OFFICIALS' REPORT

ON PARTS 5 AND 6 OF THE

LIMITED PARTNERSHIPS BILL: TAX ASPECTS

November 2007

Prepared by the Policy Advice Division of Inland Revenue

OFFICIALS' REPORT ON THE LIMITED PARTNERSHIPS BILL: INTRODUCTION

This is the officials' report on Parts 5-6 of the Limited Partnerships Bill, dealing with the tax aspects of the bill. The report is divided into three parts – a covering report (Part A), a clause by clause analysis (Part B), and an annex providing further information that the Committee has requested (Part C).

Along with the introduction of limited partnership vehicles, the bill introduces new tax rules for limited partnerships and updates the tax rules for general partnerships.

If the proposed regulatory rules were to be introduced without any change to the income 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 the company level. The bill will ensure that the limited partnership will not be taxed. Instead, each partner will be subject to tax individually, in the same way that income from general partnerships is taxed. The bill also proposes that a limited partner's tax loss in any given year will be restricted to the amount that the partner has at risk in the limited partnership.

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.

The new rules also cover tax aspects of entering and leaving all partnerships, whether general or limited. They include requiring exiting partners to account for tax in certain circumstances and clarifying the extent to which selling partners must realise gains on underlying partnership assets. Partners will be required to account for tax on exiting a partnership essentially only if they have earned more than $50,000 profit from the disposal, and the carve-outs don't apply. This is designed to reduce compliance costs.

The covering report (Part B) addresses key policy issues raised by submitters and officials. These are:

- Deemed dissolution of the partnership for tax purposes where there is a 50% change in ownership
- Transactions between partners deemed to be at market value
- Anti-streaming rule
- Loss limitation rule for limited partners
- Amendments should be made to the Income Tax Act 2007, not the Income Tax Act 2004

The clause by clause analysis (Part B) includes these key policy issues, and also deals with other technical issues raised by submitters and officials.

The annex (Part C) provides further information that the committee has requested on loss attributing qualifying companies (LAQCs).

OFFICIALS' REPORT ON THE LIMITED PARTNERSHIPS BILL: TAX ASPECTS

PART A
COVERING REPORT

DEEMED DISSOLUTION OF PARTNERSHIP AT 50% CHANGE IN OWNERSHIP (CLAUSE 116, HD 3)

Existing legislation is generally silent on the tax consequences of dissolving a partnership. The proposed new rules are intended to provide certainty about the tax treatment that applies in these circumstances.

Proposed new section HD 3 of the Income Tax Act 2004 will therefore 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 was 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 smaller change in partnership interests.

Submitters were concerned that a deemed dissolution at an ownership change of 50% over 12 months is not appropriate, as the operation of the rule is not sufficiently clear.

Officials' comment

The rule deeming a partnership to dissolve when there was a 50% change in ownership over 12 months was designed to prevent partners effectively selling their underlying assets in the partnership by transferring their partnership interest to another partner for the value of the underlying asset. However, if the transaction results in a greater than $50,000 profit the transferring partner will be taxed on the profit. Officials therefore consider that the provision is not necessary and can be removed.

Officials consider that a deemed sale and reacquisition by all partners at market value should instead occur when the partnership dissolves through the agreement of partners, or through operation of law by which fewer than two parties remain or by an order of the court. This is necessary to ensure that there is not a permanent avoidance of tax on partnership assets.

TRANSACTIONS BETWEEN PARTNERS MUST BE AT MARKET VALUE (CLAUSE 116, GD 16)

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.

Submitters argued that this rule should be removed, as this is a departure from existing law and practice and it can be difficult to determine market value.

Officials' comment

This requirement was designed to protect the tax base. Officials were concerned that assets could be transferred in and out of a partnership, under- and over-value, for tax benefits. For example, a controlling partner could introduce valuable assets into a partnership to accelerate their own tax deductions.

However, officials agree with submitters that this rule should not affect situations where non-market transactions between partners occur legitimately. Applying the rule in these circumstances could result in high compliance costs. Officials therefore recommend replacing this rule with a specific anti-avoidance rule that essentially deems a transaction to have occurred at market value where the transaction is subject to an arrangement entered into to avoid tax. This should strike an appropriate balance between the integrity of the tax system and the compliance cost concerns of the submitters.

ANTI-STREAMING RULE (CLAUSE 116, HD 2(2))

In its review or the tax rules, the Valabh Committee[1] noted that the current legislation is generally silent on the apportionment of income, expenses tax credits, rebates, gains, or losses that flow through to partners.

The proposed rule in HD 2(2) follows the Valabh Committee's recommended proportionate approach by ensuring that these items are generally allocated to the partners in proportion to each partner's share in the partnership's income. Partners are therefore not able to "stream" different types of income to individual partners.

Submitters argued that this rule should be removed, as there may be commercial reasons why items are allocated to partners in different proportions.

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

Officials' comment

This rule ensures that different types of income cannot be streamed to take advantage of the different tax circumstances of the partners. In the absence of anti-streaming rules, certain types of income that is exempt from tax (such as capital gains) can be disproportionately allocated to partners on higher marginal tax rates, and taxable income can be allocated taxpayers on lower marginal tax rates or who are exempt from paying tax - such as a charity - in order to reduce the amount of tax that would normally be payable.

The following example illustrates the issue:

Two partners each own 50% of a business. Partner A is on a marginal tax rate of 39%, and Partner B is a taxpayer who is exempt from paying tax. The business earns $100 of taxable income and $100 of capital gains (non-taxable income).

1. *If the profit is distributed proportionately, Partner A will have $50 of taxable income and $50 of capital gains income. Partner A's tax liability will be:*

   Taxable income: $50 x 39% = $19.50
   Capital gains (non-taxable income): $50 x 0 = $0.

   Partner B's tax liability will be:
   Taxable income: $50 x 0% = $0
   Capital gains (non-taxable income): $50 x 0 = $0.

   Total tax payable is $19.50.

2. *If the partners were allowed to stream the profits to take advantage of their different circumstances, they could ensure that the exempt income is disproportionately allocated to the partner on the higher marginal rate. For example, if all the taxable income is streamed to Partner B (the exempt partner), and all the capital gains are streamed to Partner A (the partner on 39% marginal rate):*

   Partner A's tax liability will be:
   Taxable income: $0 x 39% = $0.
   Capital gains (non-taxable income): $100 x 0 = $0.

   Partner B's tax liability will be:
   Taxable income: $100 x 0% = $0.
   Capital gains (non-taxable income): $0 x 0 = $0.

   No tax is paid in this instance.

Tax could similarly be reduced by disproportionately allocating taxable income to a taxpayer on lower marginal tax rates, and allocating non-taxable income to partners on higher marginal tax rates.

LOSS LIMITATION (CLAUSE 116, HD 11)

Proposed section HD 11 of the Income Tax Act ensures that any loss that a limited partner claims does not exceed the amount that the limited partner has at risk in the partnership. Submitters argued that this rule should be removed to encourage investment in venture capital, and because they considered that it conflicted with the normal tax treatment for losses.

Officials' comment

Without these rules, limited partnerships would provide opportunities for taxpayers to receive tax deductions in excess of the expenditure that they personally have at risk in the partnership. This is because the losses of the partnership would flow through to partners, but the partners would only be liable for the capital that they have contributed to the partnership.

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.

AMENDMENTS SHOULD BE MADE TO INCOME TAX ACT 2007

The amendments to the Income Tax Act 2004 should be replaced with amendments to the newly enacted Income Tax Act 2007.

Officials' comment

The Income Tax Act 2007 received Royal Assent on 1 November 2007. The 2007 Act rewrites the income tax legislation into plain language, and repeals the Income Tax Act 2004.

The Income Tax Act 2007 commences on 1 April 2008. In the officials' report on Parts 1-4 of the Limited Partnerships Bill, MED are recommending that the Limited Partnerships Act 2007 also commences on 1 April 2008.

Officials therefore recommend that the current provisions relating to the Income Tax Act should be replaced with provisions relating to the Income Tax Act 2007.

PART B
CLAUSE BY CLAUSE ANALYSIS

Number	Issue	Submission	Submitter	Officials' response
		General comments		
1		The aggregate approach adopted in the proposed legislation for taxing partnerships is inappropriate and should be changed to an entity approach. Under this approach, the assessability and deductibility of income and expenditure would be first tested at the entity level, and then tested at the partner level to determine whether any exemptions or modifications apply.	NZICA (page 11), KPMG (pages 2-4)	Disagree. The proposals aim to codify the current tax treatment of partnerships, which is more closely aligned with the aggregate approach of treating each partner as the owner of a fraction of all the assets of the partnership for tax purposes. This partnership does not exist independently from the partners. The rules attempt to provide a reasonable balance between the integrity and accuracy of this flow-through mechanism provided by the aggregate approach, and the administrative and compliance convenience of the entity approach.
2	Drafting	The proposed legislation is too prescriptive.	Corporate Taxpayers Group (page 8)	Noted. The proposals aim to codify the current tax treatment of partnerships, and aim to remove uncertainty. A natural and unavoidable consequence of this is that in some circumstances, the legislation is too prescriptive.
3	Defined terms	All limited partnership terms that are not defined terms in the Income Tax Act 2004 should be referenced to the appropriate Limited Partnerships Bill definition.	NZICA (page 8)	This is a drafting issue that has been noted.

Number	Issue	Submission	Submitter	Officials' response
		Section CX 35 ITA		
4	Position of Lloyd's underwriters under UK Limited Liability Partnerships Act 2000	It is not clear how Lloyd's underwriters under the United Kingdom's Limited Liability Partnerships Act 2000 will be treated for New Zealand tax purposes. This should be clarified.	NZICA (page 6)	Noted. The Limited Partnerships Bill will treat foreign entities with limited liability status as companies for New Zealand tax purposes. If New Zealand resident individuals who currently invest through unincorporated bodies (such as Lloyd's underwriters) incorporate, they will be subject to the current tax rules for investments in overseas companies (that is, generally fair dividend rate). The exemption from tax in section CX 35 will not apply.
		Clause 115, GD 16		
5	Transactions between partners of the partnership	Does not support introduction of the blanket "market value rule" in proposed section GD 16 for transactions between partners of a partnership.	PwC (page 6), Deloitte (pages 7-8), Corporate Taxpayers Group (page 4), NZICA (page 16-17)	Agree in part. It should be made explicit that this is an anti-avoidance rule, and should not deem all transactions to occur at market value.
6	Transactions between partners of the partnership	If proposed section GD 16 enacted, leases between partnerships should be excluded from its scope.	PwC (page 6)	Disagree. See above.
7	Transactions between partners of the partnership	If proposed section GD 16 is enacted in its current form section GD 10 of the ITA should be amended to exclude leases of property between partners and the partnership.	PwC (page 7)	Disagree. Section GD 10 is an objective rule. Conversely, the new anti-avoidance rule proposed is a subjective rule designed to apply more broadly.

Number	Issue	Submission	Submitter	Officials' response
8	Transactions between partners of the partnership	It should be clarified whether proposed section GD 16 is meant to apply to transactions between partners acting as members of the partnership, or to transactions between the partnership and partners not acting as partners.	Minter Ellison Rudd Watts (page 1), New Zealand Law Society (page 9), NZVIF (page 22)	Agree in part. It should be made explicit that this is an anti-avoidance rule, and should not deem all transactions to occur at market value.
		Clause 116, HD 2		
9	Intention of partnership	Guidance should be provided on how the intention of the partnership or partners, as per section HD 2(1)(a) is to be determined.	Minter Ellison Rudd Watts (page 2), NZVIF (page 23), KPMG (page 4)	Noted. The submission raises an interesting point, however officials consider that it should not present a problem in practice, as the status, intention and purpose of the partnership can be derived from a range of factors including the partnership agreement and the nature of the partnership's business.
10	Anti-streaming rule	The last word in proposed section HD 2(2) should be changed from "income" to "profit" to make it consistent with the Partnership Act 1908 which refers to the partner's share in "capital and profits".	PwC (page 9), NZICA (page 14)	This is a drafting issue that has been noted.
11	Anti-streaming rule	The term "gain" should be clarified to confirm it includes capital gain amounts.	NZICA (page 14)	Disagree. A capital gain amount is, by its very nature, a gain.
12	Anti-streaming rule	The section should be clarified to address how it would apply if there was negative income.	NZICA (page 15)	Agree. Section HD 2(2) should be amended to confirm that it applies to partnership losses.
13	Anti-streaming rule	The partnership agreement should override the flow-through provision where capital gains are derived by the partnership and the partnership agreement allocates capital gains to partners that were in the partnership when the asset was acquired.	PwC (page 9)	Disagree. This would represent an exception to the anti-streaming rule in section HD2(2) and would difficult to administer.

Number	Issue	Submission	Submitter	Officials' response
14	Anti-streaming rule	Proposed section HD 2(2) should be removed from the Bill.	Minter Ellison Rudd Watts (page 3), NZICA (page 13), NZVIF (page 24), KPMG (page 5)	Disagree. The proposed anti-streaming rule is designed to provide a specific prohibition on the streaming of different types of income, credits and deductions to different categories of partner in order to gain tax benefits. Relying on the general anti-avoidance rule in the area would result in uncertainty.
15	Anti-streaming rule	The relationship between the anti-streaming rule in proposed section HD 2(2) and the "stepping-in" rule in proposed sections HD 5 to HD 10 should be clarified.	Minter Ellison Rudd Watts (page 4), NZVIF (page 27)	Agree. This can be addressed by ensuring that proposed section HD 2(2) does not apply to interests acquired from disposals which resulted in a gain or loss being recognised by the disposing partner.
16	Expenditure incurred before partner was a partner	Support the proposal in section HD 2(3) to allow new partners a deduction for partnership expenditure incurred prior to the partner being admitted to the partnership. The words "may be" should be replaced with the word "is".	PwC (page 10), NZICA (page 15)	Officials disagree with the submission that the words "may be" should be replaced with the word "is".
17	Expenditure incurred before partner was a partner	The provision should ensure that the deduction is allocated to either the exiting or the incoming partner. The deduction should not be available to both.	Officials' submission	Agree.
18	Expenditure incurred before partner was a partner	The provision should be clarified to ensure that it does not prevent an exiting partner being able to claim expenses up until the date of disposal to the entering partner.	NZICA (page 15)	Disagree. Officials consider that the provision already achieves this result.
19	Expenditure incurred before partner was a partner	The relationship of section HD 2(3) and the general deductibility rule should be clarified.	NZICA (page 15)	Noted. This provision only addresses a particular technical issue concerning incurrence. All the other rules for deductions must still be met. This rule would override sections HD 4 – HD 10.

Number	Issue	Submission	Submitter	Officials' response
		Clause 116, HD 3		
20	Dissolution of a partnership when greater than 50% disposal of partners' interests.	The proposed section HD 3 which deems the partnership to dissolve when interests of 50% or more are disposed of in a 12 month period should be removed.	PwC (page 11), Minter Ellison Rudd Watts (page 4), Deloitte (page 8), New Zealand Law Society (page 10), Corporate Taxpayers Group (page 5), NZVIF (page 25), NZICA (page 21), KMPG (page 6)	Agree. This rule was designed to prevent partners effectively selling their underlying assets in the partnership by transferring their partnership interest to another partner for the value of the underlying asset. However, provided the transaction results in a greater than $50,000 profit the transferring partner will be taxed on the profit. Therefore, the provision is not necessary and can be removed.
21	Dissolution of partnership	Officials consider that a deemed sale and reacquisition by all partners at market value should occur when the partnership dissolves through the agreement of partners or through operation of law by which fewer than 2 parties remain or by an order of the court.	Officials' submission	Agree. This is necessary to ensure that there is not a permanent avoidance of tax on partnership assets held on revenue account.
		Clause 116, HD 4 and HD 5		
22	Sections HD 4 and HD 5 – disallowance of disposing partner deductions and income attribution	It should be clarified that sections HD 4(2) and (3) and HD 5(3) and (6) are intended to apply to both income and deductions of the acquiring partner. The actual deductions incurred and income derived by the disposing partner up to the time of disposal ought to be available to that partner.	Bell Gully (page 1)	Noted. Officials consider that this result is already achieved by the provisions but will consider whether the drafting can be made any clearer.

Number	Issue	Submission	Submitter	Officials' response
		Clause 116, HD 4		
23	Disposal of partner's interest within the partnership	The title to this provision should be amended to read, "adjustment of rights to profits within partnership"	New Zealand Law Society (page 10)	Noted.
24	Disposal of partner's interest within the partnership	The phrase contained in proposed section HD 4(1) "disposes of some or all of their partner's interest" should be replaced with the phrase "disposes of some of their partner's interest".	PwC (page 13), NZICA (page 20), KPMG (page 8), Bell Gully (page 1)	Agree. This is a drafting error that should be rectified as suggested by the submission.
24	Disposal of partner's interest within the partnership	Proposed section HD 4 should be amended to remove the criterion that the section will apply if no consideration is paid or payable.	KPMG (page 7)	Disagree. Section HD 4 is intended only to apply to disposals of partners' interests where no consideration has been provided.
26	Disposal of partner's interest within the partnership	The proposed section HD 4 should be amended to provide consistency in references to the partner's partnership interest.	PwC (page 14)	Agree. This is a drafting error that should be rectified as suggested by the submission.
27	Disposal of partner's interest within the partnership	The application of section HD 4 in the situation where a new partner contributes new capital to the partnership, or withdraws that capital on exit, should be clarified.	Minter Ellison Rudd Watts (page 4), NZVIF (page 26)	Noted. Officials consider that the proposed legislation can be interpreted to achieve the correct policy result, but will reconsider the drafting to see if it can be made any clearer.
		Clause 116, HD 5 – HD 9		
28	Sections HD 5 - HD 9.	NZICA is pleased that realistic partial relief rules have been included as they will result in a saving in compliance costs.	NZICA (page 24)	Noted.

Number	Issue	Submission	Submitter	Officials' response
29	Sections HD 5 - HD 9.	The mechanism for electing whether sections HD 5-HD 9 apply should be stated. The preferred approach would be for the election to be made in the partnership return.	NZICA (page 22)	Agree.
30	Sections HD 5 – HD 9.	To make the exit rules work appropriately there should be a requirement that the exiting partner provide information about their tax status to the partnership.	NZICA (page 22)	Disagree. Sharing information when businesses are bought and sold is a current commercial issue.
31	Undertaking actual tax calculations to determine tax liabilities on entry or exit	When partners enter or exit a partnership they should have the option of applying the entry or exit rules proposed in sections HD 5 to HD 10.	Corporate Taxpayers Group (page 6)	Disagree. To provide the option of electing into sections HD 6 to HD 10 would provide opportunities for inappropriate "cherry picking" of tax treatment.
		Clause 116, HD 5		
32	Disposal of partner's interest for $50,000 or less profit	Supports the increase in threshold to $50,000.	NZICA (page 21), KPMG (page 8)	Noted.
33	Disposal of partner's interest for $50,000 or less profit	The formula in section HD 5 should be removed and replaced with a simple written rule that provides that a partner is required to account for tax on exit only if the proceeds exceed the total net tax book value of the partner's share of partnership property by more than $50,000.	PwC (page 15), NZICA (page 21)	Disagree. The provisions are structured so that section HD 5 is an exception to the general rule in section HD 2 that partners must account for tax when they exit a partnership.

Number	Issue	Submission	Submitter	Officials' response
34	Amendments to formula in section HD 5	The formula in section HD 5(1) should be amended to provide additional clarification – namely: • The reference to "interests" in subsection (2)(a) should be replaced with a reference to "current interests" to make it consistent with subsection (1). • The formula in section HD 5(1) is intended to operate on all the partner's disposals that have occurred in the last 12 months. Therefore the references to "current interests" and "previous interests" should be replaced with a reference to "all disposals in the last 12 months".	PwC (page 15), NZICA (page 21)	Agree with first submission. Agree with second submission.
35	Consequences of section HD 5 not applying.	The proposed section HD 5 should be amended to state the consequences of the section not applying.	PwC (page 16)	Disagree. The provisions are structured so that section HD 5 is an exception to the general rule that partners must account for tax when they exit a partnership.
36	Section HD 5 disposal of partner's interest	Section HD 5(2)(c) should be amended to refer to "cost" not "value". Also, it should be amended to refer to the cost of the partnership property/assets, not the cost of the interest	New Zealand Law Society (page 10)	Disagree with the first point. It is appropriate to use the adjusted tax book value of the asset disposed of as this provides an accurate calculation of the profit. The second point is noted.
37	Section HD 5 disposal of partner's interest	Section HD 5(2)(b) should be written as a specific anti-avoidance rule and applied at the discretion of the Commissioner of Inland Revenue.	NZICA (page 22)	Disagree. The provision is designed so that taxpayers can self-assess whether or not the rule applies.

Number	Issue	Submission	Submitter	Officials' response
38	Section HD 5 disposal of partner's interest	Section HD 5 should state that the section does not apply if any of sections HD 6-HD 9 apply.	NZICA (page 22)	Disagree. The provisions are structured as stand-alone rules and it is clear that sections HD 6-HD 9 can apply even if the $50,000 threshold in section HD 5 is exceeded.
39	Section HD 5 disposal of partner's interest	Section HD 5(4) should clarify that it only applies if the $50,000 threshold is not breached.	NZICA (page 22)	Disagree. Section HD 5(1) provides the necessary clarification as it states that section HD 5 only applies if the $50,000 threshold is breached.
40	Section HD 5 disposal of partner's interest	The definition of "net adjusted tax value of partnership property" in section HD 5(2)(c) should only measure tangible things.	NZICA (page 23)	Disagree.
41	Section HD 5 disposal of partner's interest	That the word "adjusted" be removed from the term "net adjusted tax value of partnership property" as it is superfluous.	NZICA (page 23)	Disagree.
42	Definition of "year"	The term "year" should be included in the list of defined terms in proposed section HD 5.	PwC (page 16)	Agree.
		Clause 116, HD 6		
43	Section HD 6 – disposal of trading stock	Supports the de minimis threshold of $3 million for the exiting partner to account for income/loss on their share of partnership trading stock. Also supports the option for partnerships of five or less partners to choose whether or not to account for changes in partnership interest in trading stock.	KPMG (page 9)	Noted.
44	Section HD 6 – disposal of trading stock	Clarify that the provision applies when the turnover of the partnership is less than $3 million.	NZICA (page 24)	This is a drafting point that has been noted.
45	Section HD 6 – disposal of trading stock	Exiting partners of farming partnerships should have the option of using the relief under HD 6.	NZICA (page 24)	Disagree. Livestock is not necessarily turned over quickly. Therefore the application of this provision could result in significant tax deferral.

Number	Issue	Submission	Submitter	Officials' response
46	Section HD 6 – disposal of trading stock	Section HD 6(5) is not effective in providing a deduction to the entering partner – as purported by section HD 6(3). The deduction would arise under the general deductibility or trading stock rules.	NZICA (page 25)	Disagree. Officials consider that the rules operate appropriately as currently drafted.
		Clause 116, HD 7		
47	Section HD 7 – disposal of depreciable property	Supports the de minimis threshold of an original cost price of $200,000 for the exiting partner to account for income/loss on their share of depreciable property (excluding depreciable intangible property). KPMG also supports the option to not apply the provision to small partnerships.	KPMG (page 9)	Noted.
48	Section HD 7 – disposal of depreciable property	Section HD 7(5) is not effective in providing a deduction to the entering partner – as purported by section HD 7(3). Does the deduction more appropriately arise under the depreciation rules?	NZICA (page 25)	Disagree. Officials consider that the provisions operate appropriately as currently drafted.
49	Section HD 7 – disposal of depreciable property	The relief provided by section HD 7 should apply if the depreciated value (rather than historical cost) of the item in question is $200,000 or less.	NZICA (page 25)	Disagree. Using the depreciated value rather than historical cost could allow partners to avoid recognising their depreciation recapture.
50	Section HD 7 – disposal of depreciable property	That depreciable intangible property should be included as depreciable property for relief under section HD 7.	NZICA (page 25)	Disagree. Including intangible property as depreciable property for relief under section HD 7 could result in significant revenue risk.

Number	Issue	Submission	Submitter	Officials' response
		Clause 116, HD 8		
51	Section HD 8 – disposal of financial arrangements	That exiting partners should not have to perform a base price adjustment (BPA) for all financial arrangements held by the partnership.	NZICA (page 26)	Disagree. If this submission were accepted it could result in significant deferral of tax for partnerships that are in the business of trading financial arrangements. It should be noted that a BPA will not be required for most financial arrangements.
52	Section HD 8 – disposal of financial arrangements	Section HD 8(1)(b) should be amended so it refers to the partners not deriving income *from the partnership* from a business of holding financial arrangements.	New Zealand Law Society (page 10), NZVIF (page 28)	Agree. This amendment will clarify that the proposed section HD 8 applies provided that the partnership is not in the business of holding financial arrangements.
53	Section HD 8 – disposal of financial arrangements	It is not clear whether the proposed section HD 8(3) overrides the requirement in the financial arrangements rules for the exiting partner to calculate the base price adjustment (BPA) and the allowance of a deduction if the result of the BPA is a negative amount.	KPMG (page 9)	Agree. The provisions should be clarified to ensure that an exiting partner does not perform a base price adjustment in relation to financial arrangements covered by this section.
54	Section HD 9 – short-term agreements	NZICA agrees with the proposed provision.	NZICA (page 26), KPMG (page 10)	Noted.
		Clauses 116, 106 and 109 (HD 10, CB 23B and DO 5C)		
55	Section HD 10 – disposal of specified livestock	An entering partner should be allowed to opt out of the five year spreading method	PwC (page 22)	Agree. This is achieved under section HD 10(3).

Number	Issue	Submission	Submitter	Officials' response
56	Section HD 10 – disposal of specified livestock	Extend section CB 23B to non-specified livestock.	NZICA (page 27)	Agree.
57	Section HD 10 – disposal of specified livestock	Section HD 10 should not apply to livestock valued under the National Herd Scheme.	Officials' submission	Agree. See below.
58	Section HD 10 – disposal of specified livestock	Sections CB 23B and DO 5C should be amended to generate appropriate outcomes where a partner enters the partnership part-way through an income year	PwC (page 21)	Disagree. Officials consider that the correct policy result is achieved where a partner enters the partnership part-way through an income year if proposed section HD 10 is amended to ensure it does not apply to livestock valued under the National Herd Scheme.
59	Section HD 10 – disposal of specified livestock	Subsections (2) and (3) of proposed sections CB 23B and DO 5C should be included within the timing provisions in Part E of the Income Tax Act 2004.	PwC (page 22)	This is a drafting issue that has been noted.
60	Section HD 10 – disposal of specified livestock	Sections CB 23B and DO 5C should be amended to include a mechanism for the exiting partner to disclose his or her net revenue gain or loss to the entering partner.	NZICA (page 27)	Disagree. Sharing of information when businesses are bought and sold is a current commercial issue.
61	Section HD 10 – disposal of specified livestock	Section HD 10 should be incorporated in sections CB 23B and DO 5C to aid comprehension.	NZICA (page 27)	This is a drafting issue that has been noted.
62	Section HD 10 – disposal of specified livestock	It is not clear that sections CB 23B and DO 5C achieve their policy objectives.	NZICA (page 27)	Disagree. The provisions achieve the intended result of spreading income and deductions of incoming partners over 5 years.

Number	Issue	Submission	Submitter	Officials' response
63	Section HD 10 – disposal of specified livestock	Section CB 23B should be renumbered as section CB 29 to avoid confusion and to make it consistent with the new rewrite style.	NZICA (page 28)	This is a drafting issue that has been noted.
		Clause 116, HD 11		
64	Limitation of limited partners' losses	The HD 11 rule that limits a limited partner's deductions for a year to the amount of their "basis" is unnecessary and should be removed.	Deloitte (page 4), Corporate Taxpayers Group (page 6), Kensington Swan (page 4), NZICA (pages 30-31), KPMG (page 10)	Disagree. Without these rules, limited partnerships would provide opportunities for taxpayers to receive tax deductions in excess of the expenditure that they personally have at risk in the partnership. This is because the losses of the partnership would flow through to partners, but the partners would only be liable for the capital that they have contributed to the partnership. While the deferred deduction rule that is already part of the tax law could provide some protection to the revenue base its application is more limited.
65	Limitation of limited partners' losses	A limited partner's basis should also include current year income, as well as past year income.	Officials	Agree.
66	Limitation of limited partners' tax losses – derivation of exempt or excluded income	Proposed section HD 11 should be amended to ensure a partner is not denied a deduction for a partnership loss in situations where the partner has economic exposure to that loss (as the loss has been funded by exempt or excluded income).	PwC (page 17), Deloitte (page 5), Grant Thornton, SKYCITY (page 1), NZICA (page 31)	Officials note that excluded income and exempt income are "income" under the core provisions of the Income Tax Act, therefore no amendment is required. Officials have discussed this with one of the submitters, who agrees. Officials also consider that a partner should not receive basis for dividends received from an attributing interest in a foreign investment fund as gains from these interests will have already been included as taxable income.

Number	Issue	Submission	Submitter	Officials' response
67	Limitation of limited partners' tax losses – guarantees provided by associated persons	The definition of "guaranteed amounts" in section HD 11(7) should be extended to include guarantees provided by persons associated with the partner on the limited partner's behalf.	PwC (page 18), Deloitte (page 6), NZICA (page 7), NZICA (page 34)	Agree in part. It should be clarified that the definition of "guaranteed amounts" should be the lesser of the share of partnership debt of the partner (or any person associated with the partner), and the market value of any assets held by the partner (or a person associated with the partner) that are available to satisfy the debt.
68	Limitation of limited partners' losses	Loss limitation rules should only apply to limited partners.	Deloitte (page 6), Corporate Taxpayers Group (page 7)	Agree. If the section OB 1 definition of "partner" is amended to include general partners, the HD 11 loss limitation rules will extend to include general partners. It should be clarified that HD 11 only applies to limited partners.
69	Limitation of limited partners' tax losses – definition of "distribution"	The definition of "distribution" in proposed section HD 11(4) should exclude the market value of withdrawals to the partner from the partnership.	PwC (page 18)	Disagree. The removal of proposed section GD 16 will ensure that transactions between partners and the partnership will not be deemed to be at market value.
70	Limitation of limited partners' losses	The application of section CD 33(11) when calculating capital gains amounts should be clarified in relation to limited partners.	Kensington Swan (page 4)	Disagree. Officials consider that the provisions as currently drafted work appropriately.
71	Limitation of limited partners' losses	The reference to HD 12 in section HD 11(1) should be omitted as section HD 11 can never apply to a deduction allowed under section HD 12.	NZICA (page 32)	Disagree. Section HD 11 will apply to deductions denied by section HD 11 and then allowed by section HD 12 (see section HD 12(3)).
72	Limitation of limited partners' losses	If a limited partner becomes a general partner the person should be able to deduct any additional amounts that the person incurs.	NZICA (page 33)	Agree. However, a general partner that switches back to being a limited partner within 60 days of the end of the income year should be treated as a limited partner for the purposes of section HD 11 to prevent circumvention of the rules.

Number	Issue	Submission	Submitter	Officials' response
73	Limitation of limited partners' losses	Section HD 11(4)(a) should include an option to include unrealised increases in the market value of the partner's interest in the partnership as "investments".	NZICA (page 33)	Disagree. This rule would be difficult to administer as the value of unrealised amounts is inherently subjective.
74	Limitation of limited partners' losses	Section HD 11(4)(b)(i) the words "the market value of withdrawals to the partner" should be changed to something along the lines of "the market value of any withdrawals from the partnership by a partner". This would aid understanding.	NZICA (page 33)	Disagree. Officials consider that the current wording is sufficiently clear.
75	Limitation of limited partners' losses	The guarantee that basis is received for should be the greater (not the lesser) of the partner's partnership debts or the market value of the property against which the guarantee may be enforced	NZICA (page 33)	Disagree. The submitter's proposal, if implemented, could result in partners receiving basis for amounts that they are not at risk for.
76	Limitation of limited partners' losses	The definition of distribution in section HD 11(4)(b)(i) is confusing and should be redrafted as "the value at the time of distribution of any amounts distributed to the partner from the limited partnership."	NZICA (pages 33-34)	This is a drafting issue that has been noted.

Number	Issue	Submission	Submitter	Officials' response
77	Technical amendments to proposed section HD 11	• That subsection (4)(b)(i) should refer to *distributions* rather than *withdrawals;* • That subsection (4)(b)(iii) should exclude payments of interest; • That subsection (4)(c)(i) should include current year income; • That subsection (4)(c)(ii) should say "if the partner *were* treated as a company"; • That subsection (4)(d)(iii) is not clear and should be re-examined; • That the term "partner's associate" in subsection (7) does not appear to be used anywhere.	New Zealand Law Society (page 11), NZVIF (page 28)	This is a drafting issue that has been noted. Agree. Officials consider that subsection (4)(a)(iii) should be amended along similar lines. Agree. This is a drafting issue that has been noted. This is a drafting issue that has been noted. Agree. See response to submission on guarantees provided by associates
78	Technical amendments to proposed section HD 11	Section HD 11(4)(b)(iii) should be removed. Amounts received from financial arrangements are income and already included in HD 11(3)	NZICA (page 32)	Agree. See above.
79	Technical amendments to proposed section HD 11	The definition of the term "withdrawal" in section HD 11(7) should be modified to ensure it does not apply to amounts that are already included as income.	NZICA (page 32)	Disagree.
		Clause 116, HD 12		
80	Section HD 12 – loss limitation carry forward rules	That the proposed entitlement to a deduction in section HD 12 be modified to a right to carry forward.	NZICA (page 34)	Disagree. Officials consider that the provision as currently drafted is sufficiently clear.

Number	Issue	Submission	Submitter	Officials' response
		Transitions to limited partnerships – clause 118, subpart HZ		
81	Special partnerships and overseas limited partnerships becoming limited partnerships	Existing special partnerships or overseas limited partnerships should be allowed to use the accounting book value of their interest in the partnership when transitioning into the new limited partnership rules.	PwC (page 19), SKYCITY (page 2)	Agree.
		Clause 119, OB 1		
82	Income tax treatment of general partners	General partners of limited partnerships should be included in the definition of "partner".	PwC (page 5), Deloitte (page 4), New Zealand Law Society, Corporate Taxpayers Group (page 4), SKYCITY (page 2)	Agree. General partners of certain "overseas limited partnerships" can make equity contributions to the partnership. Therefore, it is necessary for New Zealand's flow through limited partnership rules to apply to general partners of these partnerships.
83	Definition of "partner's interests"	The proposed definition of partner's interests is circular, and should be clarified.	KPMG (page 5)	Disagree. Officials consider that the provision as currently drafted operates appropriately.
84	Definition of "partnership share"	Further guidance needs to be provided for how a "partnership share" is to be determined, particularly where partners enter and exit the partnership during the year.	PwC (page 8), Minter Ellison Rudd Watts (page 2), NZICA (page 14)	Agree. The proposed definition of "partnership share" has been drafted to accommodate situations where a partner has a different share in one type of property (e.g. income) than another (e.g. partnership assets). Officials will consider whether the provision can be made any clearer, and further clarification can be provided in Inland Revenue's *Tax Information Bulletin*.

Number	Issue	Submission	Submitter	Officials' response
85	Joint ventures and co-ownership – application of Inland Revenue Acts	The phrase "for the purposes of this Act" in paragraph (c) of the definition of "partnership" should be amended to "for the purposes of the Inland Revenue Acts".	PwC (page 20)	Agree. This would provide consistency with paragraph (b) of the definition of "partnership".
86	Treatment of foreign limited partnerships that do not have a general partner	The definition of "foreign corporate limited partnership" should be amended to clarify whether it includes foreign limited liability partnerships that have separate legal status but do not have a general partner.	Deloitte (page 6), Corporate Taxpayers Group (page 7)	Agree. The definition of foreign corporate limited partnership in clause 119 should be amended so that it applies whether or not the limited partnership has a general partner.
		Clause 121, OE 4		
87	When is income sourced in New Zealand?	The proposed source rule in OE 4(1A) should be amended so that income is apportioned appropriately between resident and non-resident partners.	Deloitte (page 8), NZICA (page 9)	Disagree. Officials consider that such an amendment would add unnecessary complexity.
		Administrative matters		
88	Income and expenditure of co-trustees	Proposed amendments to section HD 1 of the ITA and section 42 will mean co-trustees will no longer be able to file a joint return. Amendments should be made to section HH 4 and proposed section 42 to ensure co-trustees can still make joint returns.	PwC (page 23), NZICA (pages 11, 36)	Disagree. The definition of trustee already includes co-trustees.
89	Overseas limited partnerships with no New Zealand presence	It should be made explicit that only the New Zealand resident partners of overseas limited partnerships need to file tax returns, and a provision should be inserted in the Bill to make it clear that when a partnership has no New Zealand presence there is no filing requirement by the partnership	Corporate Taxpayers Group (page 7)	Disagree. Officials consider that the draft legislation already achieves this.

Number	Issue	Submission	Submitter	Officials' response
90	Partnership filing requirements	The current IR 7 and IR 7P forms should be reviewed to ensure that the information contained in those forms is consistent with the information required to be disclosed under section 42 of the TAA.	PwC (page 24), NZICA (page 11)	Noted.
91	Section HK 17 – general partners and absentees	In the case of a general partner of a limited partnership, the general partner should determine the absentee's liability as if the general partner is fulfilling the absentee limited partner's tax obligations.	NZICA (page 35)	Disagree. Officials consider that the legislation is already clear on this point.
		Other matters		
92	Limited partnerships and listing agreements	Limited partnerships that are party to a listing agreement should be companies for tax purposes.	Officials' submission	Agree. MED are recommending that limited partnerships be allowed to list, as this does not pose regulatory concerns. However, from a tax perspective, listed limited partnerships cannot be administered as flow-through entities. This is because the tax rules for entering a partnership require knowledge of the exiting partner's tax liability. This information is virtually impossible to obtain where partnership interests are bought and sold through a secondary market. This recommended treatment is consistent with the current provisions in the bill for overseas limited partnerships, which are companies for tax purposes if they are listed.
93	Re-write of the Income Tax Act 2004	Any changes in relation to the tax rules for partnerships will also need to be reflected in the Income Tax Bill 2006.	PwC (page 25)	Noted.

Number	Issue	Submission	Submitter	Officials' response
94	Application of the GST Act 1985 to limited partnerships	The legislation should provide clarity as to whether a limited partnership will be treated as a company or unincorporated body for GST purposes	PwC (page 26)	Disagree. It is sufficiently clear that a limited partnership will be treated as a company for GST purposes.
95	Partners and partnerships that have different balance dates	Partners should include in their income year all partnership income from partnerships that have the same income year.	Deloitte (page 9), Corporate Taxpayers Group (page 8)	Noted. This is a current issue and there is insufficient time to consider whether the recommended solution is appropriate in all cases.
96	Tax deductibility of interest for partnerships	An amendment is required to ensure that interest incurred by a partnership is tax deductible even if it is on a loan taken out to make distributions of current year profits	Deloitte (page 9)	Noted. This is a current issue and there is insufficient time to consider whether the recommended solution is appropriate.
97	Associated persons	The associated persons rules should not apply to limited partnerships, particularly where these limited partnerships have five or fewer persons	NZICA (page 8)	Noted. The associated persons rules are currently the subject of a review, with any future tax changes likely to be proposed in future tax bill.
98	Associated persons	That the application of the associated persons rules to the new partnership provisions require further consideration	NZICA (page 9)	See above.
99	Non-resident partners and fixed establishments	Clarify whether non-resident limited partner has fixed establishment in NZ due to membership of the partnership	NZICA (page 10)	Disagree. The policy intention of the limited partnership rules is to provide flow-through treatment and limited liability to limited partners. The review is not intended to change the rules on whether non-resident limited partners are taxable on income attributable to a permanent establishment in New Zealand. Whether or not a non-resident has a permanent establishment in New Zealand will depend on the facts of individual cases.

Number	Issue	Submission	Submitter	Officials' response
100	Treatment of New Zealand limited partnerships in foreign jurisdictions	Clause 10 of the bill should be clarified to make it clear that separate legal personality does not affect the tax treatment of limited partnerships in overseas jurisdictions.	NZVIF (page 9)	Disagree. The taxation of limited partnerships in other countries depends on the laws of those other countries, which New Zealand's domestic law cannot influence. In certain situations two countries can treat for tax purposes limited partnerships differently depending on, among other things, their interpretation of a double tax agreement. Countries can potentially resolve their differences in interpretation through bilateral discussions using the mutual agreement procedure in double tax agreements.
101	Treatment of New Zealand limited partnerships in foreign jurisdictions	The treatment of New Zealand limited partnerships in foreign jurisdictions should be addressed in future.	NZVCA (page 4), NZVIF	See above.
102	Special tax provisions for Maori businesses	The bill requires special tax provisions for domestic capital investment into Maori businesses.	Te Ratonga Ture	Disagree. This is outside the scope of the bill.

PART C
ANNEX

Loss attributing qualifying companies and limited partnerships

Loss attributing qualifying companies (LAQCs) have some qualities that are similar to the proposed limited partnership vehicle.

Both entities can flow through income, gains and losses to their owners (respectively, shareholders and limited partners), while providing them with limited liability.

Unlike proposed limited partnerships, LAQCs must be small, closely held companies. They cannot have more than five shareholders. There is no restriction on the number of limited partners in a limited partnership.

LAQCs are often used in forestry investments. Forestry investments incur expenses over a number of years, but may only earn income at the end of the investment's life. A disadvantage of investing in forestry through a normal company is that deductions cannot be used by the shareholders until the end of the investment, when income is earned. Investing through an LAQC means that the losses flow through to investors, so that they can use the investment's losses against their other income in the year that they are incurred.

The discussion document on tax treatment of partnerships that was issued in 2006 asked for submissions on whether it is necessary to retain LAQCs, given the introduction of new limited partnership rules.

Submitters argued that LAQCs would still be needed, as limited partnerships are not fully substitutable for LAQCs. Different regulatory requirements apply to LAQCs and limited partnerships – for example, LAQCs need only one investor, whereas limited partnerships require a general partner and a limited partner. There are also some differences in tax treatment – for example, investors can exit an LAQC without triggering tax consequences, whereas there will generally be tax consequences for limited partners upon exit if their profit is over $50,000. Further, there would be transactional costs for existing LAQCs if they were required to become limited partnerships.

No final decisions were made, but the issue of whether LAQCs are still needed will be the subject of a future review.

It should be noted that the contents of the Limited Partnerships Bill will not affect the LAQC rules.