Inland Revenue
Te Tari Taake

EXPOSURE DRAFT - FOR COMMENT AND DISCUSSION ONLY | HUKIHUKI HURANGA - MŌ TE TĀKUPU ME TE MATAPAKI ANAKE

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Please quote reference | Whakahuatia te tohutoro: **PUB00367**

Send feedback to | Tukuna mai ngā whakahokinga kōrero ki public.consultation@ird.govt.nz

Notes | Pitopito kōrero: We had signalled that we would issue three separate items: this general guidance item (PUB00367), one on limited partnerships (PUB00471) and one on withholding tax obligations for payments made to a partnership (PUB00472). However, we have decided to delay the withholding tax item and to consolidate the limited partnership item into this item. We will work with Inland Revenue's Policy and Regulatory Stewardship group on issues identified in relation to withholding tax on payments made to a partnership.

INTERPRETATION STATEMENT | PUTANGA WHAKAMĀORI

Income tax – Partnerships (including limited partnerships)– general guidance

Issued | Tukuna: Issue date

IS XX/XX

This interpretation statement provides general guidance on the income tax treatment of partnerships. Most of this statement is relevant to both general and limited partnerships. The rules are largely the same for both types of partnership.

All legislative references are to the Income Tax Act 2007 (**ITA**) unless otherwise stated.

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Introduction | Whakataki

1. This statement provides general guidance on the income tax treatment of partnerships. It does not address the GST treatment of partnerships. Partnerships are treated differently under the Goods and Services Tax Act 1985.

2. Most of this statement is relevant to limited partnerships as well as general partnerships. This statement explains where the rules differ for limited partnerships and, in particular, contains a discussion of the deduction limitation rule, which applies to only limited partnerships. The deduction limitation rule is intended to ensure limited partners can offset tax losses only to the extent the tax losses reflect the partners' economic losses. The deduction limitation rule is discussed from [284].

3. This statement also references existing guidance issued on specific partnership issues.

Tax and non-tax definitions of "partnership" differ

4. The following briefly discusses the different types of partnerships recognised by the law and the coverage of definitions used in the tax and non-tax contexts.

Definition of partnership under general partnership law

5. The general (non-tax) law of partnerships recognises two types of partnership:

   - partnerships (referred to as general partnerships in this statement); and
   - limited partnerships.

General partnerships

6. Under general law, a partnership (general partnership) is defined as the relationship that exists between persons carrying on a business in common with a view to profit. A general partnership does not have a separate legal personality. The law relating to general partnerships is in the Partnership Law Act 2019 (PLA).

Limited partnerships

7. Under general law, the Limited Partnerships Act 2008 (LPA) provides a regulatory regime for limited partnerships. To be a limited partnership under the LPA, a limited partnership must be registered under the LPA and meet certain requirements.

8. Under the LPA, a limited partnership is recognised as a separate legal person. A limited partnership that is registered under the LPA is not subject to the PLA.[1]

9. A limited partnership must have at least one general partner and at least one limited partner.

10. A limited partner cannot take part in the management of the limited partnership. This is the responsibility of the general partner.

11. Under the LPA, limited partners enjoy limited liability. Limited partners are not liable for the debts and liabilities of the limited partnership, provided they do not take part in the management of the limited partnership.[2]

12. Similar limited liability partnership structures exist overseas.[3] Overseas limited partnerships can also be registered under the LPA. However, partnerships registered as limited partnerships and partnerships registered as overseas limited partnerships are provided for separately under the LPA.

Definition of partnership for income tax purposes

13. "Partnership" is specifically defined for income tax purposes.[4] The income tax definition is wide and includes general and limited partnerships.

14. At its core, the income tax definition adopts the basic test that is also used under the general law of partnerships: a partnership is the relationship that exists between persons carrying on a business in common with a view to profit.[5]

15. In addition, for income tax purposes, a partnership includes the following:

    - A limited partnership registered under the LPA, provided that it is not listed on a recognised exchange.[6]

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[1] Section 9 of the PLA.

[2] Section 31 of the LPA.

[3] One purpose of the LPA is to give the business community in New Zealand the option of a flexible and internationally recognised business structure similar to limited partnerships in use in overseas jurisdictions (s 3 of the LPA).

[4] Partnership is defined in s YA 1.

[5] This doesn't mean that partnership has exactly the same meaning as it does under the PLA. Paragraph (a) of the definition of partnership in s YA 1 states that partnership means a group of two or more persons who have, between themselves, the relationship described in s 8(1) of the PLA. The definition in the PLA goes on to exclude certain entities and relationships that are included in the definition of partnership under the ITA.

[6] Paragraph (d) of the definition of partnership in s YA 1 includes a limited partnership. Limited partnership is also defined in s YA 1. Under that definition, a limited partnership is a limited partnership registered under the LPA, but listed limited partnerships are excluded.

- A partnership that is formed or incorporated outside New Zealand, provided it is not treated as a separate legal entity under the laws (other than taxation laws) of the foreign jurisdiction where it is established,[7] with:
  - one or more general partners who are liable for all the debts and liabilities of the partnership; and
  - one or more limited partners who have only limited liability for the debts and liabilities of the partnership;
- Joint venturers, if they choose to be treated as a partnership for income tax purposes;[8] and
- Co-owners of property (other than persons who are co-owners only because they are shareholders of the same company, or settlors, trustees, or beneficiaries of the same trust), if they choose to be treated as a partnership for income tax purposes.

16. This statement does not consider overseas limited partnerships or listed limited partnerships.[9] This statement focuses on unlisted limited partnerships registered under the LPA.

17. The wide income tax definition of partnership means that a provision in the ITA that applies to a partnership or its partners, may also apply to the above entities or relationships.

18. "Partner" has a corresponding meaning.[10] It includes a person who is a member of a general partnership, limited and general partners of limited partnerships, and a joint venturer or co-owner, if they make the relevant choice to be treated as a partnership.

[7] The definition of limited partnership in s YA 1 excludes a "foreign corporate limited partnership", which is defined as an "overseas limited partnership" that is treated as a separate legal entity under the laws (other than taxation laws) of the foreign jurisdiction where it is established. An overseas limited partnership included for tax purposes within the definition of limited partnership is not quite equivalent to a limited partnership registered under the LPA as the latter has a separate legal personality.

[8] The choice appears to arise by virtue of the definition of partnership itself. No other provision appears to set out formal election procedures. In the Commissioner's view, joint venturers or co-owners will make such a choice if they file a joint return of income as a partnership.

[9] For income tax purposes, a listed limited partnership is treated as a company. The definition of "company" in s YA 1 includes a "listed limited partnership".

[10] Partner is defined in s YA 1

Transparency

19. A key feature of the income tax treatment of partnerships (general and limited) is that they are treated as being transparent for some purposes.

20. This applies to a limited partnership, despite a limited partnership being a separate entity. Transparency means that tax questions (for example, whether an amount is income, or whether a deduction is allowed for expenditure) are determined at the partner level.

21. The transparent tax treatment is provided by s HG 2:

> **HG 2 Partnerships are transparent**
>
> *Look-through in accordance with share*
>
> (1) For the purposes of a partner's liabilities and obligations under this Act in their capacity of partner of a partnership, unless the context requires otherwise,—
>
> (a) the partner is treated as carrying on an activity carried on by the partnership, and having a status, intention, and purpose of the partnership, and the partnership is treated as not carrying on the activity or having the status, intention, or purpose:
>
> (b) the partner is treated as holding property that a partnership holds, in proportion to the partner's partnership share, and the partnership is treated as not holding the property:
>
> (c) the partner is treated as being party to an arrangement to which the partnership is a party, in proportion to the partner's partnership share, and the partnership is treated as not being a party to the arrangement:
>
> (d) the partner is treated as doing a thing and being entitled to a thing that the partnership does or is entitled to, in proportion to the partner's partnership share, and the partnership is treated as not doing the thing or being entitled to the thing.

22. Section HG 2 results in income derived by the partnership, from its business or from partnership property, being derived directly by the partners, and not by the partnership. Similarly, s HG 2 results in expenditure incurred by the partnership being incurred directly by the partners, and not the partnership, which means deductions are attributed to the partners. A partnership does not have any choice about whether income and expenditure and other things are attributed to partners for tax purposes; attribution happens automatically.

23. The transparent tax treatment of partnerships can be contrasted with the taxation of companies, where income is derived and subject to tax once, when derived by the company and again when distributed to the shareholders (with relief from double taxation provided through imputation credits). With partnerships, partners are treated as deriving and incurring amounts directly.

24. The transparent tax treatment of partnerships means the core provision concepts in subpart BC such as "net income", "net loss", and "taxable income" are relevant to the partners, not the partnership. The transparent tax treatment of partnerships means net income or a net loss[11] can arise only for the partners, not the partnership. This means for instance, a partnership cannot carry forward or share a tax loss.

25. Some of the specific tax treatments under s HG 2 that give effect to the transparent tax treatment are discussed further below.

26. Despite the transparent tax treatment, and despite a general partnership not being a separate entity, partnerships are given their own IRD number for return filing and other administrative purposes. Return filing is discussed further at [72].

Purposes for which transparency applies

27. Section HG 2(1) begins with the words "For the purposes of a partner's liabilities and obligations under this Act in their capacity of partner of a partnership, unless the context requires otherwise…". This wording means the transparent tax treatment of partnerships does not apply for all purposes:

- The transparent tax treatment of partnerships applies only for the purposes of a **partner's** liabilities and obligations under the ITA.[12]
- Section HG 2 does not affect the partners' rights or obligations under other tax acts (for example, under the Goods and Services Tax Act 1985) or under general law.
- The transparent tax treatment of partnerships applies for the purposes of a partner's liabilities and obligations only **in their capacity of partner of a partnership**. This limits the application of s HG 2(1) to liabilities and obligations that result from the person being a partner. For example, a partner is treated as being in the business of dealing in land if the partnership is in that business. However, this does not mean the partner will be in the business of dealing in land in relation to land they own in a capacity other than that of partner in the partnership.[13]

[11] A "loss" for which a deduction can be claimed is different. For example, a partnership can have a depreciation loss. This will be treated as a depreciation loss of the partners in proportion to the partners' partnership shares.

[12] Implicitly, s HG 2 also applies for the purposes of the partnership's liabilities and obligations under the ITA in the sense that s HG 2 results in the partnership not having liabilities and obligations that it otherwise might have had. This is necessary to avoid double taxation.

[13] This was noted in New legislation: Taxation (Limited Partnerships) Act 2008 *Tax Information Bulletin* Vol 20, No 8 (September/October 2008): 5.

- The transparent tax treatment of partnerships does not apply if the context requires otherwise. An example where the context requires otherwise is in relation to resident withholding tax exempt status (RWT-exempt status). A general partnership that has RWT-exempt status is treated as deriving amounts that are derived by the partners.[14]

28. The reference to "capacity" in s HG 2(1) does not mean a person who is a partner is taxed as if they were two entirely separate persons. The different capacity treatment is not as extensive as it is for trustees,[15] for example. In s HG 2(1) the reference to capacity is simply limiting the application of the look-through treatments provided by the subsection.

29. It follows that the taxation of amounts a person has as a partner can be affected by the person's own characteristics and non-partnership activities, provided they do not conflict with those inherited from the partnership. One example is a partner's residency (see [198]). Another example is in the context of s CB 9(1). An amount a person derives from disposing of land is income of the person if they dispose of the land within 10 years of acquiring it and, at the time they acquired the land, they carried on a business of dealing in land, whether or not the land was acquired for the purpose of the business. For further discussion of s CB 9, see [242]. Another example is in the context of the FIF rules. A partner may hold some FIF investments as a partner of a partnership and other FIF investments separately from the partnership. The application of the FIF rules depends on thresholds that consider a person's total investments in FIFs, whatever the capacity in which investments are held (for further discussion, see [276]).

30. An example of a conflict between a characteristic inherited from a partnership and a personal characteristic is where a partnership purpose is incompatible with a purpose that a partner holds personally, for example a purpose for which land is acquired by a partnership. In this case, the Commissioner's view is the partnership's purpose will prevail.

31. Specific treatments under s HG 2 that achieve transparency are discussed next.

Partner is treated as carrying on an activity carried on by the partnership

32. A partner is treated as carrying on an activity carried on by the partnership and the partnership is treated as not carrying on the activity. An activity includes a business. Therefore, if the partnership is carrying on a business, every partner (including a limited

[14] Section RE 30(3).

[15] Under s YA 5 (General rule: capacity of trustees) a person who is acting as a trustee of a trust is acting in a capacity that is separate from their other capacities.

partner of a limited partnership) is treated as carrying on the business, instead of the partnership.

33. Because the partners are treated as carrying on the business, s CB 1 (the business income taxing provision in the ITA) is applied to each partner, not the partnership. This, in combination with other specific treatments under s HG 2, results in each partner deriving the income directly (rather than receiving a distribution from the partnership).

34. This result, that partners are treated as carrying on the business and deriving business income directly, applies to limited partners of limited partnerships. This is even though under general law, a limited partner is prohibited from taking part in the management of the limited partnership (and, therefore, the business).[16] Section HG 2 treats a limited partner as carrying on the business for the purposes of determining a partner's liabilities and obligations under the ITA.

35. Being treated as carrying on a business carried on by the partnership can have implications, for example, for determining whether income has a source in New Zealand. Source is discussed further at [200]. This is illustrated in Example | Tauira 1

Example | Tauira 1 - Limited partner treated as carrying on business in New Zealand

Facts

A limited partnership carries on a business in New Zealand. The partnership has two limited partners, who are resident in South Korea. In 2023, the limited partnership derives $200,000 of business income.

Tax treatment

This income is treated as being derived by the limited partners under s CB 1 (the business income taxing provision in the ITA) because the limited partnership is transparent for income tax purposes. The income is business income in the hands of the limited partners because, as partners in a partnership, the limited partners are treated as:

- carrying on the business carried on by the limited partnership; and
- being entitled to amounts the partnership is entitled to.

The income has a source in New Zealand because the income is derived from a business carried on in New Zealand.[17] Because the partners are treated as carrying on

[16] Section 20 of the LPA.

[17] Section YD 4(2)(a).

the business, which is carried on in New Zealand, the income has a source in New Zealand for the partners.

Because the income has a source in New Zealand, the income can be part of the partners' assessable income.[18]

Partner is treated as having a status, intention, and purpose of the partnership

36. For income tax purposes, every partner is treated as having the purposes or intentions of the partnership (not any purposes or intentions that they might hold separately). This can affect how a taxing provision applies to a partner. For example, if a partnership acquires land with a purpose of disposing of it, every partner is treated as acquiring the land with this purpose. If the land was sold, this might result in s CB 6 (Disposal: land acquired for purpose or with intention of disposal) applying to a partner's share of the sale proceeds.

37. Partners are also treated as having a status of the partnership.

General partnership intention or purpose

38. A partnership can have a purpose or intention based on purposes or intentions agreed by the partners. The purposes or intentions of a partnership might be evident from the partnership agreement, communications between partners, their conduct or other surrounding circumstances. In some cases, evidence given by the partners who are involved in the management of the business will be particularly relevant.[19]

39. Where differences exist between partners, the purpose or intention of a partnership on a matter might be that held by the majority of the partners.[20]

40. Although in theory a partner could have a purpose or intention that is different from that of their fellow partners, for income tax purposes, every partner is treated as having the purpose or intention of the partnership. To the extent this is inconsistent with a

[18] Section BD 1(4) and (5).

[19] The facts in *CIR v Boanas* (2008) 23 NZTC 22,046 (HC) provide an example of this. In that case, all four partners were found to be effectively of one mind. Two of the partners discussed all initiatives thoroughly, and while the other two partners were informally involved, the other partners tended to go along with the proposals the first two partners advanced.

[20] This is consistent with s 51(1) of the PLA, which states any difference about ordinary matters connected with the partnership business may be decided by a majority of the partners. The way in which decisions are made about ordinary matters could also be modified by agreement. Section 35 of the PLA states that the mutual rights and duties of partners (which includes how decisions are made) may be varied by the consent of all the partners (for instance, in the partnership agreement).

purpose or intention that they hold personally, the partnership purpose or intention will prevail. This is illustrated in Example | Tauira 2 and Example | Tauira 3.

Example | Tauira 2 - Partner is treated as having purpose or intention of the partnership

Facts

A property investment partnership has three partners with equal partnership shares.[21] The partners have an email conversation in which they discuss the purchase of land that has come up for sale in their area for $900,000. Two partners want to buy the land and sell it for a profit. The third wants to buy the land and use it to provide rental accommodation. The partners all agree to buy the land. At the time, the third partner goes along with the purchase in the hope of convincing the others to use the land to provide rental accommodation.

The partnership later sells the land for $1,200,000, making a $300,000 profit.

Tax treatment

Each partner is treated as deriving income of $400,000 from the sale of the property under s CB 6 (Disposal: land acquired for purpose or with intention of disposal). This is because each partner is treated as having acquired the land for a purpose of disposing of it. Deductions are also allowed for each partner's share of the cost of the land.

The fact the third partner did not want to dispose of the land does not affect the outcome. Two out of the three partners had a purpose or intention of resale when the land was acquired. In this case, the majority purpose or intention is the purpose or intention of the partnership, and the third partner is treated as having that purpose or intention for income tax purposes.

Example | Tauira 3 – purpose on acquiring another partner's interest in land - s HG 5

Facts

Partnership A owns land. It has three partners (partners 1 to 3) with equal partnership share. The partnership originally acquired the land to derive income from leasing the land, so held the land on capital account. Partner 1 now thinks they should sell the land and invest elsewhere. However, partners 2 and 3 disagree. Partner 1 convinces partner 2 to sell their partnership interest to partner 1. After acquiring partner 2's partnership interest, partner 1 can dictate what the partnership does with the land

[21] The meaning of "partnership share" is discussed at [48].

(under partnership A's partnership agreement, where partners cannot agree, a decision is made by poll based on partnership share). Soon after, the land is sold. The partnership makes a gain on sale of $600,000.

Tax treatment

When the land was originally acquired it was purchased on capital account. This is still clearly the case with respect to partner 1's original one-third share and partner 3's one-third share. The circumstances suggest partner 1 acquired the other one-third share from partner 2 with the purpose of resale. Further, given that partner 1 could dictate what the partnership did with the land, partner 1's purpose with respect to the land became the partnership's purpose with respect to the land in future.

The tax treatment of the disposal of the land for partner 1 depends on whether the safe harbour rule in s HG 5 applies to the acquisition of partner 2's interest in the land. The safe harbour rules are discussed at [111].

If the safe harbour rule in s HG 5 applies, partner 1 would be treated as if they had originally acquired and held the one-third share acquired from partner 2. When the land was originally acquired, the partnership's purpose was to hold the land on capital account. If s HG 5 applies, partner 1 would be treated as having acquired the interest from partner 2 on capital account (as that was the partnership's purpose when the interest in land was acquired by partner 2) and no amount would be included in income under s CB 6 (Disposal: land acquired for purpose or with intention of disposal).

If s HG 5 does not apply, partner 1 may have income under s CB 6 in relation to the interest in land that it acquired from partner 2 as this interest in land was acquired with a purpose of resale. Partner 1 will not have income under s CB 6 in relation to their original one-third share in the land.

Limited partnership intention or purpose

41. As with a general partnership, the purposes or intentions of a limited partnership might be evident from the partnership agreement and surrounding circumstances.

42. In determining whether a limited partnership has a particular purpose, the relevance of limited partners' purposes may be affected by the fact limited partners are prohibited from taking part in the management of the limited partnership. Nevertheless, some activities do not constitute taking part in the management of the limited partnership. These are listed in sch 1 of the LPA. One example is taking part in a decision about whether to approve or veto investments proposed to be made by the limited partnership:

- if the value of the investments would be more than half the value of the limited partnership's assets before the investment; or
- as a member of an advisory committee of the limited partnership.

43. Therefore, the relevance of purposes held by limited partners in determining the purpose of the partnership may depend, among other things, on the size of a transaction and whether the partners are members of an advisory committee.

44. Where a transaction does not involve limited partners, the purposes or intentions of a limited partnership may be those of the general partner, who is responsible for the management of the limited partnership.

Treatment applies only in the person's capacity as a partner

45. A status, intention or purpose that a partner is treated as having will not apply to the partner in relation to their non-partnership activities. For example, a partner of a land-dealing partnership is not treated as having the purpose of the partnership in relation to land that the partner owns in their separate capacity. Section HG 2 applies to partners only in their capacity as partners.

Ownership of partnership property

46. A key concept of general law is that partners do not have individual rights in partnership property.[22] The interest a partner holds has been described as "a beneficial interest in the entirety of the partnership assets and in each and every particular asset of the partnership".[23] This is consistent with s 36(1) of the PLA, which states that partnership property must be held and applied by the partners exclusively for the purposes of the partnership and in accordance with the partnership agreement. No one partner can deal with any portion of the partnership property in their own interests.

47. For income tax purposes, a partner is treated as holding property that a partnership holds, in proportion to the partner's partnership share, and the partnership is treated as not holding the property. Among other things, this means income derived from partnership property (for example, royalties) is derived by the partners, not by the partnership.

[22] This point has been made in several cases, including *Hadlee & Sydney Bridge Nominees Ltd v CIR* (1993) 15 NZTC 10,106 (PC), *CIR v Boanas* and *Crowe v C of T* (1958) 100 CLR 532 (HCA). It was also confirmed by P Webb and A Molloy in *Principles of the law of partnership* (6th ed, Butterworths, Wellington 1996).

[23] *Hadlee* at 10,110.

48. "Partnership share" means, for a particular right, obligation, or other property, status, or thing, the share that a partner has in the partnership.[24] This is discussed further at [56].

Party to an arrangement

49. For the purposes of a partner's liabilities and obligations under the ITA in their capacity of partner of a partnership, a partner is treated as being party to an arrangement to which the partnership is a party.

50. "Arrangement" is defined in the ITA. It means an agreement, contract, plan, or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect.[25] The term is used in various parts of the ITA.

51. Being treated as party to an arrangement means a partner may be treated as being party to, for example, a financial arrangement[26] or a tax avoidance arrangement[27] that a partnership is party to.

Actions and entitlements

52. For the purposes of a partner's liabilities and obligations under the ITA in their capacity as a partner in a partnership, a partner is treated as doing a thing and being entitled to a thing the partnership does or is entitled to.

53. An entitlement to a thing, includes an entitlement to an amount of income.

Attribution of income and expenditure

Attribution based on a partner's partnership share in the partnership income – no streaming rule

54. For income tax purposes, partners cannot choose how much income or expenditure (of a particular nature or from a particular source) to attribute to each partner; attribution is automatic. Under s HG 2 and the transparent tax treatment of partnerships, partners

[24] Section YA 1.
[25] Section YA 1.
[26] Under subpart EW.
[27] Under s BG 1.

are treated as having income and expenditure of the partnership in proportion to the partner's **partnership share in the partnership's income**.

55. In the case of limited partnerships, a limit exists on the amount of deductions a limited partner can claim in an income year as a partner of a limited partnership. This is called the deduction limitation rule. This is discussed from [284].

56. A partner's partnership share in the partnership's income could differ from their partnership share in, for example, the partnership property. This occurs in some professional services partnerships, for example.

57. "Partnership share" is defined in s YA 1. Partnership share means, for a particular right, obligation, or other property, status or thing, the share a partner has in the partnership. This definition reflects that a partner's partnership share can be different for different things. This is relevant in the context of s HG 2(1). As discussed above, under s HG 2(1) a partner is treated as:

- holding property that a partnership holds, in proportion to the partner's partnership share;
- being party to an arrangement to which the partnership is a party, in proportion to the partner's partnership share; and
- doing a thing and being entitled to a thing that the partnership does or is entitled to, in proportion to the partner's partnership share.

58. However, under s HG 2(2), a specific partnership share is used, being a partner's partnership share in the partnership's income. This partnership share is used to determine a partner's share of certain amounts, including the total amount of income, tax credit, rebate, gain, or expenditure or loss that partners have from a particular source or of a particular nature.[28]

59. Section HG 2(2) prevents the streaming of an amount of income, tax credit, rebate, gain, expenditure, or loss of the partners from particular sources or of a particular nature.[29] For example, if a partnership attributed foreign-sourced income to non-resident partners and New Zealand-sourced income to New Zealand resident partners, s HG 2(2) would recharacterize the attribution for income tax purposes. All the partners would be treated as having a share in the foreign-sourced and New Zealand-sourced income based on the partners' partnership share in the partnership's income.

[28] The difference between subs (1) and (2) is reflected in the opening words "despite subsection (1)" in s HG 2(2).

[29] This is reflected in the subsection heading "No streaming".

60. The no streaming rule in s HG 2(2) is subject to three exclusions. The exclusions relate to a person entering a partnership where the safe harbour rules do not apply, supplementary dividends and imputation credits.

Identifying a partner's partnership share

61. A partner's partnership share to different things will normally be specified in a partnership agreement. If not, the general presumption is that partners have equal partnership shares.[30]

62. Records should be kept of any changes in the partners' partnership shares as these may be required as evidence to support a change in the attribution of income and expenditure to partners for income tax purposes. It is understood that some partnerships have earn-in arrangements for new partners under which the partner's partnership share in the partnership's income increases year by year.

63. A partner's partnership share of partnership income may need to be calculated for each income year if the partner has different shares in different sources of income or income of a different nature. This is illustrated in Example | Tauira 4 where Partner 10 has a 6% partnership share in business income but a 10% share in other income.

Example | Tauira 4 - No streaming rule

Facts

Professional Services Partnership recently appointed a new partner, partner 10. Partner 10 has a 10% partnership share of partnership property and to any income derived from the partnership property, including rent derived from the sublease of office space and interest derived on investments.

However, partner 10's share of the partnership's business income in their first year as partner is subject to performance.

Partner 10's performance in their first year entitles them to a 6% share of the partnership's business income.

For the first year, Professional Services Partnership has the following amounts:

Business income	$800,000
Business expenditure	$400,000
Rental income	$50,000

[30] Under s 45 of the PLA.

Income from investments	$24,000
Tax credits (33% of the income from investments)	$7,920

Professional Services Partnership has total income of $874,000 ($800,000 + $50,000 + $24,000). Partner 10 has rights to 6% of the business income ($48,000) and 10% of the rental income and income from investments ($5,000 and $2,400), which totals $55,400. Overall, Partner 10 has a 6.34% share of the partnership's income.

Tax treatment

Section HG 2(2) requires that the income, expenditure and tax credit be attributed to the partners based on each partner's partnership share of the partnership's income. To do this it is necessary to determine the partner's partnership share of the partnership's income. In this example, the appropriate approach is to use the weighted percentage of 6.34% (as calculated above) to attribute all the income, expenditure, and tax credit. Partner 10's 6.34% partnership share of the partnership's income means they are attributed:

- $55,411.60 of the $874,000 business income ($874,000 x 6.34%);
- $25,354.69 of the $400,000 business expenditure ($400,000 x 6.34%); and
- $502.02 of the $7,920 tax credits ($7,920 x 6.34%).

Anti-avoidance provisions

64. It is also noted that an anti-avoidance provision in s GB 23 gives the Commissioner the ability, in specified cases, to reallocate income and deductions as the Commissioner considers reasonable.

65. One of the specified cases is where a partnership employs or engages a relative of a partner,[31] and the Commissioner considers the income payable to the relative for the services they provide is excessive.[32]

66. Another case is where one partner in a partnership is a relative of another partner,[33] and the Commissioner considers the other partner's share of the partnership's income and deductions is excessive.[34]

[31] Or, in the case of a company, a relative of a director or shareholder in the company.

[32] Section GB 23(2).

[33] Or, in the case of one or more of the partners being a company, the relationship can be with a relative of a director or shareholder in the company.

[34] Section GB 23(3).

67. In applying s GB 23, the Commissioner can take into account:

- the nature and extent of the services rendered by the relative;
- the value of the contributions made by the respective partners, by way of services, capital, or otherwise; and
- any other relevant matters.

68. Section GB 23 does not apply if there is a "genuine" partnership contract. Section GB 24(2) outlines eight situations in which a contract is treated as genuine.

69. Further discussion of this topic is in **QB 14/09: Income tax – meaning of "excessive remuneration" and "excessive profits or losses" paid or allocated to relatives, partners, shareholders or directors**,[35] which explains the meaning of "relative", "excessive remuneration", "excessive profits or losses", and when a contract is treated as genuine.

70. Another anti-avoidance provision that supports the partnership rules is s GB 50. Section GB 50 applies if:

- a partner enters into an arrangement;
- the arrangement involves a non-market value amount of consideration; and
- the arrangement has a purpose or effect of defeating the intent and application of subpart HG.

71. Where it applies, a market value amount of consideration is substituted for the consideration under the arrangement.

Joint return of income

72. Although there is no joint assessment of income, for most partnerships, partners are required to file a joint return of income. This applies to:[36]

- The partners of a limited partnership if the limited partnership is registered under the LPA.[37] This applies whether or not the limited partnership carries on business in New Zealand and whether or not any of the partners (limited or general partners) are resident in New Zealand.

[35] *Tax Information Bulletin* Vol 26, No 9 (October 2014): 22.

[36] Section 42 of the TAA.

[37] The requirement for the limited partnership to be registered under the LPA means that this joint return requirement does not apply to an "overseas limited partnership", despite an overseas limited partnership being included in the definition of "limited partnership" for income tax purposes.

- The partners of a general partnership if the partnership carries on a business in New Zealand.[38]

73. Joint venturers or co-owners of property can choose to be treated as a partnership.[39] The Commissioner will treat joint venturers or co-owners of property as having made this choice if they file a joint return of income as if they were a partnership.

74. The joint return of income must include:

- the total amount of income derived by the partners as members of the partnership (that is, the income the partnership derived, ignoring s HG 2);
- the partners' partnership shares in the income; and
- a summary of the deductions of each partner.

75. The joint return can be completed online or using Inland Revenue forms IR7 and IR7P. The IR7 records the income and deductible expenditure of the partnership and the IR7P shows how the income and deductible expenditure is attributed to each partner.

76. In some cases, there may be insufficient room on the IR7P (if using the manual form rather than MyIR) or it may be impracticable to enter information separately for a large number of partners. In such cases, you can provide the information required by the form in a separate document, provided you notify the Commissioner you are doing this and the document contains all the information required by the form. The Commissioner also has a specific power to approve the provision of return information by electronic means.[40]

77. It is important to include each partner's IRD number, as prescribed by the Commissioner in the IR7P (as well as the partnership's own IRD number). Section 35 of the Tax Administration Act 1994 (TAA) gives the Commissioner the power to prescribe forms for income tax purposes, including for the purpose of partners providing a joint return of partnership income. Further, s 53(2) of the Legislation Act 2019 gives the Commissioner the power to identify information to be supplied. In the Commissioner's view, these powers give the Commissioner authority to require all partners' IRD numbers be included in the return. Requiring such information is also consistent with the purpose of the ITA to assess each partner based on each partner's share of the partnership income and deductions.

78. Despite partners being required to file a joint return, income is not jointly assessed. Instead, each partner's income is assessed separately.

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[38] Ignoring for a moment the transparent treatment of partnerships under s HG 2, under which a partnership is treated as not carrying on an activity.

[39] See definition of "partner" in s YA 1.

[40] Section 36 of the TAA.

Separate return of income

79. To facilitate the separate assessment, each partner must include their share of the partnership income and deductions in a separate return of income.[41]

80. Being a partner of a partnership triggers an obligation under s 33 of the TAA to file an income tax return each year (if the partner is not already required to file a return).[42]

81. In the case of a partnership that derives only foreign-sourced income, the non-resident partners may not have any assessable income, so may not be required to file an individual income tax return for their partnership income. However, the partners will still be required to file the joint partnership return of income, even if the assessable income is nil. This is for the purposes of international obligations New Zealand may have concerning the partnership.

82. A non-resident can apply for an IRD number (a tax identification number). This will allow a non-resident to pay the right amount of tax from the start instead of higher "no-notification" rates.

83. A partner to whom the joint return obligation does not apply (for example, a partner of an overseas limited partnership) must nevertheless include their share of the joint income and deductions in a separate return of income.

Non-standard balance dates

84. If the partnership has a non-standard balance date, the partners, when filing their separate returns, can return their share of the partnership income to the same balance date as the partnership. The Commissioner will treat the partners as having the same non-standard balance date for this source of income. The partners do not have to reallocate the income based on their separate balance dates.

85. A partner should continue to return other income to 31 March or another relevant date (if the partner has a non-standard balance date for another business).

86. This is illustrated in Example | Tauira 5.

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[41] In an IR3 if the partner is a natural person, in an IR4 if the partner is a company, or in an IR6 if the partner is the trustee of a trust.

[42] This is required by s 42(3)(b) of the TAA. Section 33 of the TAA requires a person to file a return of income for a tax year in the form and with the particulars the Commissioner prescribes. In the case of a limited partnership that derives only foreign-sourced income, the non-resident partners may not have any assessable income, so may not be required to file an individual income tax return for their partnership income. However, the partners are still required to file a joint partnership return of income, even if the assessable income is nil. This is for the purposes of international obligations New Zealand may have concerning the partnership.

Example | Tauira 5 - Partnership with non-standard balance date

Facts

A farmer carries on a sheep farming business. He is also a partner in Honey Partnership, which carries on a bee keeping business.

The farmer elected to have a non-standard 30 June balance date for the sheep farming business. The partners of Honey partnership elected to have a non-standard balance date of 31 December. The Commissioner consented to both elections.

For the 2023 tax year (ending 31 March), the farmer has the following income:

- income from the sheep-farming business of $200,000 for the year ended 30 June 2023;
- income derived as a partner of Honey partnership of $50,000 for the year ended 31 December 2022; and
- dividends from investments of $4,000 for the tax year ended 31 March 2023.

Tax treatment

In the farmer's income tax return for the 2023 tax year, the farmer should return the $200,000 of income from the sheep-farming business (calculated to 30 June 2023), the farmer's $50,000 share of income from the Honey Partnership (calculated to 31 December 2022) and the $4,000 of dividends. The farmer's annual gross income for 2023 is $254,000.

Even though the year ended 31 December 2022 crosses over the 2022 and 2023 tax years (ending 31 March), all $50,000 of the partnership income is included in the return for the 2023 tax year. No reallocation of this amount is required between the tax years in which the $50,000 was derived.

Transactions between a partnership and a partner

87. The Commissioner's view is there is a full (rather than a partial) disposal of property in the following situations:

    - A person transfers property to a partnership of which they are a partner.
    - A partnership transfers property to a partner of the partnership.

88. In these situations, it might be argued that because of s HG 2, a partner is treated as holding the property, or at least part of the property based on the partner's

partnership share, before and after the transfer, so there is no disposal of the property, or the relevant part.

89. The Commissioner's view is that s HG 2 does not apply in this context. This is because:

- Section HG 2 applies for the purposes of a partner's liabilities and obligations under the ITA **in their capacity as partner**. A person who is a partner of a partnership can act in two capacities: in their capacity as a partner of the partnership and in their separate non-partnership capacity.
- Section HG 2 only applies if the context does not require otherwise. The context here requires that s HG 2 not apply. Legal fictions such as those created by s HG 2 are only meant to be taken as far as is necessary to achieve the purposes of the provision. The Commissioner's view is that s HG 2 was not intended to apply to a transaction between a partner and a partnership.
- From a non-tax perspective, in these situations an interest in property held by a person before the transfer will differ from the interest in the property held afterwards because of the nature of partnerships and the interests in partnership property held by partners.

90. An example of a transfer between a partner and a partnership is a capital contribution made by a person on joining a partnership or acquiring additional partnership share. This is considered in **QB 17/09: Is there a full or partial disposal when an asset is contributed to a partnership as a capital contribution?**[43]

91. The view expressed at [89] is consistent with QB 17/09, but goes further. In comparison with QB 17/09, the view expressed at [89] is more general, applies to transactions in either direction (from a partner to a partnership or from a partnership to a partner) and is based on additional reasoning (s HG 2 does not apply because the context requires otherwise).

Changes in partners

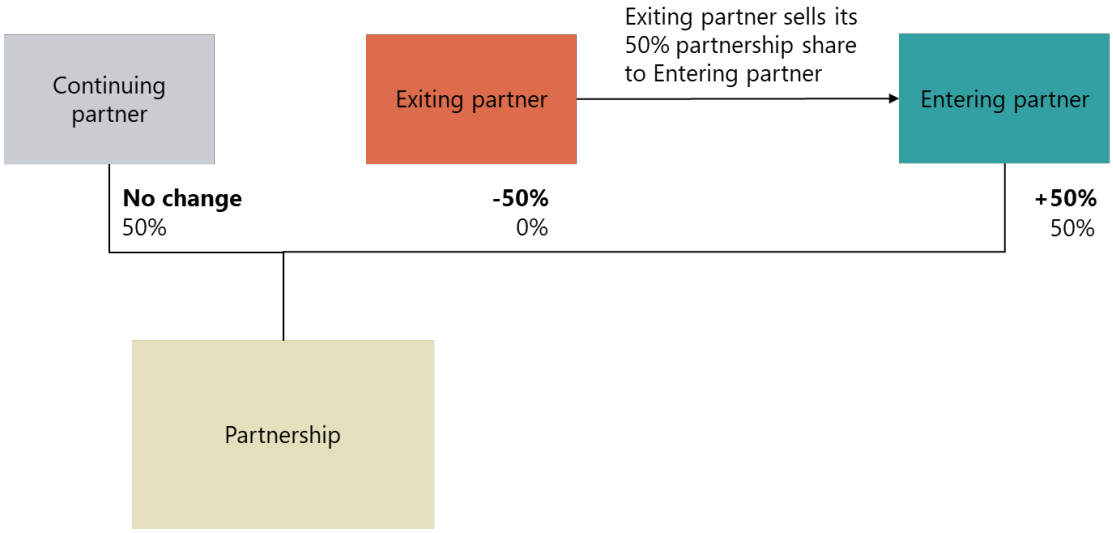
92. When a new person joins a partnership or an existing partner increases their partnership share (in either case, the person is referred to as an entering partner), they take partnership share from one or more of the existing partners (these partners are referred to as exiting partners, whether they are giving up all or part their partnership share).

93. An entering partner, when they join a partnership, may take partnership share from any number of partners.

[43] *Tax Information Bulletin* Vol 30, No 1 (February 2018): 10.

94. For example, in a partnership consisting of two existing partners with equal partnership shares, an entering partner may acquire the partnership share of one of the existing partners. In this case, the entering partner takes the place of the exiting partner. The continuing partner's partnership share is unaffected. This is illustrated in Diagram | Hoahoa 1.

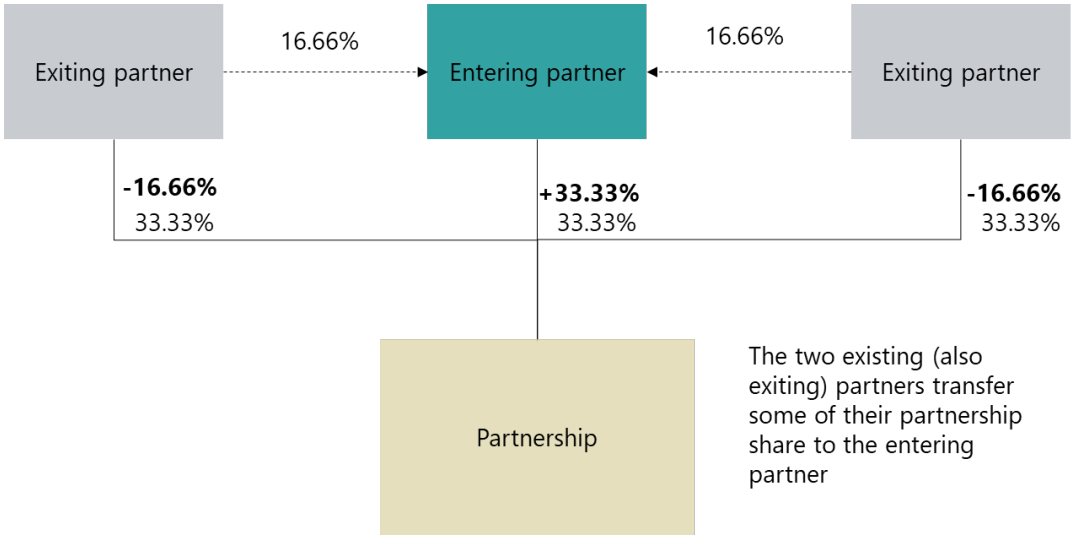
Diagram | Hoahoa 1 - Continuing partner no change in partnership share



95. Another example is where, in a partnership consisting of two existing partners with equal partnership shares, an entering partner joins the partnership, adding a third partner and giving each partner a one-third partnership share.[44] In this case, the two existing partners' partnership shares are both reduced. This is illustrated in Diagram | Hoahoa 2.

[44] The partnership shares of each partner do not necessarily need to be equal. Partners can agree to have unequal shares. However, in the absence of any agreement, it is assumed partnership shares are equal.

Diagram | Hoahoa 2 - Change in partnership shares



96. An entering partner can provide consideration for the acquisition of partnership shares by paying amounts to the exiting partners or by introducing new property to the partnership, in which the other partners will obtain an interest.

97. If introducing new property, the value of the new property may be such that the total value of the property in which the existing partners have an interest remains the same. Despite this, if an existing partner gives up some of their partnership share, they are treated as disposing of an interest in the existing partnership property, while acquiring an interest in the new property added by the entering partner.[45] This is because a partner's interest in any partnership property is determined by their partnership share.[46] If a partner's partnership share changes, their interest in the partnership property also changes. This is illustrated in Table | Tūtohi 1.

[45] This is also discussed in **QB 14/02 Income tax – entry of a new partner into a partnership – effect on continuing partners** *Tax Information Bulletin* Vol 26, No 5 (June 2014): 53.

[46] Under s HG 2, a partner is treated as holding property that a partnership holds, in proportion to the partner's partnership share.

Table | Tūtohi 1 – New property introduced to partnership

Before capital contribution				
	Partnership share	*Existing property*		*Total value of property*
Partner 1	50%	$60		$60
Partner 2	50%	$60		$60
Total		$120		$120
After capital contribution				
	Partnership share	*Existing property*	*New capital contribution property*	*Total value of property*
Partner 1	33.33%	$40	$20	$60
Partner 2	33.33%	$40	$20	$60
Partner 3	33.33%	$40	$20	$60
Total		$120	$60	$180

98. In Table | Tūtohi 1, Partners 1 and 2 have each disposed of an interest in the existing partnership property valued at $20. If the property was held on revenue account, Partners 1 and 2 could each have $20 of income from the disposal.

99. Where an entering partner contributes property to a partnership, the partner is treated as making a full disposal of the property, despite the partner, after the disposal, having an interest in the property as a partner.

Disposal of partnership property on change of partners

100. Under general law, a change in partners can mean a dissolution of the partnership, which would mean a disposal by all partners of all their interests in partnership property. However, this result is modified for income tax purposes.

101. The definition of "dispose" in the ITA departs from the general law position. For tax purposes, for a partner (like the continuing partner in Diagram | Hoahoa 1), a disposal does not occur merely because **another partner** disposes of that partner's interests.[47]

[47] Paragraph (h)(i) of the definition of "dispose" in s YA 1.

This means, for income tax purposes, a partner whose partnership share is not reduced when a new partner joins the partnership (but other partners' partnership shares are reduced) does not dispose of any interest in partnership property.

102. The position is different on a final dissolution of a partnership where the business of the partnership will not continue to be carried on in partnership.

Death of a partner

Asset transfer rules in subpart FC

103. If a partner is a natural person and that partner dies, the deceased partner's interests in the partnership assets are transferred to the administrator or executor of the deceased's estate.

104. The asset transfer rules in subpart FC apply to this transfer and any subsequent distribution of those interests by the administrator or executor of the deceased's estate. Under these rules, subject to some exceptions, the transfer and subsequent distribution are treated as having been made at market value. If the property was, for example, revenue account property for the deceased partner, this could lead to an income tax liability.

105. The exceptions may apply where certain property is transferred to a spouse, civil union partner or de facto partner, a person related to the deceased partner within the second degree of relationship, or a charity. Where the requirements of these exceptions are met, the transfer of the property can instead be treated as a settlement of relationship property under subpart FB. This may prevent an income tax liability arising on the transfer of the property.

106. The asset transfer rules are discussed in **Death and asset transfers**.[48]

Partnership can continue after the death of a partner

107. Under general law, for a general partnership, the death of a partner could trigger the dissolution of a partnership.

[48] *Tax Information Bulletin* Vol 17, No 7 (September 2005): 42.

108. For tax purposes, a general partnership can continue for the surviving partners, provided that there are still at least two partners.[49] A general partnership must have two or more partners.[50]

109. Where a general partnership consists of two partners and one partner dies, the Commissioner may treat the partnership as continuing provided the business continues and the administrator or executor of the deceased's estate transfers, within a reasonable period, the partnership interests of the deceased partner to a new partner or partners. It will be question of fact and degree whether there is a change in partners or a new partnership.

110. A limited partnership must have at least one general partner and at least one limited partner. If a partner dies and there is no general partner or no limited partner for 10 working days, this could be a "terminating event" under s 86 of the LPA (this 10 working-day period can be extended). A terminating event could lead to the liquidation and deregistration of a limited partnership.[51] This would be a final dissolution for the purposes of s HG 4. A final dissolution would trigger deemed disposals of a partner's interests in the partnership, which could result in income and other tax implications.

Safe harbour rules

111. Where an exiting partner is treated as disposing of property under the ITA, the safe harbour rules may apply to alter the tax effect of the disposal for the exiting and entering partners.

112. Essentially, if certain requirements are satisfied, where partners change, the safe harbour rules allow an entering partner to step into the shoes of an exiting partner,[52] with the disposal being ignored for tax purposes. The entering partner takes on the cost base of the exiting partner, so on a subsequent disposal the entering partner may have a tax liability similar to what the exiting partner would have had if they had not disposed of their partnership interest to the entering partner.

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[49] This is supported by s HG 4 (Disposal upon final dissolution). The circumstances in which s HG 4 applies do not exactly match the circumstances of a dissolution for non-tax purposes. For s HG 4 to apply, s HG 4 also requires that the partnership's business will not continue to be carried on in partnership. This additional requirement implies that, for tax purposes, the partnership can continue despite an event that, under general law, could result in the final dissolution of the partnership.

[50] A general partnership is defined as the relationship that exists between persons carrying on a business in common with a view to profit.

[51] See ss 86 to 92, 92A and 93 to 99 of the LPA.

[52] The entering partner could be an existing partner who is acquiring further partnership interests from other partners. Similarly, an exiting partner may be disposing of only some of their partnership interests.

113. Section HG 5 provides a general safe harbour rule that can apply to the whole of the partnership interest that is disposed of. If s HG 5 does not apply, ss HG 6 to HG 10 provide safe harbour rules that may apply to the disposal of specific types of partnership interest.

Safe harbour rules do not apply on final dissolution

114. The safe harbour rules in ss HG 5 to HG 10 do not apply if the partnership is finally dissolved, **and** the partnership's business will not continue to be carried on in partnership.[53]

115. The tax treatment on the final dissolution of a partnership is discussed further at [142].

Small partnerships

116. The partners of a small partnership can elect not to apply the safe harbour rules in ss HG 5 to HG 9. To do this the entering partner, exiting partner, and partnership simply need to file returns of income that ignore the sections.

117. A "small partnership" is a partnership that is not a limited partnership, and that has five or fewer partners that are not companies or partnerships themselves.

General de minimis rule – s HG 5

118. Section HG 5 applies where:

- an exiting partner disposes of some or all of their partnership interests to an entering partner; and
- the amount calculated using the formula in s HG 5(1) is less than zero.

119. The formula in s HG 5(1) is as follows:

> disposal payment + previous payments − (gross tax value − liabilities) − $50,000.

120. The formula in s HG 5(1) examines whether the amounts paid or payable to the exiting partner (including the consideration for the current interests and any consideration for other disposals of their partner's interests that have occurred in the last year) exceed the difference between the "gross tax value" and liabilities by more than $50,000. If the amount paid to the exiting partner is too high, as measured by this formula, s HG 5(1) does not apply.

[53] Section HG 3(1).

121. In the formula, gross tax value is the total value of the interests disposed of. For the purposes of determining the gross tax value amount:

- interests that are revenue account property, depreciable property, or financial arrangements have the value given to them by the ITA:
  - revenue account property will have its cost value;
  - depreciable property will have its adjusted tax value; and
  - the Commissioner will accept a reasonable calculation of the value of a financial arrangement, for example the value of any interest or principal repayment amounts receivable less any amounts payable under the financial arrangement; and
- other interests have their market value, for example land held on capital account.

122. The effect of s HG 5 applying for an exiting partner is as follows:

- The total amount of consideration paid or payable to an exiting partner for their partnership interests is treated as excluded income of the exiting partner.
- No deduction is allowed in relation to the partnership interests to the extent to which the entering partner is allowed a deduction. This is related to the entering and exiting partners being able to choose whether the exiting or entering partner will claim deductions for some or all the expenditure or loss incurred in the income year before the transfer. See [139].

123. The effect of s HG 5 applying for an entering partner is as follows:

  - No deduction is allowed for the consideration paid or payable for the interest in the partnership.
  - The entering partner is treated as if they had originally acquired and held the interests, not the exiting partner. This means the entering partner takes on the cost base of the exiting partner for the partnership interests acquired. This applies only for the purposes of calculating the income and deductions of an entering partner for the part of the income year after the disposal of the interests occurs and later income years.

124. This is illustrated in Example | Tauira 6, firstly where s HG 5 does not apply and then, in the variation, where it does apply.

125. The application of s HG 5 in the context of the land rules is discussed at [254].

Example | Tauira 6 – Safe harbour – general de minimis rule – s HG 5

Facts

Limited partnership A has two limited partners, partner 1 and partner 2.

Partner 2 sells their partnership interests to a new partner, partner 3, for $300,000.

Limited partnership A owns land on revenue account that was originally acquired for $500,000. The land has a market value of $1 million when partner 2 sells their partnership interest to partner 3.

No item of depreciable property held by the partnership cost more than $200,000.

At the time of sale, limited partnership A had assets and liabilities of:

- land held on revenue account (at cost, market value is $1 million) $500,000
- depreciable property (adjusted tax value) $100,000
- liabilities (generally accepted accounting practice) $500,000

Tax treatment

When the formula in s HG 5 is applied, the result is greater than zero, so s HG 5 does not apply:

amount paid for the interest - (gross tax value - liabilities) - $50,000

$300,000 – ($300,000[54] - $250,000[55]) - $50,000 = $200,000

However, s HG 7 does apply to limited partnership A's depreciable property.

Partner 2 is treated as having received $500,000 for the interest in the land held on revenue account, so has a taxable gain of $250,000.

Partner 3's cost base for the partnership interests they acquired is based on the amount they paid for the assignment of the assets. The question of how a global purchase price is allocated to particular assets is a separate topic outside the scope of this statement.[56] However, for the purposes of this example, it is assumed:

- $500,000 is paid for the land ($1 million ÷ 2);
- $50,000 ($100,000 ÷ 2) is paid for the depreciable property; and
- the purchase price is reduced by $250,000 for the liabilities ($500,000 ÷ 2).

[54] Partner 2's half share of the value of the land and depreciable property: ($500,000 + $100,000) ÷ 2 = $300,000.

[55] Partner 2's half share of the liabilities: $500,000 ÷ 2 = $250,000.

[56] Guidance on purchase price allocation rules is provided in *Tax Information Bulletin* Vol 33, No 6 (July 2021): 28.

This reconciles with the purchase price: $500,000 + $50,000 - $250,000 = $300,000.

Partner 3's cost base in relation to the partnership interest will be:

- land held on revenue account of $500,000; and
- depreciable property of $50,000

Partner 1's cost base is unaffected by the change in partner. Their cost base is:

- land held on revenue account of $250,000; and
- depreciable property of $50,000.

If the land was subsequently sold for $1 million:

- partner 1 would have a taxable gain of $250,000 ($500,000 - $250,000 = $250,000); and
- partner 3 will not have any gain ($500,000 - $500,000 = 0).

Variation where s HG 5 applies

This variation has the same facts as given above, except the land cost $920,000.

Tax treatment

When the formula in s HG 5 is applied, the result is less than zero, so s HG 5 applies:

amount paid for the interest – (gross tax value – liabilities) - $50,000

$300,000 – ($510,000[57] - $250,000[58]) - $50,000 = -$10,000

The amount received by partner 2 (the exiting partner) for the partnership interest is treated as excluded income. They will not have any taxable gain on the disposal of assets.

Partner 3 (the entering partner) is treated as if they, not partner 2, had originally acquired and held the partnership interests. This means partner 3 takes on the cost base of partner 2 for the partnership interests acquired.

Partner 3's cost base in relation to the partnership interest is:

- land held on revenue account of $460,000 ($920,000 ÷ 2); and
- depreciable property of $50,000

Partner 1's cost base is unaffected by the change in partner.

If the land was subsequently sold for $1 million, partner 1 and partner 3 would each have a taxable gain of $300,000 ($500,000 - $460,000 = $40,000).

Trading stock that is not livestock – s HG 6

126. Section HG 6 applies to the disposal of trading stock that is not livestock. It applies only if for the income year of disposal, the total turnover of the partnership is $3 million or less.

127. The effect of s HG 6 applying for an exiting partner is as follows:

- The consideration received for the trading stock is excluded income.
- No deduction is allowed in relation to the trading stock for the income year to the extent to which the entering partner is allowed a deduction because of s HG 6(5).

[57] Partner 2's half share of the value of the land and depreciable property: ($920,000 + $100,000) ÷ 2 = $510,000.

[58] Partner 2's half share of the liabilities: $500,000 ÷ 2 = $250,000.

128. The effect of s HG 6 applying for an entering partner is as follows:

- No deduction is allowed for the consideration paid or payable to the exiting partner for the trading stock.
- The entering partner is treated as if they had acquired and held the trading stock, not the exiting partner (s HG 6(5)). This means the entering partner takes on the cost base of the exiting partner for the trading stock. This applies only for the purposes of calculating the income tax liability of the entering partner.

Depreciable property – s HG 7

129. Section HG 7 applies to the extent to which an exiting partner disposes of depreciable property that is not depreciable intangible property to an entering partner. Section HG 7 applies if the total cost of the item when it was first acquired by the partners of the partnership is $200,000 or less.

130. The treatment for the exiting partner and the entering partner follows the same pattern as for trading stock.

Financial arrangements and certain excepted financial arrangements – s HG 8

131. Section HG 8 applies to the extent to which an exiting partner disposes of a financial arrangement or an excepted financial arrangement described in s EW 5(10) (an interest free, repayable on demand loan in New Zealand currency - excepted for the lender only). It applies only if the purpose for which the arrangement was entered into was necessary and incidental to the business of the partnership and the partnership does not derive income from a business of holding financial arrangements.

132. Again, the treatment for the exiting partner and the entering partner follows the same pattern as for trading stock and depreciable property. However, in addition, the exiting partner is not required to perform a base price adjustment calculation, despite s EW 29 (When calculation of base price adjustment required).

Short-term agreements for sale and purchase – s HG 9

133. Section HG 9 applies to the extent to which an exiting partner disposes of a short-term agreement for sale and purchase. "Short-term agreement for sale and purchase" is defined in s YA 1. A short-term agreement for sale and purchase is an excepted financial arrangement, except for a party who makes an election under s EW 8.

134. Again, the treatment for the exiting partner and the entering partner follows the same pattern as for trading stock, depreciable property, and financial arrangements.

Specified livestock that is female breeding livestock – s HG 10

135. Section HG 10 applies to the disposal of specified livestock that is female breeding livestock. Section HG 10 is an elective provision that applies for an entering partner if the entering partner files a return of income that applies the section (s HG 3(3)). The section applies only if the partners use the national standard cost scheme or the cost price method for specified livestock.

136. The effect of s HG 10 applying is that s EC 26B (entering partner's cost base) may apply to the entering partner for the purposes of determining the value of the specified livestock at the end of the income year for the purposes of s EC 2.

Cost base for entering partners where the safe harbour rules do not apply

137. As discussed above, where the safe harbour rules apply, an entering partner takes on the cost base of the exiting partner for the relevant property.

138. If the safe harbour rules do not apply on a change of partners, the entering partner will have a cost base for the partnership interests acquired that is based on the amount paid, or the amount they are treated as having paid, for the interests. In this case, it is possible for the entering partner's cost base, as a proportion of the total of the cost bases of all partners, to be greater than the entering partner's partnership share. For example, on acquiring a one-third interest in a partnership, $20 of the purchase price for the partnership interest might be allocated to the acquisition of a one-third interest in an item of property owned by the partnership (based on the current market value of the property). The continuing partners', who now also each have a one-third interest in the property, might each have a cost base for their one-third interest of $10.

Deductions for exiting and entering partners

139. Where partners change during the partnership's income year, the entering and exiting partners can choose whether the exiting or entering partners will claim deductions for some or all the expenditure or loss incurred in the income year before the change in partners. This allows an entering partner to claim a deduction despite not being a partner when the expenditure or loss was incurred. However, other deductibility tests must be met, and only one of the partners can claim a deduction for such expenditure.[59]

[59] Section HG 2(3). *Tax Information Bulletin* Vol 20, No 8 (September/October 2008): at 6.

Final dissolution

140. The following applies when a partnership is finally dissolved by agreement of the partners, court order, or otherwise, and the partnership's business will not continue to be carried on in partnership.

141. When the partnership is finally dissolved, a partner will generally:

- sell their partner's interests in the partnership property to an unassociated third party;
- keep their interest (and potentially acquire other partners' interests); or
- sell their partner's interest to an associated party (which might include a new partnership or other business structure).

142. Subject to two exclusions, s HG 4 ensures the partner's interests,[60] if not actually disposed of for market value, are treated as such. It does this by treating a partner as:[61]

- disposing of all their partner's interests in the partnership, immediately before the dissolution, to a (notional) single third party for a payment equal to the interests' market value; and
- re-acquiring all their partner's interests immediately after the dissolution, from the third party for a payment equal to the interests' market value.

143. Where the above treatment applies, actual amounts the partner receives in relation to the final dissolution of the partnership are ignored.[62] The tax effects of dissolution are determined based on the deemed disposal and reacquisition described above.

144. As noted above, s HG 4 is subject to two exclusions.

First exclusion to s HG 4

145. The first exclusion is that s HG 4 does not apply to the extent that a partner disposes of their interest to an unassociated third party.[63] With these disposals, the partner accounts for tax based on the amounts that they receive, which are assumed to be market values. This is illustrated in Example | Tauira 7.

[60] "Partner's interests" means the relevant interests in rights and obligations and other property, status, and things a partner has as a result of applying s HG 2.

[61] Section HG 4(2).

[62] Section HG 4(3).

[63] Section HG 4(4).

Example | Tauira 7 - Sale to non-associated party

Facts

Partnership A has two partners, Partners 1 and 2, with equal partnership shares. The partners decide to sell the partnership business to Company A for $300,000 and dissolve the partnership. Neither partner is associated with Company A.

Tax treatment

Because the partnership is dissolved and will not continue to be carried on in partnership the safe harbour rules do not apply.

Also, because the partners have sold their partner's interests to a person who is not associated with them, s HG 4 does not apply.

The partners need to account for tax on the disposal based on the $300,000 sale price they received for the business.

After allocating the sale price to various partnership assets, the partners determine that they have depreciation recovery income and income from the sale of trading stock. The question of how a global purchase price is allocated to particular assets is a separate topic outside the scope of this statement.[64]

Variation

This variation uses the same facts as above except the partners are associated with Company A and Company A pays the partners only $260,000, despite the market value being $300,000.

Tax treatment

Section HG 4 applies to treat the partners as disposing of their partner's interests for market value. The $260,000 amount they receive from Company A would be ignored.

Where one partner acquires the interests of the other partners

146. The first exclusion to s HG 4 applies, in the case of a general partnership, where one partner acquires the partner's interests of the other partners so there are no longer two or more partners, and therefore there is a dissolution of the partnership by operation of law. A general partnership must have two or more partners.[65]

[64] Guidance on purchase price allocation rules is provided in *Tax Information Bulletin* Vol 33, No 6 (July 2021): 28.

[65] A limited partnership can have one limited partner. However, it must also have a general partner.

147. In this situation, the partner that acquires the other partners' interests is also treated as disposing of their own interests. The definition of "dispose" in s YA 1, for a partner, includes surrendering or extinguishing some or all of their partner's interests. In this situation, the partner's interests in the partnership property are extinguished because the interests have fundamentally changed from being an undivided share in the property to the exclusive ownership of the property. Further, although the definition of dispose excludes the situation where a partner's interests may be treated as disposed of by operation of law because another partner disposes of that partner's interests, the definition provides that this does not apply on the final dissolution of a partnership when the partnership's business will not continue to be carried on in partnership. In this situation, generally, the partner who acquires the other partners' interests should treat their own partner's interests as having been disposed of for market value. This is illustrated in Example | Tauira 8.

Example | Tauira 8 - Partner acquiring other partners' interests

Facts

Partnership A has two partners, partners 1 and 2, with equal partnership shares. Partner 1 wishes to retire, so the partners agree that partner 2 will purchase partner 1's partner's interests. Partners 1 and 2 are not associated. One of the partnership assets is residential land that was acquired with the intention of disposal in terms of s CB 6.

Tax treatment

The purchase causes a final dissolution of the partnership because only one partner remains.

Because the partnership is dissolved and the partnership business will not continue to be carried on in partnership, the safe harbour rules do not apply.

Also, because partner 1 sold their partner's interests to a person who is not associated with them, s HG 4 does not apply.

However, because the partnership is finally dissolved and the partnership business will not continue to be carried on in partnership, both partners are treated as having disposed of their partner's interest. The definition of "dispose" in the ITA applies to this situation.

The result is that partner 1 needs to account for tax on the disposal of their partner's interest based on the amount they receive from partner 2.

Partner 2 also needs to account for tax on the disposal of their partner's interest. Partner 2 should treat the disposal as having occurred at market value.

After allocating the disposal amounts to the various partnership assets, the partners return income from the disposal of their interests, including income derived under s CB 6 from the disposal of the land acquired with the intention of disposal.

Partner 2's future cost base is the total of the amount paid to partner 1 and an amount equal to the market value of partner 2's partner's interest on disposal.

Bright-line test

The bright-line test in s CB 6A does not apply in this example because the disposal of the land is covered by s CB 6 (Disposal: land acquired for purpose or with intention of disposal). Section CB 6A does not apply if any of the land rules in ss CB 6 to CB 12 apply.

However, if the bright-line test did apply (if, among other things, there was no evidence of an intention of disposal for the land), it would be necessary to consider whether partner 2 would be eligible for rollover relief in relation to the disposal of the interest in land that was part of their partner's interest. The disposal of this interest in land is a transfer to self that would potentially be covered by ss CB 6AB(4), FC 9B(c) and FC 9C. The application of the bright-line rules to partnerships is outside the scope of this statement, so is not discussed further.

Second exclusion to s HG 4

148. The second exclusion is provided for partnerships of partners who are married to each other, in a civil union together, or in a de facto relationship together. This exclusion applies if:[66]

- immediately before the dissolution, there are only two partners of the partnership and they are married to each other, in a civil union together, or in a de facto relationship together; and
- the dissolution of the partnership:
  - is caused by death of a partner; or
  - relates to the settlement of relationship property; and
- on dissolution, all partner's interests of one partner are transferred to the other person (ignoring any intervening transfer to an executor or administrator); and
- the transfers of those partner's interests are subject to provisions in subparts FB or subpart FC (which relate to transfers of relationship property and gifts,

[66] Section HG 4(5).

respectively), and those provisions treat the transfers as disposals for amounts that are not the interests' market values.

149. This means, in the case of death for example, where the surviving partner inherits the deceased partner's interests, there is a tax base rollover[67] in relation to both the:

- deceased partner's interest that the surviving partner inherits; and
- surviving partner's own partner's interest.

150. When the partnership rules were first introduced, in the case of death, the tax base rollover applied only to the deceased partner's interest.[68] Despite that relief, the surviving partner potentially had to account for tax on the disposal of their own partner's interest caused by the dissolution of the partnership. This was seen as inappropriate,[69] so tax base rollover relief was extended to the surviving partner's interest as well.[70] This is illustrated in Example | Tauira 9.

Example | Tauira 9 - Dissolution on death of a partner

Facts

Partner 1, a partner of partnership A, dies. Before partner 1's death, partnership A had two partners, partners 1 and 2.

Partners 1 and 2 were in a de facto relationship. After partner 1's death, partner 2 decides to carry on the business herself.

Tax treatment

Partner 1's death results in the dissolution of the partnership.

The executor of partner 1's estate distributes all partner 1's partner's interests to partner 2. This distribution is treated as a transfer of property under a settlement of relationship property under subpart FB.[71] In this case, because of the nature of the property (trading stock), partner 1's partner's interests are treated as being transferred at the original cost to the partnership.

[67] This means they do not have to account for tax on this disposal event, but they may need to account for tax when the asset is subsequently disposed.

[68] New legislation: Taxation (Limited Partnerships) Act 2008 *Tax Information Bulletin* Vol 20, No 8 (September/October 2008): 4, at 8.

[69] Until the property is sold by the surviving partner to a third party, the surviving partner may not have the cash to pay for any liability arising from a deemed disposal on dissolution of the partnership.

[70] Section 270 of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009.

[71] Subpart FB normally only applies where there is a settlement under a relationship property agreement, but s FC 3(2) treats a transfer by an executor like in this example as if it was a transfer of property under a settlement of relationship property under subpart FB.

The transfer of the property is not subject to s HG 4(2). The exclusion in s HG 4(5) applies.

Partner 2 will hold what were partner 1's partner's interests on the same basis as they were held by partner 1. Partner 2 is treated as having the same cost as partner 1, having acquired the property on the same date as partner 1, and holding the property with the same status, intention and purpose as partner 1. If partner 2 subsequently sells the property, she will need to account for any tax on the sale.

Withholding tax considerations for payment made by a partnership

151. The following is about the withholding tax obligations that arise for payments made **by a partnership**.

PAYE on payments made by a partnership

One employer

152. The transparent tax treatment of partnerships is modified for the purposes of determining the frequency with which a partnership, as an employer, must pay PAYE deductions to the Commissioner.

153. In the PAYE rules, s RD 4 specifies when, and with what frequency, an employer must pay PAYE deductions to the Commissioner. Under s RD 4(2)(a), an employer must pay amounts to the Commissioner monthly if the employer has, in the relevant tax year,[72] gross amounts of tax of less than $500,000 withheld under s RA 5(1)(a) and (c) (which includes PAYE, fringe benefit tax (FBT) and employer's superannuation contribution tax (ESCT).

154. The transparent tax treatment of partnerships under s HG 2 would result in a dilution of the threshold in s RD 4(2)(a) as each partner would be treated as withholding a portion of the PAYE. However, s RD 4(6)(b) avoids the dilution by providing that for the purposes of s RD 4, all the partners in a partnership are treated as one employer.[73]

[72] The current tax year for new employers or the previous tax year otherwise.

[73] Section RD 4(6).

Liability

155. Where a partnership makes a PAYE income payment, the liability to withhold and pay PAYE to the Commissioner falls on:

- in a general partnership, all the partners; and
- in a limited partnership, the general partners.

156. The liability to withhold and pay PAYE to the Commissioner is imposed on an employer. "Employer" in this context means a person who is liable to pay a PAYE income payment.[74] This includes all partners of a general partnership (as all partners are jointly liable under a contract of employment or service entered in the name of the partnership[75]) and the general partners of a limited partnership.

157. A person will be liable for the PAYE of a partnership only if the liability to pay PAYE arose while they were a partner.[76] This means a person who joins an existing partnership is not liable for PAYE withheld before they joined the partnership. It also means a person who has ceased being a partner can be liable for PAYE withheld before they ceased being a partner.

158. The same treatment applies for the purposes of Fringe Benefit Tax (FBT) and Employer's superannuation contribution tax (ESCT) as these taxes are also applied to an employer.

Resident withholding tax and non-resident withholding tax on payments made by a partnership

159. The resident withholding tax (RWT) and non-resident withholding tax (NRWT) rules apply to a person who pays an amount of resident passive income or non-resident passive income, respectively. These rules apply to a partnership (general or limited) that pays such amounts.[77]

160. A partnership might pay an amount of resident or non-resident passive income if, for example, it has borrowed money and is paying interest on the amount borrowed. A partnership may also pay an amount of non-resident passive income if it pays a royalty

[74] Section YA 1.

[75] Section 22(1) of the PLA.

[76] Section 22(1) of the PLA.

[77] The question of whether the RWT and NRWT rules apply to a partnership paying an amount or to the partners of a partnership paying an amount appears to be academic. In any event, the partners of the partnership are jointly liable to withhold and pay RWT and NRWT to the Commissioner if the partnership or partners pay an amount that requires withholding.

that has a source in New Zealand.[78] A partnership cannot pay a dividend because a partnership is not a company.[79]

161. For there to be an obligation to withhold RWT, the payer of an amount must:[80]

- be resident in New Zealand; or
- carry on a "taxable activity"[81] in New Zealand through a fixed establishment in New Zealand.

162. Residency is not a concept that applies to a partnership (no residency tests exist for partnerships).[82] Further, the residency of the partners of a partnership may vary. However, it is considered a partnership (and, through s HG 2, the partners of a partnership) can carry on a taxable activity in New Zealand and have a fixed establishment. This applies to both general and limited partnerships. Therefore, a partnership can have an obligation to withhold RWT.

163. For an obligation to withhold NRWT to exist there must be a payment of non-resident passive income. There is no requirement for the payer to be resident or to carry on a taxable activity, as there is for RWT. However, for an amount to be non-resident passive income, the income must have a source in New Zealand.

164. Interest income has a source in New Zealand if it relates to money that is lent in New Zealand. Therefore, a partnership can have an obligation to withhold NRWT if it is paying interest to a non-resident on an amount the partnership borrowed in New Zealand.

165. The obligation to withhold and the liability to pay RWT or NRWT to the Commissioner is a partnership obligation and liability. This is because it arises from the business carried on by the partnership.

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[78] A royalty has a source in New Zealand if it is paid by a New Zealand resident and is not paid in connection with a business the New Zealand resident carries on outside New Zealand through a fixed establishment outside New Zealand. Under s YD 4(17B), income has a source in New Zealand if, treating all of the partners of a "New Zealand partnership" as resident in New Zealand, the income is treated as having a source in New Zealand under another provision of this section. "New Zealand partnership" is defined in s YA 1. This source rule and the definition of New Zealand partnership is discussed later in this statement. The royalty source rule is one of the other provisions in s YD 4 that the partnership rule can apply to. The combination of the two rules can result in a payment by a "New Zealand partnership" being treated as sourced in New Zealand.

[79] Although a limited partnership is a corporate entity, the definition of company excludes all partnerships, including limited partnerships.

[80] Section RE 4(2).

[81] The ITA makes use of the GST definition of "taxable activity" for the withholding tax purposes. This does not mean that person A must be a registered person or be carrying on a taxable activity for GST purposes.

[82] Residence is discussed further from [192].

166. In the case of a general partnership, every partner is liable jointly with the other partners for all debts and obligations of the partnership (including withholding and paying RWT or NRWT). However, a partner is liable only if the debts or obligations are incurred while the partner is a partner.[83] Joint liability means one of the partners could be liable for the whole amount if something were to happen to the other partners. Joint liability can be contrasted with several liability where liability is limited to a share of a debt.[84]

167. In the case of a limited partnership, each general partner (if there is more than one) is jointly and severally liable with the limited partnership and the other general partners (if any) for the unpaid debts and liabilities of the limited partnership (including RWT and NRWT). A general partner is liable only if the debts or obligations are incurred while the partner is a partner.[85] Further, a general partner is liable only to the extent that the limited partnership cannot pay those debts or liabilities. A limited partner who does not take part in the management of the limited partnership is not liable for the debts and liabilities of the limited partnership.

Association

168. A common question that arises in many provisions in the ITA is whether two persons are associated with each other for tax purposes. This section discusses associated person rules as they apply to partners and partnerships.

169. Association is relevant for partners generally because many taxing provisions, which are applied at the partner level, involve association requirements. For example, in the land provisions it may be necessary to determine whether a partner is associated with another person. Some specific partnership rules also involve association requirements, for example, association is relevant to the extent to which s HG 4 applies on the final dissolution of a partnership.

Association between a partner and the partnership

170. A partner and a partnership can be associated. The test of association differs for general and limited partnerships.

171. Association between a partner and a partnership is relevant because, under the tripartite relationship test (discussed at [186]), by being associated with the partnership, a partner can be associated with a person with whom the partnership is

[83] Section 22(1) of the PLA.

[84] An example of several liability is in s 22(2) of the PLA, which deals with the liability of the estate of a deceased partner.

[85] Section 26(1) of the LPA.

associated. For example, if a partner is associated with a partnership and the partnership is associated with a company in which the partnership holds shares, then under the tripartite relationship test the partner may also be associated with the company.

General partnership

172. A general partnership and a partner of the partnership are associated persons.[86] This is so, regardless of the size of the partner's partnership share.

Limited partnership

173. A limited partnership and a general partner of the limited partnership are associated persons.[87]

174. A limited partnership and a limited partner are associated only if an ownership threshold is met. An association exists if a limited partner has a partnership share of 25% or more in a right, obligation, or other property, status or thing of the limited partnership.[88]

175. In determining whether the 25% threshold is met, the partnership shares of a limited partner and a person associated with the limited partner can be aggregated.[89] The aggregation rule is designed to prevent the association test being circumvented by placing partnership share in the hands of an associated person.

176. The aggregation rule states that if a person (person A) and another person (person B) are associated under certain association tests, person A is treated as holding anything held by person B. This aggregation rule can have two related effects:

- It can result in persons A and B satisfying the 25% threshold for association with the partnership, by adding together the partnership shares of persons A and B, even if person A or person B would not, on their own, satisfy the threshold. This is illustrated in Diagram | Hoahoa 3.

[86] Section YB 12(1).

[87] Section YB 12(1). Section YB 12(1) applies to associate a partnership and a partner in the partnership. "Partnership" is defined as including a limited partnership. However, s YB 12(2) states that subs (1) does not apply if the partner is a limited partner and then sets out a test for associating a limited partner with the limited partnership. The exclusion in subs (2) applies only to limited partners, not general partners. Therefore, a general partner is associated with a limited partnership under subs (1).

[88] Section YB 12(2).

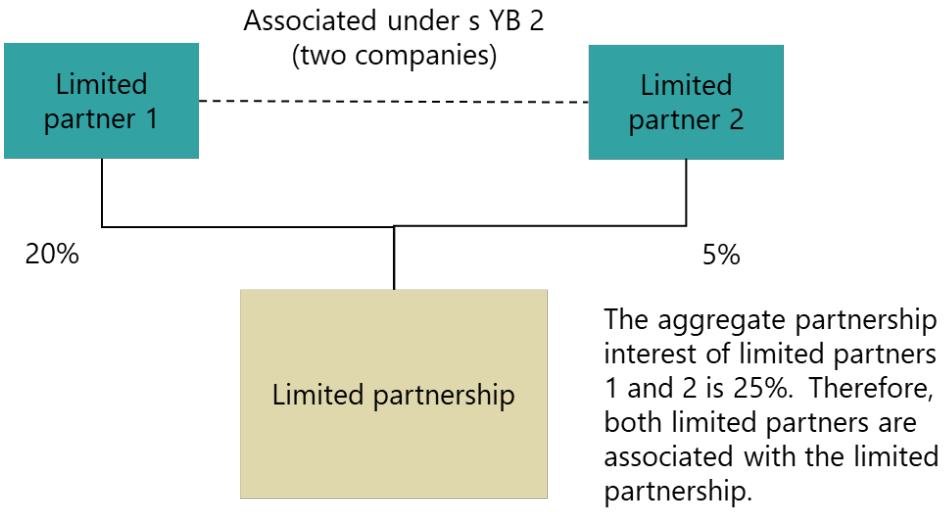
[89] Section YB 12(3). A slightly different aggregation rule in s YB 12(4) applies for the purposes of association under the land provisions.

- It can extend association with a partnership to an associate of a partner, even if the associate has no partnership share, provided the 25% threshold is satisfied by the partner or partners with whom association is established. This is illustrated in Diagram | Hoahoa 4.[90]

177. The aggregation rule is applied afresh to each party in a given scenario. Therefore, where the requirements of the aggregation rule are satisfied, both parties are each treated as holding the partnership shares that the other holds (if any) in addition to their own partnership shares (if any).

178. It is noted that person A or person B may be a partner of the partnership, or partners or look-through owners of another partner of the partnership, if that other partner is itself a partnership or a look-through company, respectively. This is illustrated in Diagram | Hoahoa 5.

Diagram | Hoahoa 3 – Limited partnership association – aggregation rule



[90] The two related effects are reflected in the New definitions of associated persons (special report, Policy Advice Division, Inland Revenue, October 2009). The special report describes (at 24) the partnership aggregation test as similar to the company and person other than a company aggregation test in s YB 3. Examples (at 10 to 12) for the company and person other than a company aggregation test show the two related effects.

Diagram | Hoahoa 4 – Limited partnership association - aggregation rule, extension effect

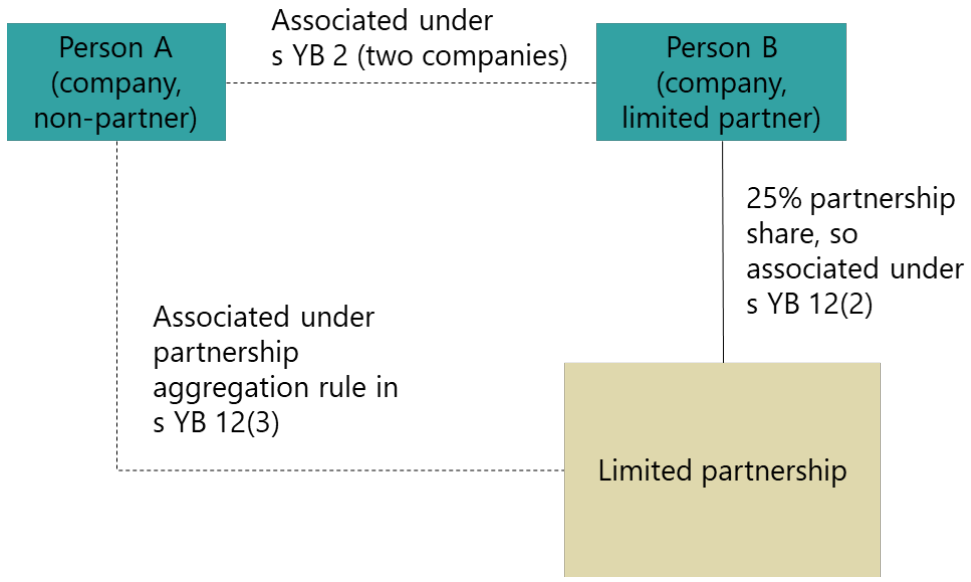
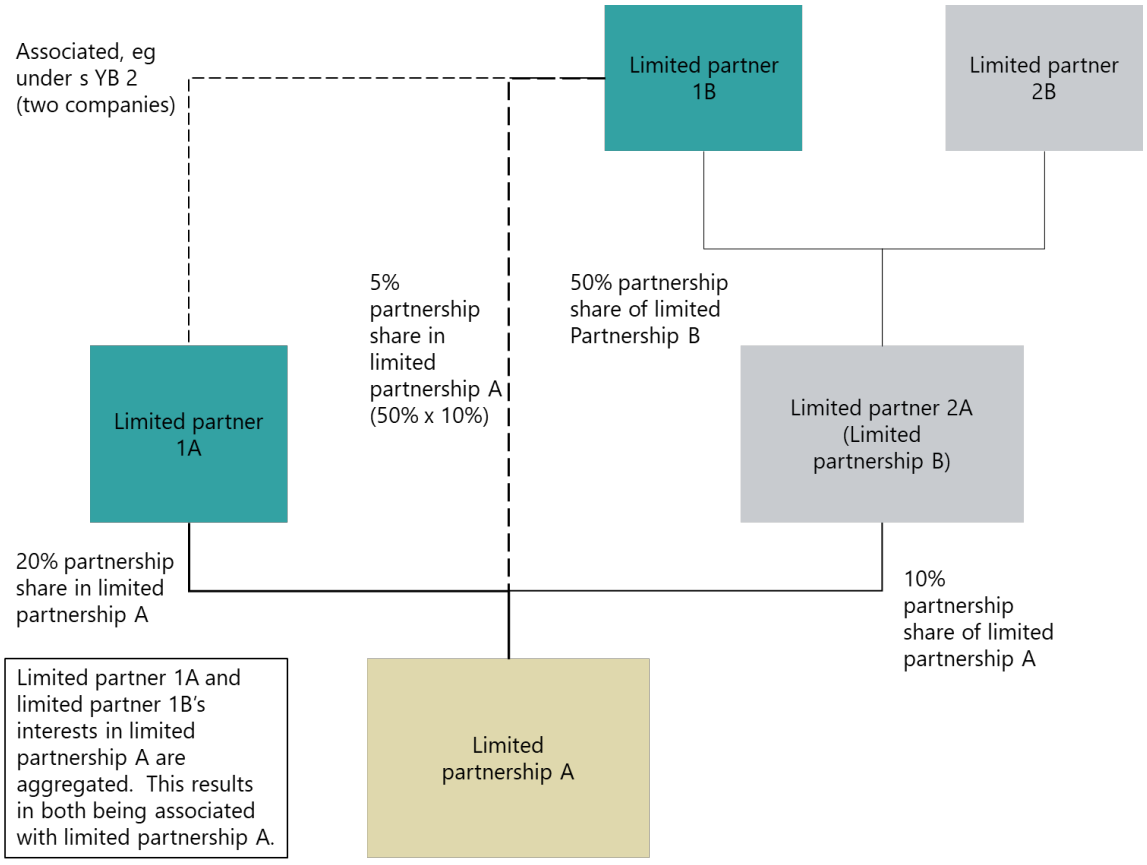


Diagram | Hoahoa 5 – Limited partnership aggregation – with look-through partner



Association between partners

179. Two partners of a partnership (a general or limited partnership) are not associated with each other merely because they are both partners of the partnership. Although both partners may be associated with the partnership, the tripartite relationship test (discussed below) does not apply to associate each partner because it would require the same test of association to be applied twice.[91]

180. Two partners can be associated with each other under other associated person tests, for example if the two partners are within two degrees of blood relationship.[92]

Association through holding partnership property

181. A partnership may be associated with a company under s YB 3 by holding voting or market value interests in the company of 25% or more.[93]

182. For the purposes of s YB 3, s HG 2 does not treat the partners of a partnership as holding the voting or market value interests in a company that are held by the partnership. Section HG 2 applies to a section in the ITA only if the context does not require otherwise. The context of s YB 3 requires otherwise. Part of this context is the existence of the associated person test in s YB 12. The test in s YB 12 would have limited application if partnerships were not sometimes associated with another person.

183. However, s YB 12 works with the tripartite relationship test in s YB 14 (discussed at [186]) to associate a partner with a person with whom the partnership is associated, which could include a company owned by the partnership.

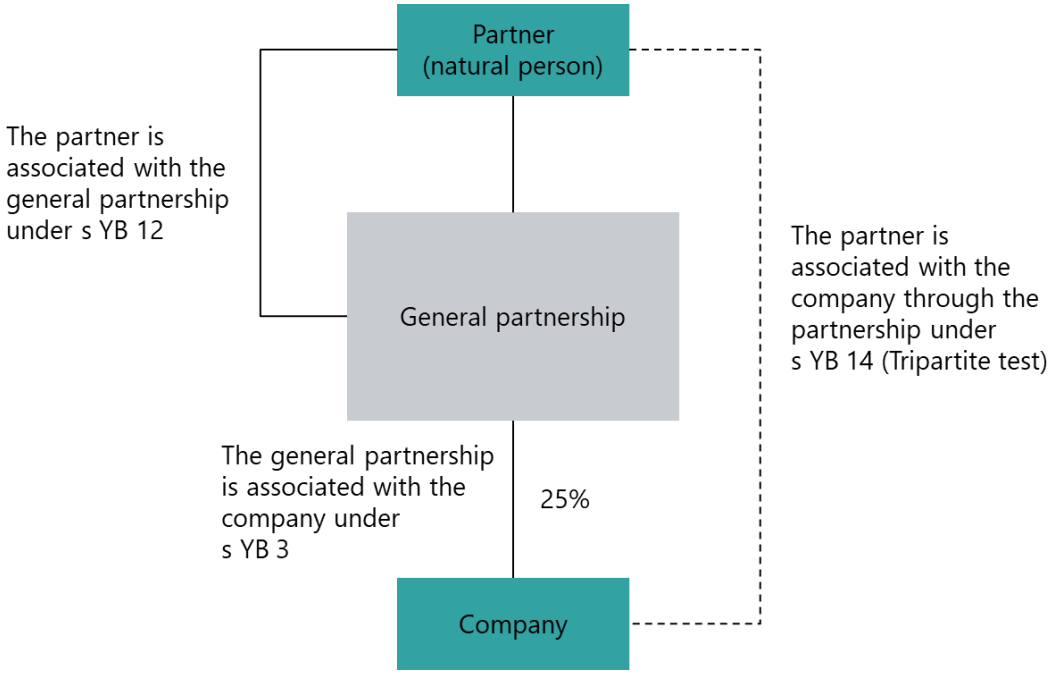
184. Where a partnership is associated with a company on this basis, a partner of the partnership can, under the tripartite relationship test, also be associated with the company through their association with the partnership. This is illustrated in Diagram | Hoahoa 6.

[91] Section YB 12(1)(b).

[92] Section YB 4(1)(a).

[93] This is consistent with A guide to associated persons definitions for income tax purposes – IR620 (guide, April 2017).

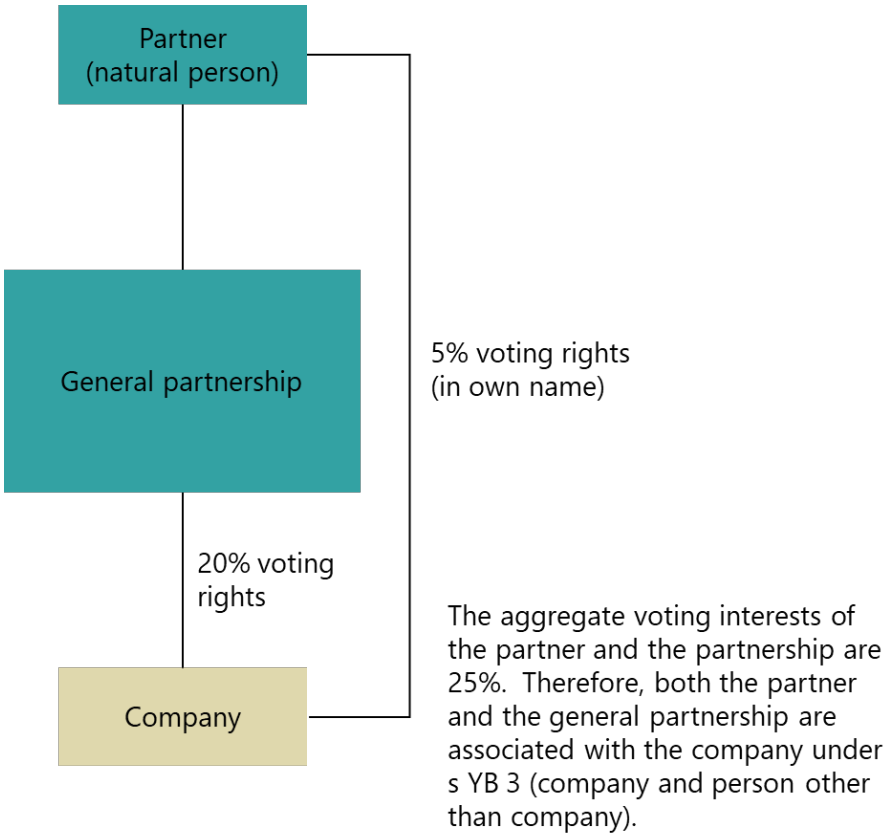
Diagram | Hoahoa 6 – Tripartite association



185. Where a partner of a general partnership holds voting or market value interests in a company in their own name, these interests are aggregated with interests in the company held by the general partnership.[94] This could result in both the partner and the partnership being associated with the company. This is illustrated in Diagram | Hoahoa 7 and Example | Tauira 10 – Aggregation rule.

[94] Under s YB 3(3).

Diagram | Hoahoa 7 – Company and person other than company aggregation – interests held by partnership and a partner in their own name



Example | Tauira 10 – Aggregation rule

Facts

General partnership A holds 15% of the shares in a company. Two of partnership A's partners, partners 1 and 2 (both natural persons), also each hold (in their own names, not through the partnership) 5% of the shares in the company.

Tax treatment

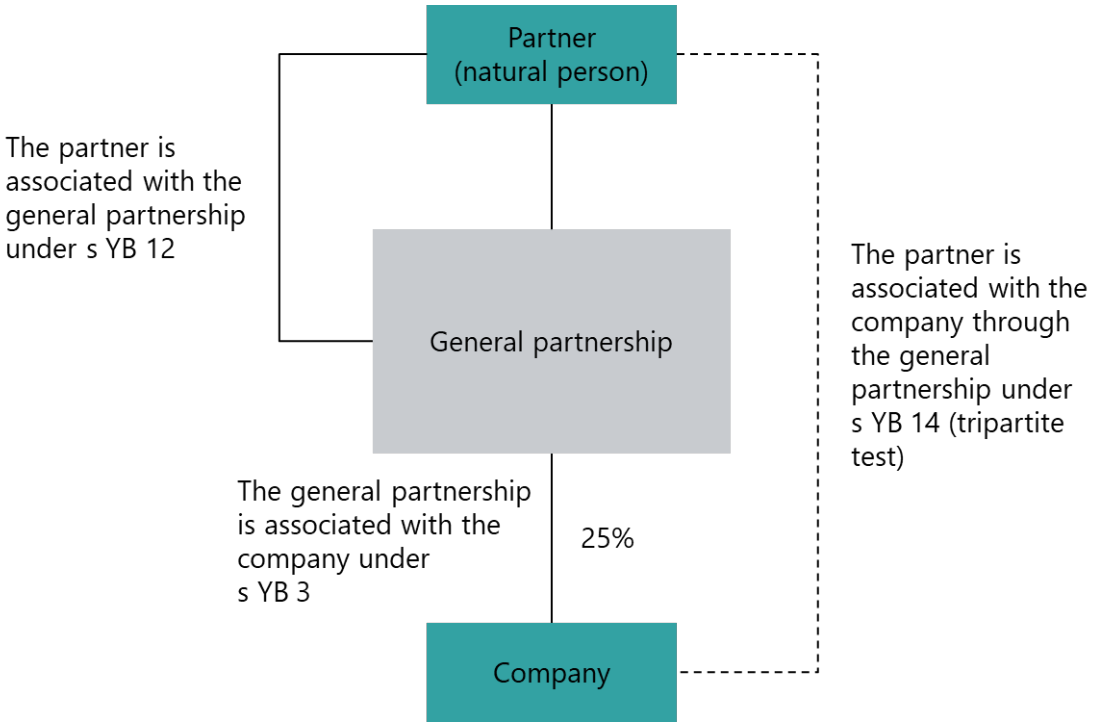
Individually, none of partnership A, partner 1 or partner 2 is associated with the company, but because of the aggregation rule, all three are treated as holding 25% voting rights in the company, so all three are associated with the company under s YB 3 (company and person other than company).

Association through the tripartite relationship test

186. If a partnership and a partner are associated, then under the tripartite relationship test the following may arise:

- A partner and a person that the partnership is associated with can be associated. For example, a partner of a general partnership will be associated with a company if the partnership holds voting interests of 25% or more in the company. This is illustrated in Diagram | Hoahoa 8.
- The partnership and a person that a partner is associated with can be associated.[95] For example, a general partnership can be associated with a company that is associated with a partner of the general partnership under s YB 2 (two companies). This could be relevant to association under the land rules where the partnership, for example, is carrying on a business of dealing in land.

Diagram | Hoahoa 8 – Tripartite association – partner and company owned by general partnership



187. The tripartite relationship test contains a special rule for limited partnerships that is intended to prevent associations involving small ownership interests. The rule achieves this by treating a limited partnership as a company for the purposes of the tripartite relationship test.[96] This, in combination with another rule, prevents association from occurring. The other rule is that the tripartite relationship test does not apply to a tripartite scenario where both "legs" of association would rely on the same test of

[95] A limited partnership and a person a limited partner is associated with might also be directly associated under the partnership aggregation rule in s YB 12(3) or (4).

[96] Section YB 14(4).

association.[97] The operation of this combination of rules is seen in the following two scenarios.

188. In the first scenario, a limited partner that is a company is not associated under the tripartite relationship test with a company owned by the limited partnership through the partner's partnership share in the limited partnership.[98]

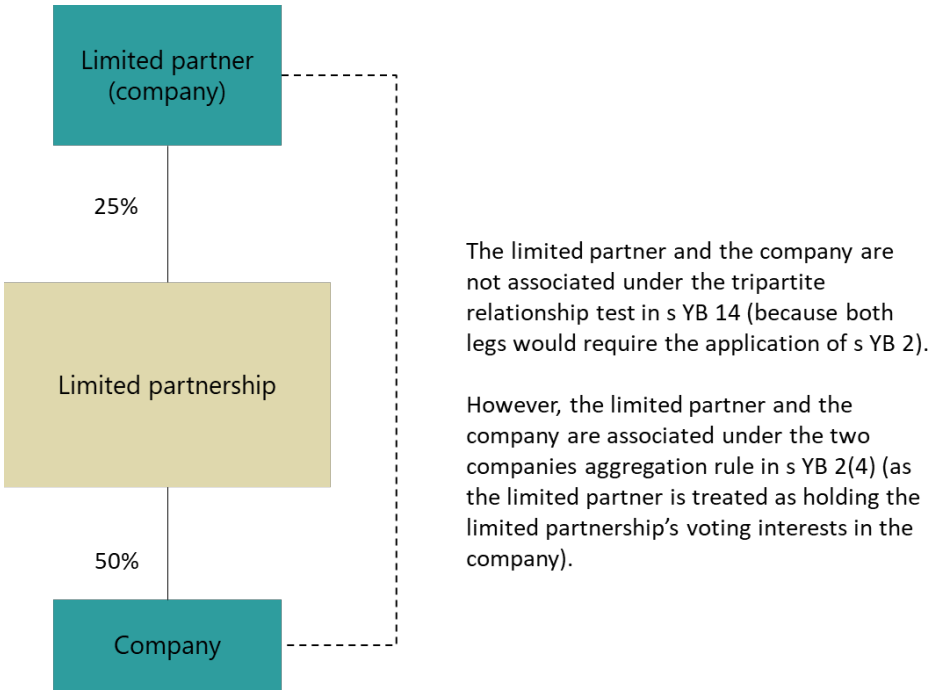
189. In the absence of the special rule treating a limited partnership as a company, if a limited partner company had a 25% partnership share in a limited partnership and the limited partnership held 25% of the voting interests in a company, the limited partner and the company would be treated as associated under the tripartite test in s YB 14(1). This is because the limited partner would be associated with the limited partnership under s YB 12(2), and the limited partnership would be associated with the company under s YB 3. Further, each leg of association would rely on a separate test of association, so the tripartite relationship test could apply. This association under the tripartite relationship test would result, despite the limited partner having an effective indirect interest of only 6.25% in the company.

190. However, in this first scenario, the special rule treating a limited partnership as a company prevents association under the tripartite relationship test. Treating the limited partnership as a company results in all three persons in the scenario being a company, which results in both legs of association being based on the same test (s YB 2 (two companies)), which prevents association under the tripartite relationship test. The relief s YB 14(4) provides in this scenario is limited however, as a limited partner could be associated with a company owned by the limited partnership under the two-companies aggregation rule in s YB 2(4). This is illustrated in Diagram | Hoahoa 9.

[97] Section YB 14(1)(b).

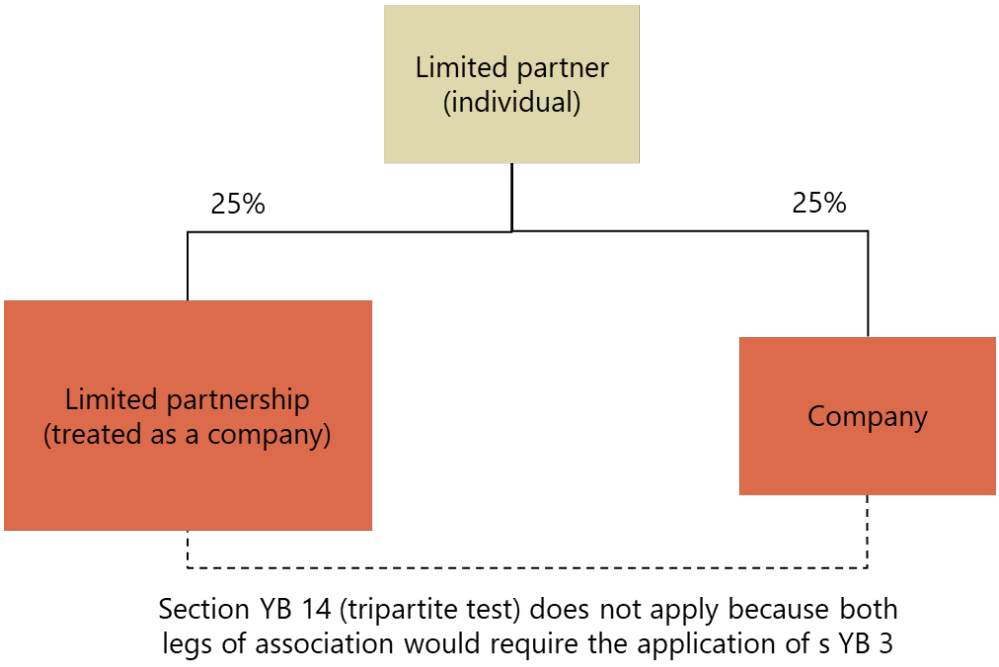
[98] The partner might still be associated under s YB 2 if there is a group of persons whose voting or market value interests in both the partner and the company is 50% or more.

Diagram | Hoahoa 9 – Company partner associated with company owned by partnership



191. In the second scenario, a limited partnership and a company are not associated where a single person (a natural person or company) holds a partnership share of 25% or more in the limited partnership and voting or market value interests of 25% or more in the company. This is illustrated in Diagram | Hoahoa 10.

Diagram | Hoahoa 10 – Limited partner and company not associated through a limited partner or shareholder



Residency

192. Given the transparent income tax treatment of partnerships, residency is generally relevant to the partners of a partnership, not to the partnership itself. Consistent with this, no residency tests exist for general or limited partnerships.

193. A general partnership is not an entity in its own right; it is a relationship between partners. Because it is not an entity, a general partnership does not fall within any of the residency tests in the ITA.

194. A limited partnership is a separate legal entity. However, partnerships (including limited partnerships) are excluded from the definition of company in section YA 1. Therefore, the company residency tests do not apply to a limited partnership.

195. A limited partnership is not resident in New Zealand merely because it is incorporated or registered in New Zealand. Residency is determined by the residency tests, which do not apply to partnerships.

196. A partnership is not resident in New Zealand merely because it comes within the definition of "New Zealand partnership" in s YA 1 (discussed at [210]). This definition applies only for the purposes of the source rules to determine whether an amount has a source in New Zealand.

197. Although partnerships do not have residency status, a partner of a partnership may have a residency status (unless it is also a partnership).

198. A partner's residency is determined by applying the normal residency rules to the partner having regard to their individual circumstances. The partner's residency is not determined by their capacity as a partner.[99]

199. A partner's residency can affect the partner's tax obligations and liabilities in their capacity as a partner. For example, a partner who is non-resident will only be liable for tax on income derived in their capacity as a partner if the income has a New Zealand source.

[99] However, a person's economic interests and business connections can be relevant factors in determining whether a person has a permanent place of abode, which is relevant for the residency of a natural person. See IS 16/03 Tax Residence (20 September 2016) *Tax Information Bulletin* Vol 28, No 10 (October 2016) taxtechnical.ird.govt.nz/interpretation-statements/is-1603-tax-residence

Source

Partners derive income from sources directly

200. Given the transparent income tax treatment of partnerships, the source of an amount is generally relevant to the partners of a partnership, not to the partnership itself.

201. Partners are treated under s HG 2 as carrying on the business carried on by the partnership, as holding property that is held by the partnership and as being entitled to a thing that the partnership is entitled to in proportion to their partnership shares. This means that partners are treated as deriving income directly, in proportion to their partnership share of partnership income.

202. An amount of income that a partner has by virtue of s HG 2 may have a source in New Zealand under the general source rules in s YD 4 (classes of income treated as having New Zealand source). The source of income for a partner is the same as the source of the income that the partnership would have had in the absence of s HG 2.

203. The amount of income a partner has from a particular source is calculated by multiplying the total income the partnership has from that source by the partner's partnership share in the partnership's income.[100]

204. Income derived from a business has a source in New Zealand if the business is:[101]

- wholly carried on in New Zealand; or
- partly carried on in New Zealand, to the extent to which the income is apportioned to New Zealand under s YD 5.

205. This income, in the hands of each partner, has a source in New Zealand for the purpose of determining each partner's assessable income. Income with a source in New Zealand may be included in a non-resident's assessable income, which may result in an income tax liability for the non-resident.

[100] Section HG 2(2) (no streaming). See from [54].

[101] Section YD 4(2).

Special rule for partnerships where source rules are dependent on the residence of a payer

206. A special source rule is provided in s YD 4(17B) for partnerships. The rule in s YD 4(17B) works with other source rules in s YD 4 that are dependent on the payer of an amount being resident in New Zealand.[102]

207. For example, the source rules in s YD 4 treat the following types of income, with some exceptions, as having a source in New Zealand:

- interest or a redemption payment derived from money lent outside New Zealand to a New Zealand resident;[103]
- a royalty payment made by a New Zealand resident;[104] and
- a payment for the use of personal property paid by a New Zealand resident.[105]

208. When a partnership includes only New Zealand partners it is clear that payments of interest, royalties and rents from a partnership have a New Zealand source. However, the question is how to deal with payments by New Zealand partnerships that include New Zealand and non-resident partners.

209. Section s YD 4(17B) partly addresses this question by treating all partners of a "New Zealand partnership" (discussed at [210]) as resident in New Zealand for the purposes of the source rules (even if some partners are non-resident). This will result in a payment being fully sourced in New Zealand with no apportionment required.

210. "New Zealand partnership" is defined in s YA 1. It means a partnership that:

- is a limited partnership registered under the LPA; or
- has 50% or more of its partners' interests in capital,[106] by value, held by New Zealand residents; or
- has its centre of management in New Zealand ignoring s HG 2.

211. If a partnership is not a New Zealand partnership, and has resident and non-resident partners, an apportionment is required for payments of interest, royalties and rents to

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[102] Section YD 4(17B) was introduced in response to an issue identified by the Valabh Committee (the Consultative Committee on the Taxation of Income from Capital, appointed in 1989 and chaired by Arthur Valabh). The issue is discussed in General and limited partnerships – proposed tax changes (discussion document, Policy Advice Division, Inland Revenue, June 2006).

[103] Section YD 4(11)(b)(i).

[104] Section YD 4(9)(a).

[105] Section YD 4(8)(a).

[106] In the Commissioner's view, partners' interests in capital refers to the capital contributions of the partners.

determine the extent to which the payments have a source in New Zealand. The Commissioner's view is that the apportionment should be based on the total partnership share in the partnership's income of partners resident in New Zealand.[107] This is illustrated in Example | Tauira 11.

Example | Tauira 11 – Apportionment of royalty paid by a partnership with a source partly in New Zealand

Facts

Partnership A sells products online into Australia and New Zealand. It pays a royalty to an overseas company for intellectual property needed to support its products. The partnership's centre of management is in Australia, and it does not have a permanent establishment in New Zealand.

Partnership A is a general partnership with three partners. Each partner has capital contributions of $100,000 and has equal partnership shares in partnership property and to partnership income. One partner is New Zealand resident, and the other two partners are resident in Australia. The New Zealand partner is not actively involved in the business of the partnership.

Tax treatment

The partnership is not a "New Zealand partnership" because it is not a limited partnership, only one-third (less than 50%) of the partners' interests in capital by value are held by New Zealand residents, and the partnership does not have its centre of management in New Zealand. Therefore, s YD 4(17B) does not apply. Because one of the partners is resident in New Zealand and they have a one-third partnership share in partnership income, one-third of the royalty paid for the use of the intellectual property has a New Zealand source.

Fixed establishments

212. A fixed establishment includes, among other things, a fixed place of business in which substantial business is carried on by a person.

213. Under s HG 2, the partners are treated as carrying on the business of the partnership and as holding property held by the partnership. If a partnership (ignoring transparency under s HG 2) has a fixed place of business in which substantial business

[107] This is consistent with the income tax treatment of the New Zealand partners who will have a deduction for the royalty based on their partnership share in partnership income.

is carried on by the partnership, then under s HG 2 the partners of the partnership will be treated as having a fixed establishment in New Zealand.

214. The same applies for a fixed establishment that is a branch, factory, shop or workshop in which, in each case, substantial business is carried on. Similarly, if the partnership has a mine, oil well, quarry or other place of natural resources subject to exploitation, the partners will be treated under s HG 2 as holding the rights held by the partnership and, therefore, will be treated as having a fixed establishment.

215. This applies to both general and limited partnerships. In the case of limited partnerships, limited partners can be treated as having a fixed establishment as outlined above.

216. Although the management role of the general partner in a limited partnership might seem relevant, the fact that the general partner is a New Zealand resident or the fact that the general partner has a registered address in New Zealand are not determinative of whether there is a fixed establishment. The registered address of the general partner would only be relevant if that was a fixed place of business for the partnership and substantial business was carried on there by the limited partnership.

Example | Tauira 12 – Fixed establishment

Limited partnership A is a limited partnership registered under the LPA.

The general partner of limited partnership A is a company incorporated in New Zealand, so is a New Zealand resident. The general partner has a registered address in New Zealand (the address of its law firm) but does not have any employees. The general partner has one New Zealand resident director, but its other directors are non-resident.

The limited partners of limited partnership A include non-residents.

Limited partnership A's only activity is making passive investments in a New Zealand stock portfolio from which it receives dividend income. Limited partnership A acquires management services as needed from an agent in New Zealand. The directors of the general partner meet via video call to review and approve investment decisions presented by the limited partnership's agent. This does not involve any "substantial business" being carried on in New Zealand.

The limited partners are treated as carrying on the investment activity that is carried on by the limited partnership and as holding any investments that are held by the partnership. However, neither the partnership, nor the partners under s HG 2, are treated as having a fixed establishment in New Zealand.

The fact that the general partner is resident in New Zealand and that it has a registered address in New Zealand do not create a fixed place of business for the partnership or the partners.

Permanent establishments

217. Where a partnership (general or limited partnership) has a permanent establishment in a contracting state, the partners are treated as also having a permanent establishment in that state. This is supported by the Commentary to the OECD Model Tax Convention to Partnerships,[108] which discusses art 5 of the model tax convention (the permanent establishment article). It is also supported by Application of the OECD Model Tax Convention to Partnerships.[109]

Liability of partners as agents

General law

218. In the case of general partnerships, every partner of a general partnership is an agent of the partnership and the other partners for the purpose of the business of the partnership.[110] Partners are jointly liable for the debts and obligations of the partnership incurred while they are a partner.[111]

219. In the case of limited partnerships, a general partner is the agent of the limited partnership for the purposes of the business of the limited partnership.[112] The general partner is liable for unpaid debts and liabilities of the partnership incurred while they are a partner,[113] to the extent the partnership cannot pay those debts or liabilities.[114] Limited partners are not treated as agents for the partnership or the other partners and are not liable for the debts or liabilities, provided they do not take part in the management of the limited partnership.[115]

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[108] *Commentary to the OECD Model Tax Convention to Partnerships* (OECD, Paris, 1999) at [43] and [56].

[109] *Application of the OECD Model Tax Convention to Partnerships* (OECD, Paris, 1999) at R(15)-26 [81].

[110] Section 17 of the PLA.

[111] Section 22 of the PLA.

[112] Section 47 of the LPA.

[113] Section 26 of the LPA.

[114] Section 28 of the LPA.

[115] Sections 31 and 46 of the LPA.

Tax debts

220. The general law described in [218] and [219] applies to a tax debt if the tax debt is a partnership debt. A partnership tax debt will arise, for example, if RWT or NRWT is withheld by a partnership. The partners of a general partnership or a general partner of a limited partnership may be liable for such a debt.

221. In relation to RWT, s RE 30(4) confirms that each partner of a general partnership is jointly and severally liable for the RWT that the general partnership is required to pay.[116] Section RE 30(4) states that this applies "for as long as the member [partner] remains part of the body [general partnership]".

222. The words "for as long as the member remains part of the body" could be interpreted as meaning that a person ceases to be liable for any RWT after they cease being a partner, even if the RWT liability arose while they were a partner. However, the context of s RE 30(4) suggests the words merely limit liability to the liability that arises while the partner is part of the partnership. This is supported by the immediate context of s RE 30(5)(a), which addresses the liability of the estate of a deceased partner. Section RE 30(5)(a) would not be required if liability for all RWT ceased when the partner ceased being part of the partnership.[117] Parliament is unlikely to have intended a person to be released from all liability when exiting a partnership, but still impose liability on the person's estate if, instead of exiting, the person died. This interpretation (that the words limit liability to the liability that arises while the partner remains part of the partnership) is also consistent with the approach taken under the PLA in relation to the liability of a partner for partnership debts (discussed at [218]).

Partner is generally not liable for another partner's income tax liability

223. A partner can be liable for a partnership debt. However, a partnership debt does not include an income tax liability of a partner on their share of partnership income. Therefore, subject to the rule relating to absentee partners discussed below, a partner is not liable for the income tax liability of another partner.

[116] This section applies only if the partnership has RWT-exempt status that relates to a taxable activity carried on by the partnership.

[117] For tax purposes, a partnership does not cease to exist when a partner dies. However, the deceased partner ceases to be a partner.

Absentee partners

224. Special rules apply in the case of absentee partners. This will be relevant for many limited partners of limited partnerships, which are often non-resident foreign companies.

225. Under ss HD 3(2) and HD 20B, a partner may be liable for the income tax obligations of an absentee partner.

226. The following discusses the meaning of "absentee", when a partner is treated as an agent for an absentee partner and the obligations of a partner if they are an agent for an absentee partner.

Meaning of "absentee"

227. "Absentee" is defined in s HD 18(2) for the purposes of subpart HD. Absentee means:

> *Meaning of absentee*
>
> (2) In this subpart, **absentee** means—
>
> (a) a natural person who is for the time being out of New Zealand:
>
> (b) a foreign company, unless it has a fixed and permanent place of business in New Zealand at which it carries on business in its own name:
>
> (c) a foreign company when the Commissioner declares that it is an absentee for the purposes of this Act by giving notice to the company, or its agent or representative in New Zealand.

228. Under this definition, a natural person is an absentee if they are "for the time being" out of New Zealand.

229. The Commissioner's view is that a person will be "for the time being" out of New Zealand if they are outside New Zealand at a time when an obligation is due to be performed. For example, a person will be "for the time being" out of New Zealand if they are outside New Zealand when they are due to file a return of income. This interpretation of the words "for the time being" is supported by the context of the agency rules, which requires an agent of an absentee to perform obligations.

230. The Commissioner's view is that a person can be an "absentee" regardless of whether they have previously been in New Zealand. This is despite some senses in which the word is used (under the ordinary meaning) that suggest an absentee is a person who is not where they have been in the past.[118] "Absentee" is specifically defined in

[118] *Shorter Oxford English Dictionary* (6th ed, 2007, Oxford University Press).

s HD 18(2). The definition in s HD 18(2) and the wider context do not indicate that absentee is used in the sense of a person who is not where they have been in the past.

231. A partner that is a foreign company will be an absentee unless it has a fixed and permanent place of business in New Zealand at which it carries on business "in its own name".

232. A "foreign company" is a company that is:[119]

- not resident in New Zealand; or
- treated under a double tax agreement as not being resident in New Zealand.

233. The requirement for a foreign company to carry on the business "in its own name" is significant because a partner can have a fixed and permanent establishment in New Zealand by being treated as carrying on the business that is carried on by the partnership in New Zealand. However, this business will be carried on in the name of the partnership, not in the name of the foreign company. The foreign company must carry on a separate business to satisfy this requirement.

234. The Commissioner can also declare a foreign company to be an absentee by giving notice to the company or its agent or representative in New Zealand. The Commissioner can do this whether or not the foreign company has a fixed and permanent place of business in New Zealand at which it carries on business "in its own name".[120]

When a partner will be treated as an agent of an absentee partner

235. Under s HD 20B, a partner of a general partnership or a general partner of a limited partnership may be treated as an agent of an absentee partner. Limited partners are not treated as agents of absentee partners.

236. Under s HD 20B, a partner of a general partnership is treated as agent of an absentee if the partner carries on a business in New Zealand in a partnership. Under s HG 2, partners are treated as carrying on a business in New Zealand if the partnership carries on business in New Zealand. This means a partner of a general partnership is treated as an agent of an absentee even if they do not have an active role in the partnership.

237. Under s HD 20B, a general partner of a limited partnership is treated as an agent of an absentee if the limited partnership carries on business in New Zealand.

[119] Under s YA 1.

[120] Section HD 18(2)(c).

Obligations of an agent for an absentee partner

238. If a partner is treated as an agent for an absentee partner, the agent partner must meet the following tax obligations in relation to the absentee's share of the partnership's income:[121]

- make the assessments that the absentee partner is required to make;
- provide all returns required of the absentee partner under the TAA; and
- satisfy the absentee partner's income tax liability.

239. In making the assessments, an agent can also claim, in relation to the agency income, deductions, tax credits, or exemptions to which the absentee partner is entitled. An agent for an absentee is treated in that agency capacity as a separate person. An agent must not claim, in relation to the agency income, deductions, tax credits or exemptions that the agent has in their own capacity.[122]

240. The agent partner and the absentee partner are jointly and severally liable for the tax obligations relating to the agency.[123]

241. If two or more partners are liable as agents in relation to an absentee's tax liability, the liability is joint and several.[124]

Application of land rules to partnerships

Introduction

242. It is useful to discuss, as an example, the application of s CB 9 in the land rules to partnerships. This discussion is useful because it combines aspects of the transparent tax treatment of partnerships and the application of the associated person and safe harbour rules.

243. As noted at [22], s HG 2 results in income being derived directly by the partners of a partnership, not the partnership. Generally, provisions in the ITA such as s CB 9 that include an amount in a person's income, or allow a person a deduction for an expenditure or loss, apply to the partners of a partnership, not the partnership.

244. This point may seem academic, but it is relevant in some situations. For example, a person who is a partner of a general partnership may be, in their separate capacity, in

[121] Sections HD 3(2) and HD 18(1).
[122] Section HD 3(4).
[123] Section HD 2.
[124] Section HD 3(3).

the business of dealing in land. The partner and the partnership are associated persons, but the partner is not necessarily associated with the other partners. If s CB 9 were applied to a partnership rather than its partners, the partnership's association with the partner in the business of dealing in land could lead to income under s CB 9, which would be attributed to all partners. The correct result is reached by applying s CB 9 to the partners. Applied to the partners, who are not necessarily associated with each other, the status of the partner who is in the business of dealing in land will not affect the other partners.

Section CB 9 – business of dealing in land

Section CB 9(1) – person in the business of dealing in land

245. Under s CB 9(1) an amount a person derives from disposing of land is included in the income of the person if:

- they dispose of the land within 10 years of acquiring it; and
- at the time they acquired the land, they carried on a business of dealing in land, whether or not the land was acquired for the purpose of the business.

246. If a person has income under s CB 9(1), they may be allowed a deduction for the cost of the property under s DA 1 (general permission) and s DB 23 (cost of revenue account property).

247. In applying ss CB 9(1) and the deduction provisions above, it is relevant to consider:

- whether there has been a disposal of land;
- when the person acquired the land and when the 10-year period begins;
- the cost of the land when they acquired the land; and
- whether the person carried on a business of dealing in land at the time they acquired the land.

248. In the partnership context, it is also necessary to consider whether partners have changed since the partnership acquired the land and whether the safe harbour rules apply to the change in partners.

249. The application of s CB 9 is considered below in three scenarios involving a disposal by an original partner and a disposal by a new partner where the safe harbour rules apply and where the safe harbour rules do not apply.

Original partner

250. A partner might have been a partner at the time the partnership acquired the land. If so, they would have acquired an interest in the land on the date the partnership acquired the land. This is the date from which the 10-year period starts and the date on which the partner must have carried on a business of dealing in land.

251. If the partnership carried on a business of dealing in land on this date, then under s HG 2 the partner is treated as having carried on the business on that date.

252. The requirement to have carried on a business of dealing in land could also be satisfied if the partner carried on such a business separately from the partnership on the date the partnership acquired the land. This is because s CB 9(1) applies "whether or not the land was acquired for the purpose of the business". The fact the partnership (and, under s HG 2, the partner) acquired the land for a purpose unrelated to the partner's separate business, does not prevent s CB 9(1) from applying.

253. For deduction purposes, the partner's cost for the land will be their share (based on the partner's partnership share in the partnership's income) of the cost of the land to the partnership.

Entering partner where the safe harbour rule applied to the acquisition of the partnership interest

254. A partner (an entering partner) may have acquired a partnership interest after the partnership acquired the land. In that case, if the safe harbour rule in s HG 5 applies, an entering partner is treated as if they had originally acquired and held an interest in the land. Further, the partner (or partners) the entering partner acquired the partnership interest from (the exiting partner) is treated as not having acquired and held the interest.

255. The 10-year period starts from the date the exiting partner acquired the interest in the land.

256. The entering partner takes on the cost base of the exiting partner.

257. The question of whether the entering partner carries on a business of dealing in land is determined as at the date the entering partner acquires the partnership interest. The Commissioner considers the date on which this question is determined is not affected by s HG 5 as it is outside the intended scope of the fiction created by that section.

258. A partner could satisfy the requirement to carry on a business of dealing in land:

- if the partner carried on such a business in a capacity separate from the partnership;[125] or
- if the partner is treated under s HG 2 as having carried on such a business (if such a business were carried on by the partnership).

Entering partner where the safe harbour rule did not apply to the acquisition of the partnership interest

259. If the safe harbour rule did not apply to the acquisition of the partnership interest, the entering partner acquires the interest in the land on the date they acquire the partnership interest. This is the date from which the 10-year period starts and the date for the determination of whether they carried on a business of dealing in land.

260. The entering partner's cost is the portion of the consideration paid for the partnership share allocated to the land.

261. In this scenario, [258] also applies.

Section CB 9(2) – person associated with a person in the business of dealing in land

262. Under s CB 9(2) an amount is included in the income of a person (person A) if:

- person A derives an amount from disposing of land within 10 years of acquiring the land; and
- at the time they acquired the land, person A was associated with another person (person B) who carried on a business of dealing in land.

263. For the avoidance of doubt, s CB 9(2) applies whether or not:

- person A carried on a business of dealing in land; or
- the land was acquired for the purpose of person B's business.

Application of s HG 5

264. The application of s HG 5 to a partner who may be subject to s CB 9(2) raises similar questions to those raised for s CB 9(1).

265. If the partner was a partner at the time the partnership acquired the land, the question of whether the partner was associated with a person who carried on a business of

[125] The taxation of amounts that a person has as a partner can be affected by the person's own characteristics and non-partnership activities. See [28] and [29].

dealing in land should be determined as at the date the partnership acquired the land.[126]

266. In the case of an entering partner, and whether or not the safe harbour rules applied to the acquisition, the question of whether the partner was associated with a person who carried on a business of dealing in land should be determined as at the date the entering partner acquired their interest in the partnership. Commissioner considers that date on which this question is determined is not affected by s HG 5 as it is outside the intended scope of the fiction created by that section.

Role of person A in s CB 9(2) in the context of a partnership

267. In the context of a partnership, person A referred to in s CB 9(2) (the person who may have income under s CB 9(2)), could be a partner in the partnership or could be a person associated with a partner. Consequently, person B (the person who carries on the business of dealing in land) could be a person who carries on the business separately from any partnership, or person B could be a partnership[127] that carries on such a business. Both scenarios are discussed below.

Person A as a partner

268. When s CB 9(2) is applied to land owned by a partnership that is not in the business of dealing in land,[128] the question will be whether a partner (person A) was, at the time the land was acquired, associated with a person (person B) who carried on a business of dealing in land.

269. Person B could be a:

- person unrelated to the partnership, for example the person may be associated with the partner (person A) as a relative[129] (this is illustrated in Example | Tauira 13); or

[126] To be clear, the parties need to be associated on this date and the business needs to be carried on on this date.

[127] As discussed further at [274], in this scenario, person B would be the partnership, not a partner, because the transparent tax treatment of partnerships would not apply.

[128] If the partnership is in the business of dealing in land, then person A would also be treated under s HG 2 as being in the business of dealing in land. Therefore, s CB 9(1), rather than s CB 9(2), would apply to person A without any need for association.

[129] For the purposes of the land rules (including s CB 9(2)), two people are associated as relatives if they are married, in a civil union or in a de facto relationship (s YB 4(1)(b)). Two people are associated as relatives because of a blood relationship only if one is the infant child of the other (s YB 4(2)).

- company in which the partnership holds shares if the partner (person A) is associated with the company through the partnership, under either the tripartite relationship test or an aggregation test.

270. Section CB 9(2) does not necessarily apply where person B is another partner who, in their separate capacity, is in the business of dealing in land. This is for two reasons:

- Partners are not associated merely because they are partners of the same partnership. The tripartite relationship test does not associate two partners merely because they are partners. The answer would be different if the partners were associated under a different test (for example, under s YB 4 (two relatives)).
- The fact the partnership may be associated with person B (who is in the business of dealing in land) is not relevant to the application of s CB 9(2) to partner A. Person A themselves must be associated with the person who is carrying on the business. This is because s CB 9(2) is applied to partner A, not the partnership.

271. This is illustrated in Example | Tauira 14.

Example | Tauira 13 - Partner associated with a dealer

Facts

Person A is a partner in a partnership.

The partnership sells land that it held on capital account. The partnership held the land for 7 years.

Person A was a partner of the partnership when the partnership acquired the land. On the date the partnership acquired the land, person A's de facto partner, person B, carried on a business of dealing in land. However, the land was not acquired for the purpose of person B's business.

Tax treatment

Section CB 9(2) applies to include person A's partnership share of the sale proceeds in his income.

Section CB 9(2) applies despite the land not being acquired for the purpose of person B's business.

Example | Tauira 14 – Where another partner carries on a business of dealing in land

Facts

Partnership A carries on a business of providing residential accommodation, so holds residential properties on capital account. Partnership A has two partners, persons A and B.

Person B carries on another business in her own name involving buying and selling residential properties.

Partnership A sells one of its properties and makes a gain on sale.

Tax treatment

Person A does not carry on a business in dealing in land and is not associated with person B, so person A's share of the sale proceeds is not included in person A's income under s CB 9(2).

Section CB 9(1) applies to include person B's share of the sale proceeds in person B's income.

For person B, the tax treatment of the sale of the partnership property is affected by the nature of the business person B carries on in her own name. Section CB 9(1) applies whether or not the land was acquired for the purpose of the business of dealing in land.

Person A as a non-partner

272. Section CB 9(2) could apply to include an amount in the income of a non-partner (person A) if they are associated, under the tripartite relationship test, with a person (person B) who is a partnership[130] carrying on a business of dealing in land.

273. Person A (the non-partner to whom s CB 9(2) is being applied) may be associated with person B (the partnership) if person A is a company and person B (the partnership) has voting or market value interests of 25% or more in person A. Alternatively, person A may be associated with person B under the tripartite relationship test, through an association with a partner of person B.

274. In this scenario (where person A is a non-partner), person B is necessarily a partnership and not a partner. The transparent tax treatment of partnerships under s HG 2 applies only for the purposes of determining a partner's liabilities and obligations under the ITA. In this scenario, s CB 9(2) is being considered in relation to person A, who is a non-partner, so s HG 2 does not apply. In the absence of s HG 2 applying, the

[130] Not a partner. See [274].

partnership is regarded as carrying on the business, so the relevant association in this scenario is with the partnership.

275. This is illustrated in Example | Tauira 15.

Example | Tauira 15 - Application of s CB 9(2) to a non-partner associated with a partnership

Facts

Person 1 derives an amount from the sale of land.

On the date person 1 acquired the land:

- she was in a de facto relationship with person 2;
- person 2 was a partner of partnership A; and
- partnership A carried on a business of dealing in land.

Tax treatment

The amount person 1 derived from the sale of the land is included in person 1's income under s CB 9(2). This is because on the date she acquired the land, person 1 was, under the tripartite relationship test, associated with partnership A (through her de facto relationship with person 2), and partnership A was in the business of dealing in land.

Foreign investment fund rules and partnerships

276. The foreign investment fund (FIF) rules apply to the partners of a partnership, not the partnership. This is in itself a useful illustration of the transparency of partnerships in the ITA.

277. It is outside of the scope of this item to discuss the FIF rules in any detail. However, in response to questions that have been raised in this area in the past, the following discusses how two thresholds in the FIF rules are applied in the case of shares owned by a partnership. The two thresholds are relevant in the following situations:

- A natural person may have no FIF income where the total cost of all FIFs that the person held at any time during the income year was $50,000 or less.[131]

[131] Section CQ 5(1)(d).

- A person may have no FIF income if the person has an income interest of 10% or more in a FIF that is a controlled foreign company (CFC).[132]

278. There are further details associated with these thresholds that would need to be considered by anyone using them. The focus here is on determining whether the thresholds are met where shares are owned by a partnership, given the transparent tax treatment of partnerships.

279. In both cases, in the context of a partnership, the persons referred to will be partners of a partnership who, because of s HG 2, holds a share of a FIF.

280. For the $50,000 threshold, a partner may satisfy the $50,000 threshold if the partner's cost base for the FIF is $50,000 or less. This cost base is calculated based on the partner's partnership share. For example, if a partnership purchases shares for $90,000 and a partner has a one-third partnership share in the assets of the partnership, the partner has a cost base of $30,000 for the shares.[133]

281. The partner's cost base may arise from being a partner at the time the FIF is acquired or by acquiring a partnership share. In the latter case, the partner's cost base for the FIF that is acquired as a result of acquiring the partnership share depends on whether the safe harbour rules apply.

282. For the 10% threshold, a partner may satisfy the threshold if the person has an income interest of 10% or more in a CFC. This income interest is calculated based on the partner's partnership share in the partnership's income. For example, if a partnership holds 30% of the shares in a CFC and a partner has a 40% partnership share in the partnership's income, the partner has an 12% income interest in the CFC.

283. This is illustrated in Example | Tauira 16.

Example | Tauira 16 – FIF rules apply at the level of the partners

Facts

Partnership A has three New Zealand resident partners, partners 1 to 3. Each partner has a one-third partnership share in the partnership's income.

Partnership A holds 27% of the shares in Overseas Company Ltd, which is a CFC. Partnership A purchased the shares for NZ$120,000. Partners 1 to 3 were partners at

[132] Sections CQ 5(1)(c)(iv) and EX 34.

[133] This is consistent with the comments in *Tax Information Bulletin* Vol 19, No 3 (April 2007): 31 regarding the application of the $50,000 FIF exemption threshold in the case of a married couple or a couple in a de facto relationship or civil union. Such a couple could together hold shares costing $100,000 if half of the shares were held in each partner's name or if they owned the shares jointly.

the time the shares were purchased and there has not been in any change in the partners' interests since.

Partner 3 also holds 1% of the shares in Overseas Company Ltd in their own name. The remaining 78% of shares are owned by another person who is also New Zealand resident.

On 1 April 2022, at the beginning of the 2023 income year, the market value of the shares held by partnership A in Overseas Company Ltd was NZ$300,000.

During the 2023 income year Overseas Company Ltd paid a NZ$30,000 dividend to the partnership.

Partner 1

Partner 1 is a natural person. Partner 1 does not hold shares in Overseas Company Ltd in their own name, nor does partner 1 hold any other interests in overseas companies or other investments classified as a FIF.

Partner 1's total attributing interests in FIFs is NZ$40,000, being their one-third share of the $120,000 cost of the shares.[134] This is not more than $50,000, so partner 1 qualifies for a FIF exemption.

Therefore, partner 1 does not have any FIF income from the interest in Overseas Company Ltd. However, partner 1 has dividend income of $10,000 (one-third of the $30,000 dividend).

Partner 2

Partner 2 is a natural person. Partner 2 has shares in another overseas company that is classified as an attributing interest in a FIF. These other shares cost $20,000.

Partner 2's total attributing interests in FIFs is $60,000 ($40,000 + $20,000). Therefore, partner 2 does not qualify for an exemption from the FIF rules. Partner 2 has FIF income from the investment in Overseas Company Ltd. Partner 2 uses the fair dividend rate method to calculate their income. For the 2023 income year, this method results in partner 2 having FIF income of $5,000. This is based on the $300,000 market value of the shares multiplied by one-third (partner 2's partnership share in partnership income) multiplied by the fair dividend rate of 5%.

$300,000 x ⅓ x 5% = $5,000

Partner 2's $10,000 share of the dividend (one-third of $30,000) is excluded income under s CX 57B.

[134] This assumes that the interest is not exempted from being an attributing interest, for example by being an ASX-listed Australian company.

Partner 3

Under s HG 2, each partner is treated as having a 9% interest in Overseas Company Ltd through the partnership (one-third of 27%).

Partner 3, in addition, holds a 1% shareholding in Overseas Company Ltd in their own name. This means that partner 3 has an income interest of 10% or more, so is subject to the CFC rules rather than the FIF rules.

Deduction limitation rule for limited partnerships

Introduction

284. The section applies only to limited partnerships.

285. Section HG 11 imposes a limit on the amount of deductions a limited partner can claim in an income year as a partner of a limited partnership.[135]

286. The purpose of the limitation is to discourage loss trading. Without a deduction limitation rule, investors could enter arrangements whereby small amounts of capital are invested to get access to larger tax losses.[136]

287. The deduction limitation rules ensure limited partners can offset tax losses only to the extent the tax losses reflect the partners' economic investment – the amount that they have a risk. The economic amount a partner has at risk is represented in the "partner's basis" amount defined in s HG 11. The partner's basis includes equity invested and withdrawn, capital gains and losses, income, expenditure and loss amounts, and a partner's exposure to risk.

288. This limitation on deductions is aimed mainly at limited partners because general partners have unlimited liability, so full exposure to the risk of loss.[137]

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[135] This limitation is sometimes referred to as the loss limitation rule. This is because s HG 11 applies only if the partner has a loss from the partnership and, by limiting a partner's deductions, s HG 11 has the effect of limiting the loss the partner has from the partnership. However, despite the name and this effect, the limitation calculation is focused on the partner's deductions.

[136] The rationale was discussed in the discussion document that led to the partnership rules, General and limited partnerships – proposed tax changes – a government discussion document (Policy Advice Division, Inland Revenue, 2006) at [8.2].
https://www.taxpolicy.ird.govt.nz/publications/2006/2006-dd-limited-partnerships.

[137] However, s HG 11(1)(b) contains a rule to prevent a partner avoiding the deduction limitation for an income year by becoming a general partner for the income year.

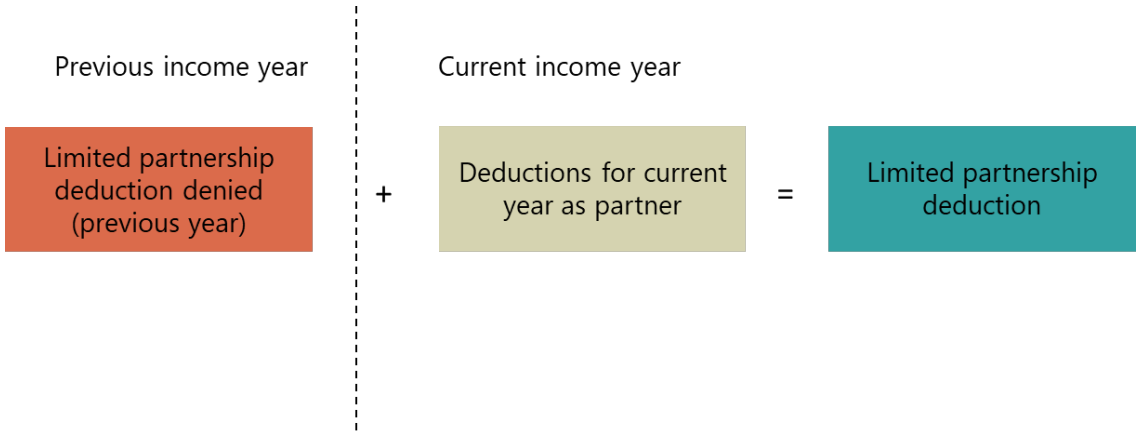
289. Deductions that are denied in an income year by the deduction limitation rule can be carried forward to the following income year.[138] However, deductions cannot be carried forward to an income year if, in the income year, the limited partner ceases to be a partner or the limited partnership ceases to be a limited partnership.[139] Also, deductions carried forward by an exiting partner are not transferred to an entering partner who acquires the partnership interests of the exiting partner.[140]

Limitation applies only if the partner has a loss from the partnership

290. As noted above, s HG 11 applies in an income year only if the partner has a loss from the partnership for that year.[141] That is, the partner's "limited partnership deduction" (s YA 1) for the income year must be more than the partner's assessable income from the partnership for the income year. If the limited partnership deduction is equal to or less than the assessable income, then a full deduction is allowed.

291. The limited partnership deduction for a partner and an income year include the deductions the partner would have in the income year as a result of s HG 2 as a partner in the partnership plus any limited partnership deductions denied in the previous income year under s HG 12. This is illustrated in Diagram | Hoahoa 11.

Diagram | Hoahoa 11- Limited partner deduction definition



[138] Section HG 12.

[139] Section HG 12(2).

[140] Section HG 12 would apply only to an exiting partner who was denied the deduction. Even if the safe harbour rule in s HG 5 applies, and the entering partner is treated as having originally acquired and held the current interests, this does not apply to a deduction carried forward under s HG 12.

[141] The deduction denied is the lesser of the amounts given by s HG 11(2)(a) and (b). If there is no loss, the amount given by s HG 11(2)(b) will be zero. The amount given by s HG 11(2)(a) can only be positive or zero. Therefore, if there is no loss then the deduction denied will be zero.

Whether the limited partnership deductions are more than the "partner's basis"

292. If a partner does have a loss from the partnership, the next question is whether the limited partnership deductions are more than the "partner's basis". The partner's basis is a measure of a partner's economic investment in a partnership. The calculation of this amount is discussed from [296].

293. If the limited partnership deductions are equal to or less than the partner's basis, then a full deduction is allowed.

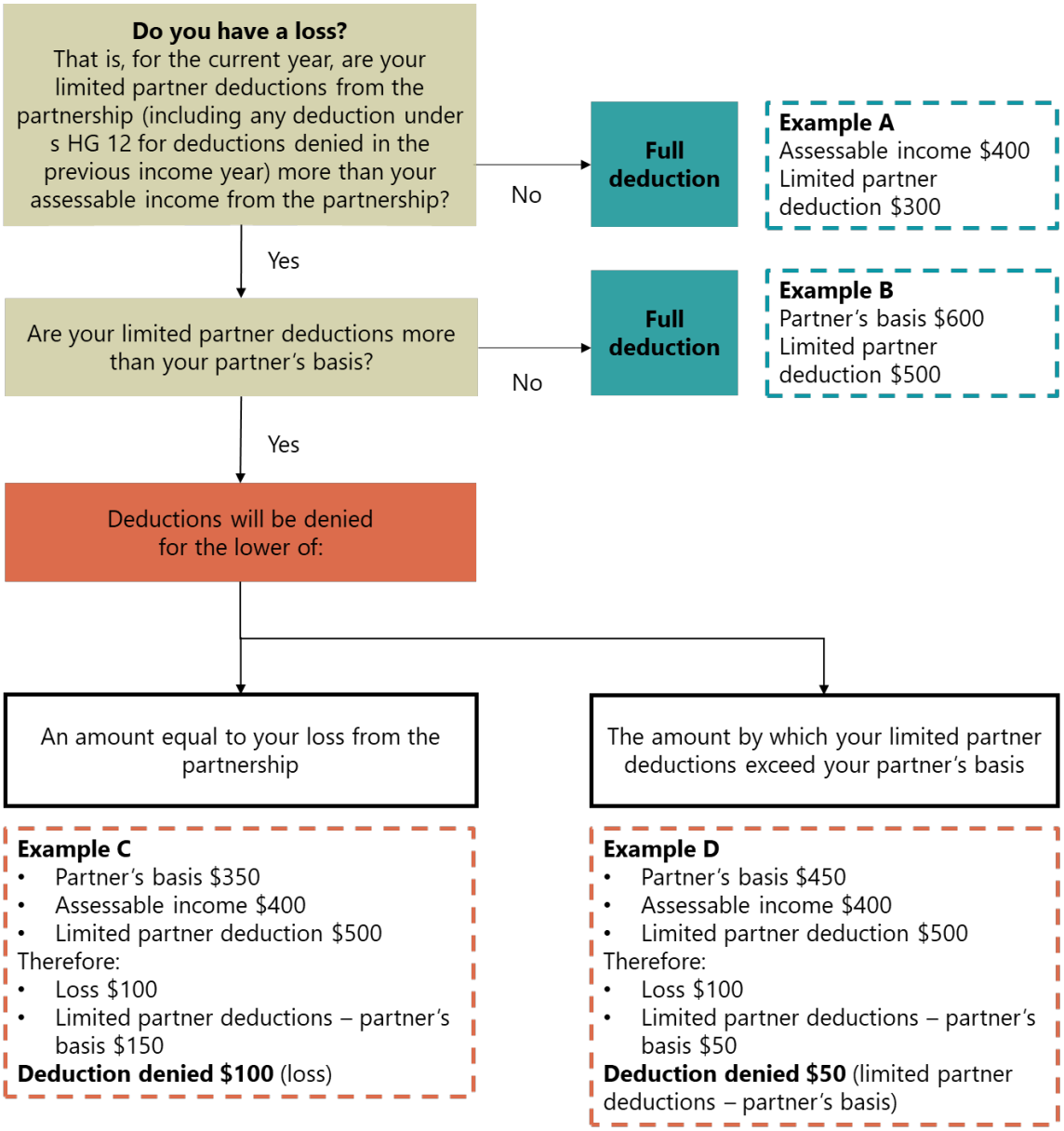
Deduction amount that is denied

294. If the limited partnership deductions are more than the partner's basis, then the limited partnership deductions amount that is denied for the income year is equal to the lower of the:

- difference between the partner's basis and the limited partnership deductions; and
- loss from the partnership.

295. This is illustrated, with examples, in Diagram | Hoahoa 12.

Diagram | Hoahoa 12 - Limitation calculation



Partner's basis

296. The "partner's basis" is a measure of a partner's economic investment in a limited partnership, including equity invested and withdrawn, capital gains and losses, income, expenditure and loss amounts, and exposure to risk.

297. The definition includes five main amounts:[142]

- investment;

[142] These terms have specific meanings in this context. For example, "income" does not have its usual meaning.

- distributions;
- income;
- deductions; and
- disallowed amount.

298. Each amount has components that are summarised below along with examples.

299. The partner's basis is found by subtracting the distributions, deductions and disallowed amounts from the total of the investments and income amounts.

300. The partner's basis is calculated on the last day of the income year.[143]

Investments

301. The "investments" amount comprises three components:

- "capital contributions" the partner made to the partnership;
- amounts the partner paid for the assignment of capital contributions (partnership assets) to the partner; and
- "secured amounts".

Capital contributions the partner made to the partnership

302. The investments amount includes the market value of capital contributions the partner made to the partnership. The market value is measured at the time the partner contributed or agreed to contribute the relevant contribution.

303. Capital contribution is defined for the purposes of s HG 11.[144] The definition includes a capital contribution as defined in the LPA. Under s 37 of the LPA, the capital contribution of a partner is defined as the share of the assets contributed, or agreed to be contributed, by a partner to the limited partnership or assigned to a partner under s 38(2) of the LPA.

304. The definition in the LPA suggests a capital contribution is linked to the asset or the share in the asset that is contributed to the partnership. However, a capital contribution is more accurately described as a nominal amount that arises for a partner equal to the value of the asset that is contributed. If the capital contribution was the asset itself, then the capital contribution would cease to exist if the asset was disposed of or converted into something else. This seems unlikely to have been what Parliament intended. For example, consider the case where partner 1 contributes land valued at

[143] See s HG 11(2)(a).

[144] See definition of "capital contribution" in s HG 11(12).

$100,000 to a limited partnership, the land is immediately sold, and the proceeds are used to purchase trading stock. Partner 1 would still have $100,000 of capital contributions.

305. The words "the share of" in s 37 of the LPA cater for the situation where a person, who owns an asset together with another person, contributes their share of the asset to the partnership. This is illustrated in Example | Tauira 17.

Example | Tauira 17 - Contribution of a share of an asset

A couple decide to start a business using a limited partnership ownership structure and contribute a property that they co-own to the partnership. Each person contributes their ownership share of the property to the partnership. An amount equal to the value of the share is included in each person's investment amount as a capital contribution.

306. The words "agreed to be contributed" in s 37 of the LPA appear to refer to an agreement to later provide an asset, rather than a fiction about the value of assets that have been contributed.

307. The assignment of assets to a partner under s 38(2) of the LPA is discussed at [310]. These words correspond to the next component of the investments amount: amounts paid by the partner for the assignment of capital contributions to the partner.

308. Under s 37(3) of the LPA, a loan by a partner to a limited partnership is not a capital contribution. However, for the purposes of s HG 11, the definition of capital contribution is extended to cover loans. To be exact, the definition of capital contribution includes amounts that the limited partnership is "debtor for in relation to the partner". This specifically includes a loan to the limited partnership and a credit balance in a current account. This is illustrated in Example | Tauira 18 and Example | Tauira 19. A loan a partner has acquired (with the partnership as debtor) also falls within this definition.

309. The Commissioner considers the repayment of loans is included in the "distributions" amount (see [329]).

Example | Tauira 18 – Contribution of assets and loan

Partners 1 and 2 establish a limited partnership. Partner 1 agrees to immediately loan $2 million to the partnership, and partner 2 agrees that three months later they will contribute land with a market value of $2 million. Each partner has made a capital contribution of $2 million, which is included in their investments amount.

Example | Tauira 19 – Credit to current account

Partner 1 sells a vehicle it held in its own name to limited partnership A for $30,000. The partnership pays for the car by making a $30,000 credit to the partner's current account with the partnership.

The credit to the current account is an amount the partnership is debtor for in relation to the partner. An amount of $30,000 is added to partner 1's investments amount as a capital contribution.

Amounts paid by the partner for the assignment of capital contributions (partnership assets) to the partner

310. The investments amount includes an amount paid by a partner for the assignment of capital contributions to the partner.[145] This could apply to a new partner or an existing partner who increases their partnership share.

311. The definition of capital contributions is relevant here. As noted above, for the purposes of s HG 11, capital contribution includes a capital contribution as defined in the LPA. The definition of capital contribution in s 37 of the LPA includes in the capital contribution of a partner the share of assets assigned to the partner under s 38(2) of the LPA.

312. Section 38 of the LPA is about the "partnership interests of a partner", which is defined in s 38(1) of the LPA. Notably, the partnership interests of a partner include the partner's share of the assets of the limited partnership. Section 38(2) of the LPA states that a partner may assign or otherwise dispose of all or part of that person's partnership interests (including their share of the assets) to another partner or, if approved by the partnership, any other person.

313. The above discussion is relevant for an entering partner who has acquired some or all of an exiting partner's partnership interests. In calculating the entering partner's partner's basis, they will have an investments amount that includes the amount they paid for "the assignment of capital contributions to the partner".

314. The wording "assignment of capital contributions" is potentially misleading because, under the LPA, capital contributions are not assigned, rather a share of assets is assigned that become a capital contribution of the entering partner. Nevertheless, an assignment of a capital contribution occurs in the sense that a capital contribution is created by the assignment of assets. Therefore, the entering partner will have an

[145] Section HG 11(5)(b).

"investment" amount that includes the amount they paid for the share of partnership assets that was assigned to them.

315. This is illustrated in Example | Tauira 20.

Example | Tauira 20 - Amount the partner paid for the assignment of a capital contribution

Limited partnership A has two existing limited partners, partners 1 and 2, who have equal partnership shares.

Partner 1 and partner 2 have each made capital contributions of $750,000.

Limited partnership A's financial position has improved as the business has grown. It now has assets valued at $6.6 million and liabilities of $3 million. Partner 1 and partner 2 each have an interest in the partnership with a market value of $1.8 million.

A new partner (partner 3) joins the partnership and takes a one-third partnership share. As consideration, based on the market value of the business, partner 3 pays partner 1 and partner 2 $600,000 each. Following this, the three partners each have an interest in the partnership worth $1.2 million.

By acquiring a one-third partnership interest, partner 3 has acquired a one-third share in the assets of the partnership.

This means that partner 3 has an initial investment amount of $1.2 million to include in their partner's basis.

Partner 1 and partner 2 each continue to have investment amounts that include their $750,000 capital contributions. Partners 1 and 2 may also have other partner's basis amounts, including amounts included in the "income" component of the partner's basis calculation (the "income" component is discussed from [333]), which includes realised capital gains. This could include any capital gains realised when assets were assigned to partner 3 as part of partner 3's acquisition of partnership interests.

Secured amounts

316. The investments amount includes "secured amounts".

317. The purpose of the secured amounts component is to recognise risks that partners or their "partner's associates" (discussed at [319]) are exposed to as guarantors in relation to partnership debt.

318. Secured amounts can arise for a partner if they are a "guarantor" for an amount of limited partnership debt. A partner is treated as a guarantor for an amount of

partnership debt if they guarantee the amount themselves or if they have a partner's associate who guarantees the amount.[146]

319. A "partner's associate" is, for a partner, a person who is not a partner of the relevant limited partnership and who is a:

- "relative" as defined in s YA 1, but excluding a person who is a relative because they are the trustee of a trust under which a relative has benefited or is eligible to benefit (para (a)(v) of the definition of "relative" in s YA 1); or
- company in the same wholly-owned group of companies.[147]

320. The secured amounts calculation provides for situations where a partner is not the only person who acts as guarantor for an amount of partnership debt. Where there is more than one guarantor, the secured amounts calculation may include only part of the partnership debt in the partner's secured amounts (even if the partner is jointly liable for the entire amount).

321. A partner's secured amounts is the lesser of the amounts calculated under paras (a) and (b) of the definition of secured amounts in s HG 11(12). Paragraph (b) can only apply to a partner if the terms of a guarantee provided by the partner, or by their partner's associate, limits the lender's recourse to particular property.[148] Limited recourse guarantees are not common, so it is expected in most cases the secured amounts will be calculated under para (a) of the definition of secured amounts.

322. Under para (a), the partner's secured amounts is calculated as the amount of the limited partnership's debt for which the partner is a guarantor (they will be a guarantor if they or their partner's associate guarantees the debt), divided by the total number of guarantors for that debt.[149] In counting the total number of guarantors, both paras (a) and (b) of the definition of "guarantor" apply. This means the total number of guarantors includes a:

- partner who guarantees the partnership debt;
- partner who has a partner's associate who guarantees the partnership debt (the partner's associate themselves is not counted as a guarantor); and
- person who is neither a partner nor a partner's associate who guarantees the partnership debt.

[146] Definition of "guarantor" in s HG 11(12).

[147] Section HG 11(12).

[148] Referred to as "recourse property", see definition in s HG 11(12).

[149] A guarantee of partnership debt made by a general partner would have no effect because the general partner is jointly and severally liable with the limited partnership for the debt. Therefore, if a general partner does guarantee the partnership debt, they should not be counted as a guarantor.

323. The calculation of secured amounts under para (a) is illustrated in Example | Tauira 21.

324. Under para (b) of the definition of secured amounts, the calculation of the partner's secured amounts starts with the market value of the recourse property to the extent of the interest that the partner and the partner's associates have in it.[150] The words "extent of the interest" allow for the situation where a partner or partner's associate owns property together with others as tenants in common (with each owner having a defined share in the property).

325. The calculation then subtracts the value of any higher ranking calls on the property (whether actual, future or contingent), then divides the result by the total number of guarantors who have an interest in the property or who have a partner's associate who has an interest in the property. For the purposes of para (b) of the definition of secured amounts, "guarantors" is restricted to partners who have provided a guarantee or who have a partner's associate who has provided a guarantee.[151] This is illustrated in Example | Tauira 22 and Example | Tauira 23.

326. The definition of "secured amounts" refers to a single amount of partnership debt for which a partner might be a guarantor. However, there may be more than one item of partnership debt with different guarantees. The definition of secured amounts must be applied to each item of partnership debt and the secured amounts for a partner for each item must be aggregated to determine a partner's total secured amounts. This is consistent with the purpose of the definition, which is to reflect the economic risk of the partner.

Example | Tauira 21 – Secured amounts where partners provide guarantees

Limited partnership A has two limited partners, partner 1 and partner 2.

Limited partnership A borrows $200,000 from bank A, secured by a mortgage over land the partnership owns. The loan from bank A is not subject to any guarantee.

Limited partnership A also borrows $150,000 from bank B. This loan is guaranteed by partner 1 and partner 2 and by a company (company 1) that is associated with, but not in a wholly-owned group with, partner 1.

The loan from bank A is not guaranteed, so is not relevant to the calculation of the partners' secured amounts.

[150] The recourse property may be property in which the partner has an interest or property in which a partner's associate has an interest (if the partner's associate is providing the guarantee).

[151] For the purposes of para (b) of the definition of "secured amounts" only para (a) of the definition of "guarantor" applies.

The $150,000 loan from bank B is guaranteed by partner 1, partner 2 and company 1. The total number of guarantors is three. Therefore, partners 1 and 2 each have secured amounts of $50,000. Company 1 is counted as a guarantor (under para (b) of the definition of that term) because it is neither a partner nor a partner's associate. Although company 1 is associated with partner 1, it is not a "partner's associate" (because it is not in the same wholly-owned group).

The secured amounts will increase partner 1 and partner 2's investment amount and, therefore, their partner's basis amounts, which will potentially allow the partners higher deductions.

Example | Tauira 22 – Secured amounts – limited recourse guarantee

This example has four variations that share the following common facts and tax treatment.

Common facts and tax treatment

Company 1 is a limited partner in limited partnership A.

Limited partnership A borrows $1.5 million.

Company 1 and company 2 provide guarantees for this loan. Company 1 and company 2 are associated companies but are not in the same wholly-owned group.

The guarantees are limited recourse guarantees, with recourse limited to a property owned together by companies 1 and 2 (not partnership property). The property has a market value of $1.4 million and is not subject to any higher-ranking call.

Under para (a) of the definition of secured amounts company 1, as a limited partner of limited partnership A, would have secured amounts of $750,000. This is equal to the debt of $1.5 million divided by the number of guarantors, which is two. This applies for all the variations below.

The following four variations consider the secured amounts that company 1 would have under para (b) and compare this with the amount under para (a). Company 1's secured amounts will be the lower of the amounts given by paras (a) and (b).

Variation 1 – Guarantee provided by two partners who own recourse property as joint tenants

Companies 1 and 2 are limited partners in limited partnership A.

Companies 1 and 2 own the recourse property as joint tenants.

As a joint tenant, company 1 has an interest in the full $1.4 million value of the property. Under para (b) of the definition of secured amounts, the $1.4 million amount is divided by the number of guarantors who have an interest in the recourse property, which is two.

Company 1, as a partner, would have secured amounts of $700,000 under para (b). This is less than the $750,000 secured amounts that would be given by para (a).

Therefore, company 1's secured amounts is $700,000. This amount will increase company 1's investment amount and, therefore, its partner's basis amount, which will potentially allow it higher partnership deductions.

Variation 2 – Guarantee provided by two partners who own recourse property as tenants in common

Companies 1 and 2 are limited partners in limited partnership A.

Companies 1 and 2 own the recourse property as tenants in common, with equal shares.

As a tenant in common, the guarantee provided by company 1 in the land is limited to company 1's interest in the property, which is $700,000. Company 1 is the only guarantor with an interest in the recourse property (the $700,000 share in the property held as a tenant in common). Therefore, the market value of the recourse property is divided by one.

Company 1, as a partner, would have secured amounts of $700,000 under para (b). This is less than the $750,000 secured amounts that would be given by para (a).

Therefore, company 1's secured amounts is $700,000.

Variation 3 – Guarantee provided by partner and non-partner who own recourse property as joint tenants

Company 1 is a limited partner in limited partnership A. Company 2 is not.

Companies 1 and 2 own the recourse property as joint tenants.

As a joint tenant, company 1 has an interest in the full $1.4 million value of the property. This amount is divided by the total number of guarantors who have an interest in the recourse property.

In this variation there is only one guarantor, company 1. In para (b) of the definition of secured amounts the relevant divisor is the total number of guarantors described in para (a) of the definition of guarantor, company 2 does not come within para (a) of the definition of guarantor because it is not a partner.

Company 1, as a partner, would have secured amounts of $1.4 million under para (b). This is more than the $750,000 secured amounts that would be given by para (a).

Therefore, company 1's secured amounts is $750,000.

Variation 4 – Guarantee provided by partner and non-partner who own recourse property as tenants in common

Company 1 is a limited partner in limited partnership A. Company 2 is not.

Companies 1 and 2 own the recourse property as tenants in common, with equal shares.

As a tenant in common, company 1 has a $700,000 interest in the property. This amount is divided by the total number of guarantors who have an interest in the recourse property, which is one. Company 1 is the only guarantor for the purpose of para (b) of the definition of "secured amounts" (and the only guarantor who has an interest in the recourse property (the $700,000 share in the property held as a tenant in common).

Company 1, as a partner, would have secured amounts of $700,000 under para (b). This is less than the $750,000 secured amounts that would be given by para (a).

Therefore, company 1's secured amounts is $700,000.

Example | Tauira 23 – Secured amounts with limited recourse property and partner's associate

Facts

Limited partnership A has three partners, partners 1, 2 and 3. Partners 1 and 2 are both in the same wholly-owned group of companies, along with company 1.

Limited partnership A borrows $4.5 million from a lender.

Company 1 and partner 3 provide guarantees for the loan. The lender's recourse under the guarantee provided by company 1 is limited to company 1's 50% interest in a piece of land with a market value of $8 million. Company 1 holds this interest with another company as tenants in common. Company 1's 50% interest in the land is subject to a higher-ranking mortgage of $2 million.

Tax treatment

A partner's secured amounts is the lesser of the amounts given by para (a) or para (b) of the definition of secured amounts in s HG 11(12).

Under para (a), the secured amounts for each partner is equal to the partnership debt divided by the total number of guarantors. Partners 1 and 2 are treated as guarantors in relation to the debt because they have a partner's associate (company 1) who has guaranteed the debt. Partner 3 also provided a guarantee. Company 1, despite guaranteeing the loan, does not come within the definition of guarantor in s HG 11(12). Therefore, the total number of guarantors for the debt under para (a) is three. Therefore, the secured amounts for each partner under para (a) would be $1.5 million ($4.5 million of debt divided by three guarantors).

Paragraph (b) could apply to partners 1 and 2 because the guarantee provided by their partner's associate, company 1, limits the lender's recourse to the land. Paragraph (b) has no application to partner 3 because partner 3's guarantee does not limit the lender's recourse.

Under para (b), the calculation of the secured amounts begins with the market value of the recourse property for the secured debt to the extent of the interest that the partner and the partner's associates have in it. Company 1 has a 50%, or $4 million, interest in the recourse property. The calculation of the secured amounts then subtracts any higher-ranking calls. In this case, company 1's interest in the land is subject to a $2 million mortgage. Therefore, the value of the recourse is only $2 million. This amount is then divided by the number of guarantors who have an interest in the property or who have a partner's associate who has an interest in the property. In this case, both partners 1 and 2 have a partner's associate, company 1, with an interest in the property. Company 1 is not counted as a guarantor. Therefore, the recourse amount is divided by two. Therefore, para (b) would result in partners 1 and 2 having secured amounts of $1 million each.

For partners 1 and 2, the amount given by para (b) of the definition of secured amounts is lower than the amount given by para (a), so the para (b) amount is their secured amounts ($1 million each) for the purposes of calculating their partner's basis.

For partner 3, only para (a) applies and that gives partner 3 secured amounts of $1.5 million.

The partners' secured amounts will increase their investment amounts and, therefore, their partner's basis amounts, which will potentially allow them higher partnership deductions.

Distributions

327. The second main part of the partner's basis calculation is distributions. This includes the following components, the:[152]

- market value of distributions to the partner from the limited partnership; and
- amount paid to the partner for the assignment of capital contributions by the partner.

328. The word distributions as used in the first component is not further defined for the purposes of s HG 11.

329. It is considered the first component includes a payment by the limited partnership of debt owing by the partnership to the partner. The inclusion of the repayment of debt in the distributions amount is consistent with the inclusion of amounts that the limited partnership is "debtor for in relation to the partner" in the investments amount (included as a capital contribution).

330. A distribution is also made when a partner withdraws some or all of a credit balance from their current account. This is illustrated in Example | Tauira 24.

331. The second component is the same as the assignment amount included in the investments amount, except seen from the perspective of the exiting partner. The amount is that paid to the exiting partner for the assignment of assets (which are included in the partnership interests that are assigned) by the exiting partner to the entering partner. An assignment of capital contributions occurs in the sense that the assets assigned become the capital contributions of the entering partner. This is illustrated in Example | Tauira 25.

332. The distributions amount includes amounts distributed or paid in the current income year and previous income years.[153]

Example | Tauira 24 - Distribution – withdrawal of credit in current account

Partner 1 is a limited partner in limited partnership A.

Partner 1 has a $40,000 credit balance in their current account with the partnership.

Partner 1 needs some money to buy a new car, so asks limited partnership A to transfer $50,000 to their personal bank account. Limited partnership A makes the

[152] Section HG 11(6).

[153] This is not specified in s HG 11(6), but it would be consistent with the purpose of the partner's basis calculation to include these amounts.

transfer and records a debit of $50,000 to partner 1's current account with the partnership.

As a result, $40,000 is included in partner 1's distributions amount. The other $10,000 paid to partner 1 is a loan to the partner from the partnership and does not affect partner 1's partner's basis.

Example | Tauira 25 - Distribution – amount paid to partner for assignment of capital contribution

This example uses the same facts as Example | Tauira 20.

Limited partnership A has two existing limited partners, partners 1 and 2, who have equal partnership shares.

Partners 1 and 2 have each made capital contributions of $750,000.

Limited partnership A's financial position has improved as the business has grown. It now has assets valued at $6.6 million and liabilities of $3 million. Partners 1 and 2 each have an interest in the partnership worth $1.8 million.

A new partner (partner 3) joins the partnership and takes a one-third partnership share. As consideration, based on the market value of the business, partner 3 pays partners 1 and 2 $600,000 each. Following this, the three partners each have an interest in the partnership worth $1.2 million.

By acquiring a one-third partnership interest, partner 3 has acquired a one-third share in the assets of the partnership.

Partner 1 has been paid $600,000 for the assignment by partner 1 to partner 3 of a share of the assets of the partnership. Therefore, this amount is included in partner 1's distributions amount. The same is true for partner 2.

Overall:

- partners 1 and 2 each continue to have investments amounts that include their $750,000 capital contributions, but they also have distribution amounts that now include an additional $600,000 each, and they may also have accumulated partner's basis from profits in previous years and from realised capital gain amounts; and
- partner 3 has an initial investments amount of $1.2 million to include in their partner's basis.

Income

333. The third main amount included in the partner's basis calculation is "income". Income is specifically defined for this purpose and has four components:[154]

- income the partner has as a partner of the partnership;
- a FIF dividend adjustment;
- capital gain amounts the partner would have by virtue of s HG 2; and
- other assessable income from goods or services contributed to the limited partnership.

Income the partner has as a partner of the partnership

334. The first component is income the partner has as a partner of the partnership by virtue of s HG 2. "Income" in this context has its normal income tax meaning. It includes income that may be exempt income, excluded income, non-residents' foreign-sourced income or assessable income.

335. This component specifically includes income the partner has in the current income year and previous income years.[155]

FIF dividend adjustment

336. The income amount includes what is referred to in this statement as a FIF dividend adjustment.[156]

337. This adjustment recognises that dividends received by a partner from a foreign investment fund (FIF) can exceed the partner's FIF income under the ITA (if any) for the FIF. The purpose of the partner's basis calculation is to determine the partner's economic investment in the partnership. To do this, it is necessary to recognise the extent to which the dividends are higher than FIF income.

338. This calculation should be performed for the current income year and previous income years and for each FIF the partnership holds in each year.[157]

339. An adjustment is required in relation to a FIF and an income year if the:

- partner has FIF income or a FIF loss from a FIF;

[154] Section HG 11(7).

[155] Section HG 11(7)(a).

[156] Section HG 11(7)(ab).

[157] This is not specified in s HG 11(7)(ab), (7B) or (7C), but it is consistent with the purpose of the partner's basis calculation to include amounts from all years and for all FIFs.

- partner has a share of a dividend from the FIF (see [340]); and
- share of the dividend is greater than the FIF income (if the partner has FIF income).

340. For the purpose of calculating a FIF dividend adjustment, the share of a dividend that a partner has from a FIF is the share that is determined under general (non-tax) law (for example, under the partnership agreement). Generally, the no-streaming rule in s HG 2(2) would treat all the partners as having a share of a dividend based on each partner's partnership share in the partnership's income. However, the no-streaming rule does not apply in the context of the definition of income in s HG 11(7)(ab). This is because the purpose of the partner's basis amount is to represent the partner's economic investment.

341. For each FIF the partnership holds, a partner needs to determine the following amount:

- if the partner's share of the dividend is equal to or less than the FIF income, zero;
- if the partner's share of the dividend is greater than the partner's FIF income, the amount equal to the partner's share of the dividend less the partner's FIF income; or
- if the partner has no FIF income, or has a FIF loss, an amount equal to the partner's share of the dividend.

342. The total of all such amounts for each FIF and for each income year is the FIF dividend adjustment.

343. This is illustrated in Example | Tauira 26.

Example | Tauira 26 – FIF dividend adjustment

Partner 1 is a partner of limited partnership A. Limited partnership A was formed at the beginning of the 2022 income year.

Limited partnership A has overseas investments that give partner 1 attributing interests in two FIFs.

Under limited partnership A's partnership agreement, dividends from FIF 1 are shared with only some of the partners, including partner 1. Dividends from FIF 2 are shared according to the partners' partnership shares in the assets of the partnership.

Partner 1 needs to calculate their partner's basis for the 2023 income year. Partner 1 did not calculate their partner's basis for the 2022 income year because the partnership had net income in that year. Without any running balance of the partner's basis, partner 1 needs to consider both the 2022 and 2023 income years.

2022 income year

FIF 1

Partner 1 has FIF income of $10,000 from FIF 1 and receives an $11,500 share of a dividend from FIF 1.

For tax purposes, partner 1 is treated by s HG 2(2) (the no streaming rule) as receiving a share of the dividend from FIF 1 that is less than $11,500. However, it is the share that partner 1 actually receives that is relevant to the calculation of the FIF dividend adjustment. Also, it is not relevant to the FIF dividend adjustment that the dividend from FIF 1 is excluded income.[158]

The FIF dividend adjustment includes $1,500 ($11,500 less $10,000) in relation to FIF 1 and the 2022 income year.

FIF 2

Partner 1 has FIF income of $10,000 from FIF 2 and receives an $8,500 share of a dividend from FIF 2.

No amount is included in the FIF dividend adjustment in relation to FIF 2 and the 2022 income year. The dividend does not exceed the FIF income.

2023 income year

FIF 1

Partner 1 has a FIF loss of $1,000 from FIF 1 and receives a $2,400 share of a dividend from FIF 1.

The FIF dividend adjustment includes $2,400 in relation to FIF 1 and the 2023 income year.

FIF 2

Partner 1 has FIF income of $10,000 from FIF 2 and receives a $12,000 share of a dividend from FIF 2.

The FIF dividend adjustment includes $2,000 ($12,000 less $10,000) in relation to FIF 2 and the 2023 income year.

Overall

In determining partner 1's partner's basis for the purposes of the 2023 income year, in the income amount, partner 1 will have a FIF dividend adjustment of $5,900 ($1,500 from the 2022 income year, and $2,400 and $2,000 from the 2023 income year).

Capital gain amounts

344. The income amount also includes realised capital gain amounts.

345. The capital gain amounts included are those the partner would have under s CD 44(7)(a) if the partner was treated as:

- holding property that is held by the limited partnership under s HG 2; and
- a company.

346. For a capital gain amount to arise under s CD 44(7)(a), the partnership must have disposed of property.[159] Therefore, the income amount is concerned with realised capital gain amounts.

347. However, capital gain amounts are not included if they have already been accounted for under s HG 11(7)(a) (income the partner has as a partner of the partnership).

348. This component specifically includes amounts for the current income year and previous income years.

Other assessable income from goods or services contributed to the limited partnership

349. Section HG 11(7)(c) includes in the income amount assessable income the partner has from goods and services they contributed to the limited partnership. This applies only if the income is not accounted for under s HG 11(5) (investments amount, which includes capital contributions) or s HG 11(7)(a) or (b) (income the partner has by virtue of s HG 2 and capital gain amounts).

350. This paragraph appears to have very limited application.

351. The paragraph does not apply to assessable income a partner derives from selling goods or services to the partnership. Such income would not represent an economic investment in the partnership (unless payment for the goods and services was left owing to the partner). The paragraph may previously have applied where a partner sold goods or services to the partnership and payment for those goods or services was left as a debt owed to the partner. However, since an amendment in 2012, amounts that the limited partnership is debtor for in relation to the partner are included in the investments amount as a capital contribution of the partner.[160]

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[158] Section CX 57B.

[159] Any kind of property, not just land or buildings.

[160] The definition of capital contribution was amended by s 85(3) of the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012.

Deductions

352. The fourth main part of the partner's basis calculation is "deductions". The deductions amount consists of three components:[161]

- expenditure or loss the partner has as a partner;
- capital loss amounts; and
- deductions relating to other assessable income.

Expenditure or loss the partner has as a partner

353. This component (expenditure or loss the partner has as a partner) includes only expenditure and loss amounts from previous income years. This is because expenditure and loss amounts for the current income year are part of the limited partnership deduction amount that is tested under s HG 11.

354. Also, this component includes only expenditure and loss amounts incurred because of s HG 2 as a partner and to the extent to which the expenditure or loss is incurred in deriving income.

355. Also, expenditure or loss amounts for which deductions have been denied under s HG 11 in the previous income years are excluded. These are included in the limited partnership deduction amount for the current income year that is tested under s HG 11.

356. This is illustrated in Example | Tauira 27.

Example | Tauira 27 - Expenditure or loss amounts and partner's basis

2022 income year

For the 2022 income year, partner 1 had:

- limited partnership deductions of $500;
- assessable income of $400; and
- a partner's basis of $450.

Partner 1 had a $100 loss for the 2022 income year from the limited partnership and their limited partnership deductions were more than their partner's basis. The difference between the limited partnership deductions and the partner's basis ($50) is less than the loss amount ($100), so the deduction denied is $50.

[161] Section HG 11(8).

2023 income year

In the 2023 income year, partner 1 has:

- assessable income of $300;
- expenditure as a partner of $300; and
- limited partnership deductions that were denied in the previous income year of $50.

For the 2023 income year, partner 1's partner's basis includes (for the first time) the expenditure and loss amounts incurred in 2022 of $500. The expenditure and loss amounts were not included in the calculation of the partner's basis in the 2022 income year because the partner's basis (in particular, the deductions amount) does not include current year expenditure or loss. Partner 1's partner's basis also includes the current year assessable income of $300. No other changes occurred in the year that affect the partner's basis. This means the partner's basis for 2023 is $250 ($450 less $500 plus $300).

Partner 1's limited partnership deductions for the 2023 income year are $350 (current year expenditure of $300 plus the deductions denied in 2022 of $50). Therefore, partner 1 has a $50 loss for the 2023 income year ($300 of assessable income less the limited partnership deductions of $350).

Partner 1's limited partnership deductions of $350 are also more than their partner's basis of $250. Partner 1's loss of $50 is smaller than the difference between the limited partnership deductions and their partner's basis, so the deduction disallowed in 2023 is the loss amount of $50.

Capital loss amounts

357. The "deductions" amount also includes realised capital loss amounts.

358. The capital loss amounts included are those the partner would have under s CD 44(9) if the partner was treated as:

- holding property that is held by the limited partnership under s HG 2; and
- a company.

359. For a capital loss amount to arise under s CD 44(9), the partnership must have disposed of property.[162] Therefore, the "deductions" amount is concerned with realised capital loss amounts.

[162] Any kind of property, not just land or buildings.

360. However, capital loss amounts are not included if they have already been accounted for under s HG 11(8)(a) (expenditure or loss the partner has as a partner of the partnership).

361. This component specifically includes amounts for the current income year and previous income years.

Deductions relating to other assessable income

362. This amount is the deductions the partner is allowed in relation to the other assessable income amounts described in s HG 11(7)(c).

363. As with the other assessable income amount described in s HG 11(7)(c), this deduction amount appears to have very limited application.

Disallowed amount

364. The fifth and final part of the partner's basis calculation is the "disallowed amount".

365. This is the amount of investments, as defined in s HG 11(5), the partner made within 60 days of the last day of the income year, if those investments are or will be distributed or reduced within 60 days after the last day of the income year.[163]

366. This is an anti-avoidance provision aimed at deterring people from artificially inflating their partner's basis by making a temporary capital contribution into the partnership for the end of the income year (the partner's basis is calculated at the end of the year).

Exclusion

367. Section HG 11(10) provides an exclusion from the deduction limitation rule.

368. The exclusion applies for a partner and an income year only if the partner disposes of some or all of their partner's interests in the income year and has an amount of net income from that disposal. By disposing of some or all of their partner's interest, a partner may dispose of, for example, an interest in revenue account property. An amount derived from such a disposal may be included in the partner's income.

369. Section HG 11(10) appears to be based on the assumption that the income and deductions that comprise the "net income" amount are not included in the partner's "assessable income", "limited partnership deduction", or "partner's basis" amounts referred to in s HG 11(2).

370. This is illustrated in Example | Tauira 28.

[163] Section HG 11(9).

Example | Tauira 28 – Exclusion from deduction limitation

Partner 1 is a partner in limited partnership A.

At the end of the income year, partner 1 sells its partner's interests, which include interests in revenue account property, to partner 3.

The disposal results in partner 1 having $175,000 of income from the disposal of its interest in revenue account property and a deduction of $100,000 for its share of the cost of the revenue account property (this assumes the disposal is not covered by the safe harbour rules in ss HG 5 to HG 10, see from [111]).

The partner's limited partnership deduction for the income year (excluding the cost of the revenue account property) is $600,000. Assessable income for the income year from the partnership (excluding the $175,000 from the disposal of their interest in revenue account property) is $400,000. On this basis, the partner has a loss of $200,000 from the partnership for the income year. The partner has a partner's basis of $500,000. The difference between the limited partnership deduction and the partner's basis is $100,000. This is less than the loss of $200,000, so the deduction denied, in the absence of s HG 11(10) would be $100,000.

Applying s HG 11(10), the $75,000 of net income from the disposition of the revenue account property is taken into account. An amount equal to the net income is not denied, meaning the deduction denied is only $25,000.

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