the other tests of deductibility in the Income Tax Act.

Background

The Valabh Committee noted that the current legislation is generally silent on the apportionment of income, expenses and other items to partners, which can create uncertainty. The proposed rules follow the Valabh Committee's recommended proportionate approach. This provides certainty in the allocation of these items for income tax purposes and ensures that they cannot be streamed to take advantage of the different tax circumstances of the partners.

Under current law, new partners are generally not entitled to claim expenditure incurred through the original partnership because they will not generally meet the “incurred test”. The proposed new rules will allow deductions for expenditure incurred through the original partnership to be claimed by new partners, subject to the other tests of deductibility in the Income Tax Act.

TRANSACTIONS BETWEEN PARTNERS AND PARTNERSHIPS

(Clause 115)

Summary of proposed amendment

Transactions between partners within partnerships (except for the payment of wages and salaries) need to be at market value for tax purposes, a requirement designed to protect the tax base.

Application date

The changes will apply to income years beginning on or after 1 April 2008.

Key features

Proposed section GD 16 of the Income Tax Act provides that transactions between partners (except salary payments) will be treated as being at market value for tax purposes. This rule applies to partners acting as members of the partnership.

Salaries are excepted because it is common in professional partnerships that partners' salaries are not set at market value, with the bulk of their income coming from their share of the partnership's income. Therefore a blanket rule would be inappropriate for salary and wages. In case of abusive manipulation of salary and wages, the Commissioner can still use other provisions such as the general anti-avoidance provisions.

Transactions that do not occur at market value, such as goods provided at a discount, are likely to have an impact on limited partners' partnership basis, with excess value given to a partnership being treated as a capital contribution, and excess value received from a partnership being treated as a distribution.

Background

Transactions between partners are either explicitly or implicitly required to be at market value. For example, the existing rule on rent transactions effectively requires the transaction to be made at market value for tax purposes, and the requirement for arm's length transactions is implicit in the requirements of section DC 4 in relation to contracts of service. The proposed amendment applies to all transactions between partners and partnerships, other than the payment of wages and salaries.

ENTRY AND EXIT OF PARTNERS AND CHANGES TO PARTNERSHIP INTERESTS

(Clauses 106, 109 and 116)

Summary of proposed amendments

A partner will be required to account for tax on exiting the partnership only if the amount of the disposal proceeds derived from the partnership interest exceeds the total net tax book value of the partner's share of partnership property² by more than \$50,000.

However, if this \$50,000 threshold is exceeded, an exiting partner will not have to account for tax on:

- trading stock, if the total annual turnover of the partnership is \$3 million or less;
- depreciable tangible property, if the historical cost of any depreciable tangible asset held by the partners of a partnership is \$200,000 or less;
- financial arrangements, provided that:
 - the partnership is not itself in the business of deriving income from financial arrangements; and
 - the financial arrangement has been entered into as a necessary and incidental purpose of the business;
- certain excepted financial arrangements.

When exiting partners account for tax in respect of their share of partnership assets and liabilities, the partnership and the incoming partner must take on a cost base in the partnership's assets and liabilities. The cost base must be equal to the amount the exiting partner was deemed to have disposed of them for under the disposal provisions.

When an exiting partner has accounted for tax on livestock, the incoming partner can choose to deduct the amount of that adjustment on a straight-line basis over a five-year period. Similarly, if an exiting partner has a loss on disposal for livestock, the incoming partner must account for income on a straight-line basis over a five-year period.

Partners in a partnership of five or fewer people (when no partner has limited liability on any debts of the partnership business) may elect to be treated as owning an undivided interest in the property and income of the partnership instead of following the proposed partnership interest disposal rules.

² Less any liabilities under generally accepted accounting practice.

Application date

The changes will apply to income years beginning on or after 1 April 2008.

Key features

New subpart HD of the Income Tax Act will reflect the current practice when a change in the partnership ownership has tax consequences only for partners who dispose of all or part of their interests. Exiting partners will be required to recognise revenue account gains and losses when there is a change in the partnership ownership, subject to the minimum threshold rule and the partial relief categories discussed below.

If the remaining partners' underlying interests are unchanged they will not be affected. However, if their underlying interests in the partnership diminish and they receive consideration for the change in interest, there may be tax consequences.

An over-arching rule will create a deemed dissolution for tax purposes if there is a change of 50 percent or more in the ownership of the partnership within any 12-month period. This is discussed further under "dissolution of a partnership".

\$50,000 minimum threshold rule

The general rule of accounting for tax on disposal of an interest (or part of an interest) will be subject to a minimum threshold rule. Partners will have to account for tax on exit only if the disposal proceeds for their interest in the partnership exceeds the net tax book value of their share in all of the partnership's property (less any liabilities under generally accepted accounting practice) by more than \$50,000.

When interests in the same partnership have been sold within a 12-month period, all sales are taken into account for purposes of the threshold.

Partial relief

Partners who do not qualify for tax relief under the minimum threshold test may still be entitled to partial relief in certain circumstances.

Trading stock

Exiting partners will not have to perform a revenue account adjustment in relation to trading stock if the total annual turnover of the partnership is less than \$3 million.

Depreciable tangible property

Exiting partners will not have to account for depreciation recovery or loss on their share of any depreciable tangible asset if the historical cost of any depreciable tangible asset held by the partnership is less than \$200,000.

Financial arrangements

Exiting partners will not be required to perform a base price adjustment in relation to their interest in a financial arrangement held through a partnership if:

- the partnership is not itself in the business of deriving income from financial arrangements; and
- the financial arrangement has been entered into as a necessary and incidental purpose of the business.

For example, exiting partners would not generally be required to perform a base price adjustment in respect of their interest in a loan that provides capital for a partnership's business.

Excepted financial arrangements

Exiting partners will not have to account for tax on certain excepted financial arrangements of a debt nature (such as short-term agreements for the sale and purchase of property).

Relief not mandatory

Exiting partners can elect to account for tax on exit, even if they are subject to the minimum threshold rule.

Incoming partners

Incoming partners will generally acquire their partnership interest at market value. This means that, generally, they will take on a market value cost base in partnership assets and liabilities. A general exception is livestock, which is discussed below. Further, when an exiting partner is not required to account for tax on disposal (as a result of the application of the minimum threshold rule or the various relief categories) the incoming partner would inherit the exiting partner's tax book value.

Livestock

When the exiting partner accounts for tax on livestock, the new partner will be able to deduct the total revenue account adjustment of the outgoing partner on a straight-line basis over five years. Similarly, if the exiting partner has a loss on disposal, the new partner will account for income on a straight-line basis over five years. This exception will not apply in relation to livestock valued under the herd scheme.

Small partnerships

Partners in a partnership of five or fewer people (when no partner has limited liability for the debts of the partnership business) may elect to treat themselves as owning an undivided interest in the property and income of the partnership instead of following the proposed partnership interest disposal rules.

Background

The Valabh Committee noted that the tax law governing the entry and exit from partnerships is unclear. There remains significant uncertainty about the correct tax treatment to apply on entry to, and exit from, a partnership. In practice, the tax treatment adopted may depart from the technical legal position. It is likely that problems associated with this uncertainty will become more pronounced with the introduction of the limited partnership structure. Accordingly, the proposed new rules seek to provide certainty and minimise compliance costs while protecting the revenue base.

DISSOLUTION OF A PARTNERSHIP

(Clause 116)

Summary of proposed amendment

The new rules will clarify when a dissolution of a partnership occurs for tax purposes, and the tax consequences of a dissolution.

Application date

The changes will apply to income years beginning on or after 1 April 2008.

Key features

Proposed new section HD 3 will deem the partnership to have disposed of all its assets at market value for tax purposes on dissolution. When there is a 50 percent or more change in the partnership ownership within 12 months there will be a deemed disposal of all of the partnership property for tax purposes. This is to prevent large asset transfers that give rise to significant deferral of tax liabilities. A partnership will not automatically be treated as dissolving for tax purposes when there is a change in partners or a smaller change in partnership interests.

Background

The current legislation is generally silent on the tax consequences of a partnership dissolution. The proposed new rules provide certainty on the tax treatment that applies in these circumstances.

LIMITATION OF LIMITED PARTNERS' TAX LOSSES

(Clause 116)

Summary of proposed amendments

New tax loss limitation rules for limited partners are being proposed to ensure that the losses claimed reflect the level of a limited partner's economic loss.

A limited partner's excess tax losses will be available for carry-forward to future income years.

An anti-avoidance rule is to be introduced to prevent an artificially high basis around the year end being used to increase any loss flow-through.

Application date

The changes will apply to income years beginning on or after 1 April 2008.

Key features

Proposed new section HD 11 will ensure that a limited partner's tax loss will be restricted if the amount of the loss exceeds the tax book value of his or her investment (the partner's basis). This is to ensure that limited partners can offset, for tax purposes, only tax losses to which they have exposure. This provision applies only to limited partners because general partners have unlimited liability and therefore full exposure to the risk of loss.

Basis calculation

A limited partner's adjusted investment in a partnership will be referred to as the "partner's basis". In calculating a limited partner's basis, the limited partner will take into account the sum of the limited partner's:

- investment contributions;
- share of the partnership debt guaranteed (or indemnities provided) by the partner;
- share of the net limited partnership income previously recognised;
- share of the capital gains previously realised;
- any previous equity injections;

less his or her:

- share of the partnership debt guarantees (or indemnities) retired or extinguished by the partner;
- share of the net limited partnership loss previously deducted;
- share of capital losses previously realised; and
- any previous distributions.

Proposed section HD 12 will ensure that if a limited partner's basis is reduced to nil, tax losses apportioned to the limited partner will not be deductible in that income year and instead will be carried forward to the next income year. The loss will be deductible when additional basis becomes available – for example, the partner contributes more capital to the partnership (putting more capital at risk) or the partnership earns income.

Anti-avoidance rule

To prevent the artificial creation of a high basis just at the end of the year when loss flow-through is taken into account, a limited partner's basis will be reduced by the amount the basis is increased by if:

- the limited partner's basis is increased within 60 days before the end of the income year; and
- the limited partner's basis is subsequently reduced within 60 days after the end of the income year.

Background

The rationale for restricting a limited partner's tax losses in any given year is to ensure that the tax losses claimed reflect the level of that person's economic loss. Given that limited partners will have limited liability on their limited partnership interest, they will not have exposure to losses greater than the amount of their investment in any year. It is therefore an appropriate policy result to allow limited partners to offset, for tax purposes, only the tax losses to which they have exposure. This will also help to protect the tax base against the use of limited partnerships as tax shelters.

Miscellaneous technical amendments

GENERAL PARTNER LIABLE IF LIMITED PARTNER AN ABSENTEE

(Clause 117)

Summary of proposed amendment

The general partner of a limited partnership will be treated as an agent of an absentee limited partner.

Application date

The changes will apply to income years beginning on or after 1 April 2008.

Key features

Section HK 17 of the Income Tax Act will be amended to ensure that the general partner of a limited partnership will be treated as an agent of an absentee limited partner for income derived from a partnership business carried on in New Zealand.

It is envisaged that limited partnerships will be widely held and similar to a company, so it would be impractical to impose this liability on all the partners.

General partners in a limited partnership are usually responsible for management of the limited partnership and are also liable for the debts and obligations of the partnership. General partners will therefore be treated as agents of an absentee limited partner for income derived from a partnership business carried on in New Zealand.

Background

Section HK 17 of the Income Tax Act currently treats all the partners as agents of an absentee partner on income derived from a partnership business carried on in New Zealand. The inference is that any or all of the other partners would, as agent of the absentee, be responsible for the reporting, disclosure and tax liabilities of the absentee in relation to that business. The term “absentee” refers to a person who is “for the time being” outside New Zealand and is likely to include non-residents. With the advent of limited partnerships and the potential for there to be many limited partners located in different jurisdictions, this requirement would be impractical. Given the nature of general partners in a limited partnership, the proposed rules will restrict the imposition of the agency relationship for tax purposes to general partners only.

RECORD-KEEPING AND FILING REQUIREMENTS

(Clauses 123 and 124)

Summary of proposed amendments

The record-keeping and filing obligations of a partnership will be clarified.

Application date

The changes will apply to income years beginning on or after 1 April 2008.

Key features

Section 22 of the Tax Administration Act will clarify that it is “the partnership”, rather than each partner in the partnership, which must maintain the records, in accordance with usual practice.

Section 42 of the Tax Administration Act will be amended to ensure that a foreign general or limited partnership is required to file a New Zealand return of income only when the partnership is a registered limited partnership or carries on a business in New Zealand.

Background

In relation to the record-keeping requirements for partnerships, confusion may arise as tax legislation often refers to a “person’s” obligation. Under current income tax law, a partnership is a legal person, as is a partner. Therefore it can be inferred that all partners must maintain separate (yet identical) records. In practice, the partnership typically keeps one set of records relating to all the partners and all the firm’s activities. The proposals would bring the law into alignment with current practice.

Current legislation is not specific about whether all partnerships (such as foreign partnerships with one or more New Zealand partners) have to file a joint return in New Zealand. The proposals clarify that a return of income filing obligation will exist when the partnership is a registered limited partnership, or carries on a business in New Zealand.

TRANSITIONAL ISSUES

(Clause 118)

Summary of proposed amendments

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.

Special partnerships continuing after enactment of the new rules will not be required to comply with the loss limitation rules.

Two options will be available for the calculation of a limited partner's opening basis amount for existing partnership interests: one based on market value and the other on the basis that the rules had always applied to the limited partnership interest.

Application date

The changes will apply to income years beginning on or after 1 April 2008.

Key features

Under proposed new section HZ 3, special partnerships will continue to exist until their expiry. Partners of special partnerships will not be required to comply with the proposed loss limitation rules for compliance cost reasons.

Generally, the cessation of a special partnership and the creation of a limited partnership would crystallise a tax event. However, under the proposed new rules, a simple transition from a special partnership to a limited partnership will not generally result in the triggering of income tax provisions to the partners if the business and ownership of the partnership remains the same.

New Zealand-resident partners of special partnerships that make the transition into the new limited partnership rules can determine their initial basis by either:

- the market value of their interest in the limited partnership; or
- calculating their basis as if the rules were, in effect, the entire time the partner has held the partnership interest.

Background

When a special partnership becomes a limited partnership, the special partnership ceases to exist and a new limited partnership 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. This can, in turn, result in the triggering of various income tax adjustments, such as depreciation recoveries and base price adjustments under the financial arrangement rules. The transition may also have other tax implications, such as the triggering of gift duty liabilities and goods and services tax liabilities relating to the transfer of assets. The transitional proposals provide that a simple transition from a special partnership to a limited partnership will not generally have income tax consequences for the partners.