

QUESTION WE'VE BEEN ASKED QB 16/04

GOODS AND SERVICES TAX – GST TREATMENT OF PARTNERSHIP CAPITAL CONTRIBUTIONS

All legislative references are to the Goods and Services Tax Act 1985 unless otherwise stated. References to the PA are to the Partnership Act 1908.

This Question We've Been Asked is about ss 8 and 57.

Question

1. Is a GST registered partnership required to account for output tax on a capital contribution made by a partner?

Answer

2. No. If there is any supply of goods and services in return for the capital contribution, then it is a supply made by a partner or partners, not the partnership.
3. The transfer of a partnership interest by an existing partner is the supply of a service, namely a chose in action consisting of a fractional interest in the future profits of the partnership business and in any surplus of assets over liabilities on winding up.
4. Where a partnership capital contribution is made in return for the transfer of a partnership interest from an existing partner, the supply of the partnership interest is made by the existing partner. The partnership interest is not supplied by the partnership. The supply of a partnership interest by a partner is made in their capacity as a partner of the partnership.
5. However, not all partnership capital contributions will necessarily involve the supply of a partnership interest. Where there is no supply of a partnership interest, no supply of any goods and services is made by the partnership.
6. The deeming provisions in ss 57(2)(b) and 57(2)(c) do not apply to the supply of a partnership interest by a partner in consideration for partnership capital contributions. That is, the supply of a partnership interest by a partner in return for a capital contribution is not deemed to be made by the partnership for GST purposes. This is because the supply of the partnership interest will not have **been made in the course of the partnership's taxable activity**.
7. Consequently, no GST is charged by the partnership on the supply of a partnership interest that is transferred in return for a partnership capital contribution.

Explanation

Background

8. QB 14/03: "GST – transfer of interest in a partnership", published in *Tax Information Bulletin* Vol 26, No 5 (June 2014): 57, considered the transfer of partnership interests by individual partners, where any payment by the recipient was made to the individual partner(s) who transferred their interests. This item considers situations when a new or existing partner in a partnership contributes capital to the partnership, as opposed to transferring it to an individual partner.

Analysis

Introduction

9. For GST purposes, a “partnership” has the meaning set out in the Partnership Act 1908 (PA) (definition of “partnership” in s 2(1)). Under s 4(1) of the PA, a “partnership” is “the relation which subsists between persons carrying on a business in common with a view to profit”. The nature of the relationship between the partners is contractual. That is, the partners have agreed to enter into a legally binding contractual relationship with each other (*Pooley v Driver* (1876) 5 Ch D 458 at 472). A partnership is not a legal entity separate from its partners (*Sadler v Whiteman* [1910] 1 KB 868 (CA) at 889; *R v Holden* [1912] 1 KB 483 (CA) at 487; *Meyer & Co v Faber (No 2)* [1923] 2 Ch 421 (CA); *Mephistopheles Debt Collection Service v Lotay* [1995] 1 BCLC 41 (CA)).
10. For GST purposes, a partnership is an “unincorporated body”. Despite a partnership not being a separate legal entity under ordinary law, there are special GST rules in the Act in relation to unincorporated bodies, including partnerships. These are set out in s 57 and allow the unincorporated body to be registered when carrying on a taxable activity. For partnership capital contributions, only s 57(2) is of direct relevance.
11. Where a partnership carries on any taxable activity and is registered for GST purposes (preliminary words of s 57(2)):
 - the partnership shall be registered under the name of the partnership (s 57(2)(d));
 - the partners shall not be registered (or liable to be registered) in relation to the carrying on of that taxable activity (ie, the taxable activity carried on by the partnership) (s 57(2)(a));
 - the partnership is deemed to supply any goods and services supplied in the course of carrying on that taxable activity (and the partners are deemed not to have supplied them) (s 57(2)(b));
 - any goods and services supplied to, or acquired by, the partners (acting in their capacity as members of the partnership) in the course of carrying on that taxable activity, not being goods or services to which s 57(2)(b) applies, are deemed to be supplied to, or acquired by, the partnership (and are deemed not to be supplied to, or acquired by, the partners) (s 57(2)(c));
 - any change of members of the partnership has no effect for GST purposes (s 57(2)(e)).
12. For s 57(2) to apply to partnership capital contributions, the following questions need to be answered:
 - Is the partnership capital contribution consideration for a supply of goods and services? If it is, then:
 - Is the supply of goods and services made to, or acquired by, a partner acting in their capacity as a member of the partnership under s 57(2)(c)?
 - Is the **supply made in the course of carrying on the partnership’s** taxable activity under s 57(2)(b) or s 57(2)(c)?
 - Is the partnership capital contribution ignored under s 57(2)(e) because it relates to a change of partners in the partnership?

Is the partnership capital contribution consideration for a supply of goods and services?

13. If there is a supply of goods and services when a partnership capital contribution is made, it will be a supply of a partnership interest. A partnership interest is a **partner's share** in the partnership property. It is the proportion of the partnership assets to which the partner would be entitled if the partnership was dissolved (*Re Bainbridge* (1878) 8 Ch D 218 at 223).
14. Richardson J described the nature of a partnership interest in *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1991) 13 NZTC 8,116 (CA) at 8,126:
- A share in a partnership is a chose in action.** It is a fractional interest in the future profits of the partnership business and in a surplus of assets over liabilities on a winding up. **The partner does not have title to specific partnership property but has a beneficial interest in the entirety of the partnership assets and in each and every particular asset of the partnership** (*Lindley on Partnership* 15th ed, 516; *Maw v Maw* [1981] 1 NZLR 25). [Emphasis added]
15. In the same case at 8,118–8,119, Cooke P described the nature of a partnership interest in this way:
- As noted in this Court in *Maw v Maw* [1981] 1 NZLR 25, the expression "share in a partnership", which is commonly used and was used on the deed of assignment in the present case, is a somewhat loose one. **The true position, so far as now relevant, is that the partners have proprietary interests in equity in all the assets, including the gross income. ...**
- All these proprietary interests of partners are assignable in equity. ...**
- ... As between the assignor and a trustee to whom he has assigned his "share" in the partnership, the section [s 34(1) of the PA] in no way limits the effect of the assignment. The assignor has divested himself of the beneficial proprietary interest to the extent that he has assigned it, and there is no restriction on his power to do so.
- In this case the references in the deed of assignment to the share of the profits and to accounts on dissolution are expressed to be without limiting the generality of the absolute assignment of "the Property", being "... the percentage of the Partner's share in the partnership ... represented by the number of units specified in the Second Schedule ...". In equity the manifest intention is entitled, I think, to full effect. As to 12.8 of the units the assignor has deprived himself of any beneficial interest, whether in capital or in income. In equity the entire beneficial interest in that (undivided) 40 per cent of his share, including the same proportion of any gross partnership income as and when received, vests in the family trust. [Emphasis added]
16. Because a partnership interest is a chose in action, a supply of a partnership interest is a supply of services (definition of "services" in s 2(1)).
17. Under ordinary law, any supply of a partnership interest will necessarily be a supply made by a partner to another partner (either existing or new). The transfer of partnership interests is made by the partners because the partnership is not a legal entity separate from the partners such that it could itself supply partnership interests.
18. In practical terms, a retiring partner may transfer their interest in the partnership to a new partner or when an additional partner joins the partnership, the existing partners must give up some of their partnership interests to the newcomer for that person to become a partner. A simple example would be where the partners in a two person partnership invited a third person to become a partner. Previously the two partners each had a 50% partnership interest but now some of their interests are transferred to the third person.
19. This is consistent with the conclusions drawn in QB 14/03, where the payment by the recipient was made to the individual partner(s) who transferred their interests. Therefore, whether the payment by the incoming partner is made to an individual partner or partners, or is made as a partnership capital contribution, is irrelevant. In either case, any supply of a partnership interest will necessarily be a supply made by a partner to another partner (either existing or new).

20. However, not all partnership contributions will necessarily involve the supply of a partnership interest. For example, where the existing partners make contemporaneous capital contributions in proportion to their existing partnership interests (eg, two partners, each holding a 50% partnership interest, each contribute an additional \$10,000), the partnership interest of each partner does not change. A second example relates to the capital contributions made by the partners of a newly created partnership. In this case, there are no existing partnership interests to be supplied. Rather, the partnership interests are created as a matter of law by the formation of the partnership. A third example relates to capital contributions made by existing partners where the default provisions of the PA apply (s 27(a) of the PA). Section 27(a) of the PA reads as follows:

27 Rules as to interests and duties of partners subject to special agreement

The interests of partners in the partnership property, and their rights and duties in relation to the partnership, shall be determined, subject to any agreement (express or implied) between the partners, by the following rules:

- (a) all the partners are entitled to share equally in the capital and profits of the business, and must contribute equally towards the losses, whether of capital or otherwise, sustained by the firm:
21. Where the default provisions of the PA apply, the partnership interest of an existing partner who makes a capital contribution will remain unchanged. Consequently there will be no supply of a partnership interest.

Is the supply of the partnership interest made to, or acquired by, a partner acting in their capacity as a member of the partnership?

22. Even if there is a supply of a partnership interest by a partner or partners when a partnership capital contribution is made, s 57(2)(c) will only apply if the partner(s) made the supply in their capacity as a member of **the body**. “Member” is defined in s 2(1) **as including “a partner”**. So, in other words, the supply must be made by the partner acting in their capacity as a partner.
23. **The supply of a partnership interest involves the supply of a share of the partner’s beneficial interest in the partnership assets (*Hadlee* at 8,126).** Without the consent of the other partners, no partner may deal with partnership property. This is according to s 23(1) of the PA, which reads as follows:

All property and rights and interests in property originally brought into the partnership stock, or acquired (whether by purchase or otherwise) on account of the firm or for the purposes and in the course of the partnership business, are called in this Act **partnership property**, and must be held and applied by the partners exclusively for the purposes of the partnership and in accordance with the partnership agreement.

24. This is consistent with the nature of the relationship between the partners, namely that they have agreed to enter into a legally binding contractual relationship with each other (*Pooley v Driver* at 472).
25. Therefore, a partner only has a partnership interest because of the partnership relationship. They cannot deal with it without the consent of the other partners. In this light, the Commissioner considers that a partner who transfers part or all of their partnership interest when a partnership capital contribution is made by another person will have made that supply in their capacity as a partner. The partner making the supply of their partnership interest could not be acting in any other capacity given the nature of what is supplied and the nature of the relationship with the other partners.

Is the supply of the partnership interest made in the course of carrying on the partnership’s taxable activity?

26. Sections 57(2)(b) and 57(2)(c) will only apply when the supply is made by, or to, **the partner “in the course of carrying on the taxable activity”**. This is a different

test from the general supply test under s 8(1) which refers to supplies made “in the course or furtherance of a taxable activity”. The phrase “in the course of” is not defined in the Act. The *Concise Oxford English Dictionary* (12th ed, Oxford University Press, Oxford, 2011) defines the phrase “in the course of” as follows:

in (the) course of **1** undergoing (the specified process). **2** during (the specified period).

27. In *Public Trustee v Henderson & Pollard, Limited* [1956] NZLR 180 (Compensation Court), Dalglish J considered the meaning of “in the course of” in the context of the phrase “arising out of or in the course of the employment” as used in the Workers’ Compensation Act 1922. At 184–185, he stated:

In various cases, the Courts have framed tests which must be satisfied in order to bring an accident within the course of a worker’s employment. Thus, in *St Helen’s Colliery Co Ltd v Hewitson* [1924] AC 59; 16 BWCC 230, Lord Atkinson said: “**A workman is acting in the course of his employment when he is engaged ‘in doing something he was employed to do’.** Or what is, in other and I think better words, in effect the same thing—namely, **when he is doing something in discharge of a duty to his employer, directly or indirectly, imposed upon him by his contract of service. The true ground upon which the test should be based is a duty to the employer arising out of the contract of employment, but it is to be borne in mind that the word ‘employment’ as here used covers and includes things belonging to or arising out of it**” (ibid 71; 238). This lastmentioned statement of the law was expressly approved in *Newton v Guest, Keen & Nettlefolds, Ltd* (1926) 19 BWCC 119, 125. [Emphasis added]

28. At 185–186, Dalglish J stated that “in the course of” an activity also includes “natural incidents” of that activity or things “necessarily incidental” to that activity.
29. At 185, Dalglish J rejected the view that “in the course of” was equivalent to “during”. While something that occurred “in the course of” employment would occur during the time that someone was employed, something more was required. The event must have happened while the person was doing something that they were employed to do (or while doing something that was naturally or necessarily incidental to their employment). Consequently, the Commissioner considers that the second dictionary definition noted in [26] above, in the absence of something more, is not sufficient for a supply to have been made in the course of carrying on the partnership’s taxable activity. Rather, as indicated in the first dictionary definition and in *Henderson & Pollard*, the supply must be made as part of carrying on the partnership’s taxable activity while undergoing that taxable activity. That is, the supply must belong to or arise out of the taxable activity or it must be a natural or necessary incident of the taxable activity.
30. Examples of supplies made in the course of carrying on a taxable activity can be seen from the facts in *Case M129* (1990) 12 NZTC 2,839 at 2,845 and *Case S41* (1995) 17 NZTC 7,280. In *Case M129*, Judge Barber held that hiring staff was a “normal incident” of running a drapery taxable activity and was therefore undertaken in the course of that taxable activity. In *Case S41*, an agreement entered into by a professional partnership to lease office premises was in the course of the partnership’s taxable activity.
31. As noted above, the phrase used in s 57(2) – “in the course of” – differs from the phrase commonly used in the Act, namely “in the course or furtherance of”. The term “furtherance” is defined in the *Concise Oxford English Dictionary* as:
- furtherance n.** the advancement of a scheme or interest.
32. In *Case N43* (1991) 13 NZTC 3,361, Judge Bathgate held that the purchase and relocation of dwellings on to land that was being subdivided and sold was in the furtherance of the taxpayer’s taxable activity. This was because it was for the purpose of enhancing the sale prospects of the subdivided land. At 3,366, Judge Bathgate distinguished “in the furtherance of” from “in the course of”:

An act done for the purpose or object of furthering the taxable activity, or achieving its goal, can be to help, achieve, or advance, and thus a “furtherance” of a taxable activity, although it may not necessarily be always in the course of that taxable activity.

33. In summary then, something done in the course of a taxable activity will be something belonging to, or arising out of, that taxable activity. It will include anything that is a necessary or natural incident of the taxable activity. Where something is not done in the course of a taxable activity, it may nevertheless be in the furtherance of the taxable activity if it advances it or helps to achieve its goals.
34. **Consistent with the use of the phrase “in the course of” in the Act**, the Commissioner considers that a direct connection or nexus is needed between the supply of goods and services and the operation or carrying on of the taxable activity for the supply to have been made “in the course of” carrying on that activity. This is consistent with *Case S84* (1996) 17 NZTC 7,526 at 7,533 where Judge Barber stated that s 57(2) was intended to apply to “day to day supplies”:
- ... in my view, s 57(2) was meant to apply to the day to day supplies to or from an unincorporated group by making it clear that, where members make or receive supplies, they are deemed to be doing so on behalf of the partnership.** I suggested that the aim of s 57(2) is to make it clear that where people operate an unincorporated body (eg a partnership), then they can register the body for GST purposes and do not need to register each member of it; and supplies (outputs) in the course of the body’s activity, made by one or more members of the body (or their agents), are deemed made by the body and not by the member; similarly with inputs regarding supplies to a member of the body for the body. [Emphasis added]
35. On the basis of the above discussion, the Commissioner considers that Parliament deliberately chose to restrict the application of ss 57(2)(b) and 57(2)(c) to when the goods and services are supplied “in the course of carrying on [the partnership’s] taxable activity”. This means that these paragraphs will not apply to supplies of goods and services merely made in the furtherance of the partnership’s taxable activity.
36. In the context of the supply of a partnership interest by a partner in return for a partnership capital contribution, the Commissioner considers that the supply of partnership interests relates to the ownership structure of the taxable activity, rather than to the operation or carrying on of the taxable activity. That the ownership structure is not directly related to the carrying on of the taxable activity can be seen from the fact that a different ownership structure would have no impact on the operation of the taxable activity. It could equally be carried on by a sole trader or by a company, for example. Therefore, the supply of a partnership interest will not be made in the course of the partnership’s taxable activity.

Consequences

37. It has been concluded that:
- The transfer of a partnership interest by an existing partner is the supply of a service, namely a chose in action consisting of a fractional interest in the future profits of the partnership business and in any surplus of assets over liabilities on winding up.
 - Where a partnership capital contribution is made in return for the transfer of a partnership interest from an existing partner, the supply of the partnership interest is made by the existing partner. The partnership interest is not supplied by the partnership. The supply of a partnership interest by a partner is made in their capacity as a partner of the partnership.

- However, not all partnership capital contributions will necessarily involve the supply of a partnership interest. Where there is no supply of a partnership interest, no supply of any goods and services is made by the partnership.
 - The deeming provisions in ss 57(2)(b) and 57(2)(c) do not apply to the supply of a partnership interest by a partner in consideration for partnership capital contributions. That is, the supply of a partnership interest by a partner in return for a capital contribution is **not** deemed to be made by the partnership for GST purposes. This is because the supply of the partnership interest will not have been made in the course of the **partnership's taxable activity**.
 - Consequently, no GST is charged by the partnership on the supply of a partnership interest that is transferred in return for a partnership capital contribution.
38. Section 57(2)(a) states that the partners shall not be registered in relation to the **carrying on of the partnership's taxable activity**. Consequently, supplies of partnership interests by partners in return for a partnership capital contribution will only be subject to GST if one or more partners carry on a separate taxable activity that involves the supply of partnership interests (and that supply is not an exempt supply of a "participatory security" (discussed in detail in QB 14/03)).
39. These conclusions are consistent with those drawn in QB 14/03. That item considered the GST treatment of the transfer of a partnership interest from one partner to a new or existing partner where there was no consequent capital contribution to the partnership.

Is the partnership capital contribution ignored under s 57(2)(e) because it relates to a change of partners in the partnership?

40. Under s 57(2)(e), "any change of members" of a partnership has no effect for GST purposes. The supply of a partnership interest by a partner in return for a partnership capital contribution may involve a change in members, although this is not always the case. But even if there is a corresponding change in members, how s 57(2)(e) applies to the supply of partnership interests (if it applies at all) must be determined.
41. In this regard, unless the partner's taxable activity involves the supply of partnership interests (something that, although possible, would be out of the ordinary), it has been concluded that no GST is chargeable on the supply of a partnership interest in return for a partnership capital contribution.
42. The Commissioner has identified two possible interpretations of s 57(2)(e). The first is that the provision only determines that there are no GST implications arising *from a change of members of a partnership*. That is, changing partners in itself does not give rise to any GST implications. This interpretation still means that a supply of a partnership interest by one partner to another could, potentially, be subject to GST if the right circumstances existed. In the **discussion that follows, this is referred to as the "narrow approach"**.
43. **Alternatively, a "wider approach"** is to interpret the provision to mean that whenever there is a change in members of a partnership – which can only ever occur by virtue of one or more partners supplying their partnership interest to a new or existing partner – then there is no effect for GST purposes at all. Adopting this approach would mean that s 57(2)(e) applies to both the change in composition of the partnership **and** the mechanism by which that is achieved (ie, the supply of the partnership interest).

44. **In the Commissioner's view, the reference to a change of members, rather than to changes of membership interests, indicates the intended scope of the provision.** For GST purposes, a registered unincorporated body, including a partnership, is treated as continuing to be the same body despite a change of members. For example, if a partnership has 25 partners and two retire and one new partner joins, the change of members does not create a new unincorporated body for GST purposes. The partnership is treated as being the same registered person before and after the change of members. It is noted that a partnership that reduces to one partner (and, therefore, is no longer a partnership at general law) **will also no longer be an "unincorporated body of persons" or a partnership for GST purposes.**
45. This interpretation is consistent with the narrow approach outlined above that s 57(2)(e) is limited to ensuring the continuity of an unincorporated body. There is nothing to suggest that Parliament intended this paragraph to be interpreted more widely so that the supply of a partnership interest is not a supply for GST purposes. However, the supply will not be a taxable supply unless the partnership interest is supplied in the course or furtherance of a taxable activity carried on by the partner who makes the supply. As noted earlier, this would be possible but uncommon.
46. Therefore, s 57(2)(e) only appears to apply to the registration and cancellation of registration provisions. That is, s 57(2)(e) means that a partnership is not required to cancel its registration when its members change and then re-register the new partnership. This will reduce the compliance costs and GST recovery issues of a change in members.

Correct GST treatment of partnership capital contributions

47. Where a partnership capital contribution involves the transfer of a partnership interest from an existing partner, there will be a supply of services, namely a chose in action. However, not all partnership capital contributions will necessarily involve such a supply.
48. A partner who transfers part or all of their partnership interest when a partnership capital contribution is made by another person will have made that supply in their capacity as a partner. The Commissioner considers that the partner making the supply of their partnership interest could not be acting in any other capacity given the nature of the services supplied.
49. The deeming provisions in ss 57(2)(b) and 57(2)(c) do not apply to the supply of partnership interests by partners in consideration for partnership capital contributions. This is because the supply of a partnership interest will not be made in the course of **the partnership's taxable activity.**
50. The non-application of ss 57(2)(b) and 57(2)(c) means that the supply of a partnership interest by a partner in return for a partnership capital contribution is not deemed to be made by the partnership for GST purposes. Consequently, the supply of a partnership interest by a partner in return for a capital contribution will only be subject to GST if the *partner* is required to charge GST under s 8(1). Under s 57(2)(a), the partners shall not be registered in relation to the carrying **on of the partnership's taxable activity. Therefore, the supply of a partnership interest by a partner in return for a partnership capital contribution will only be subject to GST if the partner carries on a separate taxable activity that involves the supply of partnership interests.**

51. The Commissioner considers that s 57(2)(e) only applies to the registration and cancellation of registration provisions. That is, s 57(2)(e) means that a partnership is not required to cancel its registration when its members change and then re-register the new partnership.

References

Related rulings/statements

QWB 14/03: "GST – transfer of interest in a partnership" *Tax Information Bulletin* Vol 26, No 5 (June 2014): 57

Subject references

GST, imposition of tax, partnerships, capital contributions, transfer of partnership interests

Legislative references

Goods and Services Tax Act 1985: ss 2(1) (definitions of "member", "partner", "partnership", "services" and "unincorporated body"), 8 and 57
Partnership Act 1908: ss 4, 23 and 27

Case references

Case M129 (1990) 12 NZTC 2,839
Case N43 (1991) 13 NZTC 3,361
Case S41 (1995) 17 NZTC 7,280
Case S84 (1996) 17 NZTC 7,526
Hadlee and Sydney Bridge Nominees Ltd v CIR (1991) 13 NZTC 8,116 (CA)
Meyer & Co v Faber (No 2) [1923] 2 Ch 421 (CA)
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Public Trustee v Henderson & Pollard, Limited [1956] NZLR 180 (Compensation Court)
R v Holden [1912] 1 KB 483 (CA)
Sadler v Whiteman [1910] 1 KB 868 (CA)