

QUESTION WE'VE BEEN ASKED QB 14/02

INCOME TAX – ENTRY OF A NEW PARTNER INTO A PARTNERSHIP – EFFECT ON CONTINUING PARTNERS

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Question We've Been Asked is about ss HG 2, and YA 1 definitions of "dispose" and "partner's interests".

Question

1. We have been asked when the entry of a new partner into a partnership will have income tax consequences for continuing partners.

Answer

2. A taxable event is not triggered for continuing partners if a new partner simply "steps into the shoes" of an exiting partner and the continuing partners' interests in the assets of the partnership have not been changed.
3. However, there will be a taxable event for continuing partners if the addition of the new partner changes the continuing partners' interests in the partnership assets.
4. Where a taxable event arises for a continuing partner, the provisions of ss HG 5 to HG 10 then apply to determine whether the continuing partner needs to account for tax. If there is a disposal, then the partner will need to apply ss HG 5 to HG 10 to determine whether there is any tax payable. These provisions are safe harbour provisions that remove the need for a partner to account for tax when the required adjustment would be below certain thresholds.

Explanation

5. Under common law, the entry or exit of a partner to or from a partnership results in the dissolution of the old partnership and the formation of a new partnership. This could lead to tax consequences for continuing partners when a new partner enters a partnership, even where partnership interests are not changed.
6. In 2008 new tax rules for partnerships were introduced. These were intended to codify and clarify various aspects of the partnership rules. *Tax Information Bulletin*, Vol 20, No. 8 (September/October 2008) explained the new rules. The TIB contained the following statement:

The introduction of a new partner into a partnership does not trigger a tax event for the existing partners. This is because the addition of a new partner would not result in a disposal of partnership property for an existing partner under s YA 1.
7. This statement could be seen as suggesting that the entry of a new partner into a partnership will never trigger a tax event for continuing partners and has created some uncertainty. We have, therefore, been asked to set out the Commissioner's position on this issue.

Partnerships are transparent

8. The Act treats partnerships as transparent. Section HG 2 gives effect to this. It deems everything done by the partnership to be done by the partners in proportion to their partnership share. Section HG 2(1) and (2) state:

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.

No streaming

- (2) Despite subsection (1), for a partner in their capacity of partner of a partnership, the amount of income, tax credit, rebate, gain, expenditure, or loss that they have from a particular source, or of a particular nature, is calculated by multiplying the total income, tax credit, rebate, gain, expenditure, or loss of the partners of the partnership from the particular source or of the particular nature by the partner's partnership share in the partnership's income.

9. "Partnership share" is defined in s YA 1:

partnership share means, for a particular right, obligation, or other property, status, or thing, the share that a partner has in the partnership.

10. Section HG 2 applies "unless the context requires otherwise". In the Commissioner's view nothing in the context of the provisions being considered in this item suggests that s HG 2 should not apply. Also, s HG 2 applies regardless of the particular terms of the partnership agreement (although the partnership agreement may set out what the partner's partnership share is). Consequently, where partnership assets are disposed of, the Act treats the disposal as being made by the partners.

11. An issue that arises when a new partner enters a partnership is whether there are tax consequences for the continuing partners. In particular, the issue is whether a continuing partner is treated as having disposed of partnership property when a new partner enters the partnership.

When a continuing partner "disposes" of partnership property

12. Under partnership law, when a partner leaves and/or a new partner enters a partnership, the original partnership is dissolved and a new partnership is formed. This would arguably have the effect of all partners disposing of (and, subsequently, reacquiring) their interests each time a partner leaves a partnership. However, the definition of "dispose" in s YA 1 means that this does not happen. "Dispose" expressly excludes the situation where a partner's interest is treated as disposed of by operation of law because another partner disposes of that partner's interests (unless the partnership is finally dissolved). It is noted that this QWBA does not cover the situation where a partnership is finally dissolved.

13. "Dispose" is relevantly defined in s YA 1 as:

dispose,— ...

- (h) for a partner,—

- (i) includes surrendering or extinguishing some or all of their partner's interests:
- (ii) does not include when their partner's interests may be treated as disposed of by operation of law because another partner disposes of that partner's interests, unless section HG 4 (Disposal upon final dissolution) applies

14. "Partner's interests" as defined in s YA 1:

means the relevant interests in rights and obligations and other property, status, and things that a partner has as a result of applying section HG 2 (Partnerships are transparent)

15. "Dispose" is defined inclusively. Therefore, it also carries its ordinary meaning. The ordinary meaning of "dispose" is to "get rid of" (*Concise Oxford English Dictionary* 12th ed, 2011). This commonly includes disposals by way of sale or other transfer.
16. "Dispose" is also expressly defined to include "surrendering or extinguishing" some or all of a partner's interests. Neither "surrender" nor "extinguish" is defined in the Act. "Extinguish" is relevantly defined in the Concise Oxford English Dictionary as "to put an end to" "to render (a right or obligation) void". "Surrender" is relevantly defined as "give up (a person, right or possession) on compulsion or demand".
17. The ordinary meaning of "extinguish" implies that something ceases to exist. This does not seem to fit the current situations where partnership interests continue to exist (although they are held by a different person). However, it is considered that the ordinary meaning of "surrender" is wide enough to cover situations where a partner gives up some or all of their partnership interests to a new partner. It also covers both voluntary and involuntary situations.
18. Therefore, there will be a "disposal" for a partner if they sell, transfer, or surrender some or all of their interests in the partnership property (as determined under s HG 2). As noted above, a partner is treated as holding partnership property in proportion to the partner's partnership share.
19. For a continuing partnership, a disposal by one partner of their partner's interest will not automatically trigger a disposal by the remaining partners (s YA 1, paragraph (h)(ii) of the definition of "disposal"). Therefore, to be a "disposal" there must be some change in the partner's interest in the partnership property. If there is a "disposal" then the "safe harbour" provisions in ss HG 5 to HG 10 could potentially apply (see [24] below).
20. If a new partner purchases the partnership interests of an exiting partner, there will be an acquisition by the new partner and a disposal by the exiting partner. However, there will be no disposal by the continuing partners. This is because the continuing partners' "partner's interests" remain the same before and after the disposal by the exiting partner. This is illustrated by Example 1, below.
21. If a new partner purchases a share of the continuing partners' partnership assets, then there will be a partial disposal by those continuing partners. This is because those partners will have disposed of part of their partnership interests to the new partner. This is illustrated by Example 2, below.
22. The situation is less clear when a new partner introduces additional capital to the partnership. Take for example a partnership between X and Y where the only asset is land worth \$200,000. Z joins the partnership by contributing funds of \$100,000. It could be argued that nothing has changed for X and Y. Prior to Z joining the partnership, they each owned a 50% share of \$200,000 worth of assets. They now each have a one-third share of \$300,000 worth of assets. However, the Commissioner considers that the correct view is that X and Y have each disposed of part of their share of the partnership assets.

23. This is because, under s HG 2, X and Y were previously deemed to own a 50% share of the land. After the entry of Z into the partnership, X and Y are each deemed to own a one-third share of the land and a one-third share of the \$100,000. The effect of s HG 2 is, therefore, that X and Y have each disposed of part of their share of the land to Z. This is illustrated by Example 3, below.

Consequences of disposition

24. If there is a disposal, then the partner will need to apply ss HG 5 to HG 10 to determine whether there is any tax payable. These provisions are safe harbour provisions that remove the need for a partner to account for tax when the required adjustment would be below certain thresholds.
25. The item applies to tax positions taken in the 2014-15 and later income years.

Examples

26. The following examples are included to assist in explaining the application of the law.

Example 1 – Exiting partner disposes of interest to new partner

27. Llama Farms Ltd and Reindeer Farms Ltd each have a 50% interest in a farming partnership. There are \$1 million of assets in the partnership. Wallaby Farms Ltd purchases Llama Farms Ltd's share of the partnership for \$500,000. Under the Act, Wallaby Farms Ltd is simply stepping into the shoes of Llama Farms Ltd. There are no tax consequences for Reindeer Farms Ltd because its interests in the partnership and the underlying net assets have not changed (that is, they remain at 50% of \$1 million).

Example 2 – Entry of new partner dilutes interests of continuing partners

28. Chris and Jo are partners who each own 50% of a forestry partnership. The forestry partnership holds assets worth \$5 million. A new partner, Alex, enters the partnership, purchasing \$4 million of Chris and Jo's partnership assets. As a result, Alex's share in the partnership becomes 80%, and Chris and Jo's shares in the partnership have been reduced to 10% each. Applying a look-through approach (as required by s HG 2), Chris and Jo's individual interests in the underlying partnership assets have each been reduced from \$2.5 million to \$500,000.
29. Chris and Jo have, therefore, both disposed of some of their "partner's interests", as their interests in the underlying assets of the partnership have been reduced.
30. There will be a taxable event for Chris and Jo because Chris and Jo have disposed of some of the interests in the partnership assets to Alex. Chris and Jo would then need to determine whether they should account for tax according to the provisions of ss HG 5 to HG 10.

Example 3 – New partner introduces additional capital to the partnership

31. Jack and Nicky own a block of land worth \$200,000. Applying the principle in s HG 2, Jack and Nicky each own 50% of the land. Their neighbour, Lisa, joins the partnership and contributes her adjoining land, worth \$100,000, to the partnership. The result is that the partnership assets have increased to a total of \$300,000.
32. As a result of Lisa joining the partnership, all partners now have a one-third share of the partnership, and each owns one-third of the underlying partnership assets. Applying the principle in s HG 2, Jack and Nicky have each sold part of their interest in the land that they own to Lisa, in exchange for a share of Lisa's land.

There has been a disposal of the continuing partners' underlying assets, which results in an event that will have to be considered for taxation purposes if the land is on revenue account.

References

Subject references

Disposal
Partner's interests
Partnerships

Legislative references

Income Tax Act 2007: ss HG 2,
HG 5, HG 6, HG 7, HG 8, HG 9, HG 10, YA 1
("dispose", "partner's interests")