Worked example

Partners and partnerships – applying the part-year provisions

Description

This example shows how a head company and an entity that joins a consolidated group part-way through its income year work out their respective shares of income or a loss from a partnership.

The example also shows how a partnership with a non-membership period works out its net income for the income year.

Commentary

Under the partnerships provisions in Part III, Division 5 of the *Income Tax Assessment Act 1936* (ITAA 1936), resident partners include in their assessable income their individual interests in the net income of the partnership for the income year. If the partnership incurs a loss for the income year, resident partners are entitled to deductions equal to their individual interests in the partnership loss.

However, special provisions apply when an entity joins or leaves a consolidated group part-way through its income year and when it would, but for consolidation, have included its share of the net income or loss of a partnership in its tax return.

Under these special provisions, the amounts a partner includes in its tax return are worked out as its share of the partnership's assessable income and deductions that are attributable to the partner's non-membership period. The head company also includes these amounts in its tax return for any period when a partner was a member of the group but the partnership was not.

These provisions apportion assessable income and deductions instead of net income so that the amount returned by the partner for its non-membership period (or returned by the head company for the partner's membership period) properly reflects the income and deductions position of the partnership for that particular period in the income year. If the apportionment were made on the basis of the partnership's net income or loss, the income or loss would effectively be spread evenly over the whole income year. This is unlikely to reflect the partner's true contribution and entitlement for a particular period within the income year.

The following example shows how a partnership's assessable income and deductions for an income year are apportioned between the partners (including the period when a partner is taken to be part of the head company) under sections 716-80 and 716-85 of the *Income Tax Assessment Act 1997* (ITAA 1997). It also shows how a partnership with a non-membership period works out its net income under section 701-30 of the ITAA 1997 so that it can include this information in its tax return for the income year in which it joins or leaves a consolidated group.

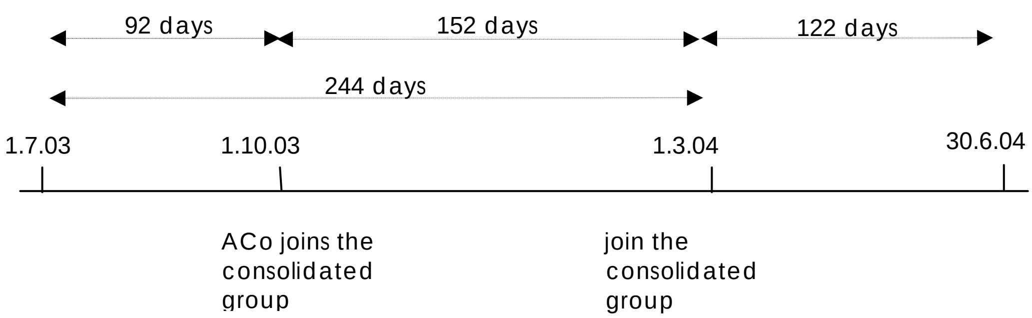
Example

Facts ACo and BCo each hold a 50% interest in partnership P.

On 1 October 2003, HCo, the head company of a consolidated group, acquires all the shares in ACo, which thus becomes a subsidiary member of the group.

On 1 March 2004, HCo acquires all the shares in BCo. By acquiring all the membership interests in BCo, HCo also acquires the remaining 50 per cent interest in partnership P, which means both BCo and partnership P become subsidiary members of the consolidated group.

Figure 1: Membership changes in HCo's consolidated group



Partnership P's assessable income and deductions for the relevant periods are shown in table 1.

The partnership's net income for the 2003–04 income year does not include amounts that relate to its period of membership in the consolidated group. During this period, partnership P is considered part of HCo for income tax purposes and HCo therefore includes in its return any assessable income and deductions that arise from partnership P's contribution to the group's income-producing activities.

Partnership P incurred borrowing expenses in the previous income year which it is required to deduct over 5 years → section 25-25, ITAA 1997. The deductible part of the borrowing expenses for the 2003–04 income year ($600) is not attributable to a particular period within the year.

Table 1: Partnership P's income and deductions – 2003–04 income year

Attributable to the period	Assessable income ($)	Deductions ($)
1.7.03 to 30.9.03 (92 days)	5000	(3000)
1.10.03 to 28.2.04 (152 days)	6000	(6400)
1.3.04 to 30.6.04 (122 days)	n/a	n/a
no particular period		(600)

Calculation of ACo's taxable income

As ACo is a subsidiary member of the consolidated group, its 2003–04 income tax return will only reflect the income and deductions attributable to the period before it joined the group. Section 701-30 in conjunction with Subdivision 716-A will determine the taxable income for that period and the tax payable for the 2003–04 financial year. → section 701-30, ITAA 1997; 'Calculating taxable income, income tax and losses for non-membership periods', C9-5-110

As a partner in partnership P, ACo normally includes its share in the net income or loss of the partnership → section 92, ITAA 1997. However, specific provisions apply when a partner or the beneficiary of a trust was a member of a consolidated group for part of an income year. → sections 716-75 to 716-100, ITAA 1997

Under section 716-85, ACo works out how much of partnership P's *assessable income* it must include in its own assessable income and how much of partnership P's *deductions* it is entitled to deduct for its non-membership period.

Note

Partnership P only has assessable income or deductions while it remains outside the consolidated group; it loses its individual identity on entry into the group and is treated as part of the head company.

ACo's share is 50%. → section 716-90, ITAA 1997

ACo includes its share of partnership P's assessable income that is reasonably attributable to its non-membership period (1 July 2003–30 September 2003) plus a proportion of any amounts that are not reasonably attributable to a particular period in the income year. → subsection 716-85(1), ITAA 1997

ACo therefore includes in its assessable income:

50% x $5,000 = $2,500

ACo is entitled to deduct its share of partnership P's deductions that are reasonably attributable to its non-membership period plus its share of a proportion of any amounts that are not reasonably attributable to a particular period. → subsection 716-85(2), ITAA 1997

Partnership P's deductions that are reasonably attributable to ACo's non-membership period are $3,000.

In addition, ACo can deduct its share of a proportion of the borrowing expenses that are not reasonably attributable to a particular period in the income year.

The proportion is worked out under subsection 716-85(3) as follows:

$$\$600 \quad \times \quad \frac{92 \text{ (days in both the non-membership period and the spreading period)}}{366 \text{ (days in the spreading period)}}$$

= $150

(Since ACo was a partner in partnership P for the whole of the 2003–04 income year, the spreading period is 366 days. → section 716-100, ITAA 1997)

ACo is entitled to deduct under subsection 716-85(2):

50% x ($3,000 + 150) = $1,575

Calculation of BCo's taxable income

BCo's 2003–04 income tax return will only reflect the income and deductions attributable to its non-membership period. Section 701-30 in conjunction with Subdivision 716-A will determine the taxable income for that period and the tax payable for the 2003 –04 financial year. → section 701-30, ITAA 1997; C9-5-110

Like ACo, BCo is a partner in partnership P and has a non-membership period. BCo must apply the specific provisions in Subdivision 716-A to work out how much of partnership P's *assessable income* it must include in its return and how much of partnership P's *deductions* it is entitled to deduct.

BCo's share is 50%. → section 716-90, ITAA 1997

BCo includes its share of partnership P's assessable income that is reasonably attributable to its non-membership period (1 July 2003–28 February 2004) plus a proportion of any amounts that are not reasonably attributable to a particular period in the income year. → subsection 716-85(1), ITAA 1997

BCo therefore includes in its assessable income:

50% x $11,000 = $5,500

BCo is entitled to deduct its share of partnership P's deductions that are reasonably attributable to its non-membership period plus its share of a proportion of any amounts that are not reasonably attributable to a particular period. → subsection 716-85(2), ITAA 1997

Partnership P's deductions that are reasonably attributable to BCo's non-membership period are $9,400.

In addition, BCo can deduct its share of a proportion of the borrowing expenses that are not reasonably attributable to a particular period in the income year.

The proportion is worked out under subsection 716-85(3) as follows:

$$\$600 \quad \times \quad \frac{244 \text{ (days in both the non-membership period and the spreading period)}}{366 \text{ (days in the spreading period)}}$$

= $400

(Since BCo was a partner in partnership P for the whole of the 2003–04 income year, the spreading period is 366 days. → section 716-100, ITAA 1997)

BCo is entitled to deduct under subsection 716-85(2):

50% x ($9,400 + 400) = $4,900

Adjustment to HCo's assessable income and deductions

Head company HCo has entities in its consolidated group for part of the income year that would, but for consolidation, have included their share of a partnership's income or loss in their tax returns. → section 716-75, ITAA 1997

HCo must therefore apply section 716-80 to both the relevant entities.

HCo's share of ACo's partnership income

HCo must include in its assessable income ACo's share of partnership P's assessable income that is reasonably attributable to the period when ACo was a subsidiary member of the consolidated group but partnership P was *not*. HCo must also include ACo's share of a proportion of any assessable amounts that are not reasonably attributable to any particular period in the income year. → paragraph 716-80(1)(a)

HCo includes 50% of partnership P's assessable income for the period 1 October 2003 to 29 February 2004:

50% x $6,000 = $3,000

HCo is entitled to deduct ACo's share of partnership P's deductions that are reasonably attributable to the period when ACo was a subsidiary member of the consolidated group but partnership P was *not*. → subparagraph 716-80(1)(b)(i), ITAA 1997

The total of these amounts is $6,400.

HCo is also entitled to deduct ACo's share of a proportion of partnership P's deductions that are not reasonably attributable to any particular period in the income year. → subparagraph 716-80(1)(b)(ii), ITAA 1997

In this case, partnership P's deduction for borrowing expenses of $600 is not attributable to any particular period in the 2003–04 income year.

The proportion is worked out under subsection 716-80(2) as follows:

$$\$600 \times \frac{152}{366}$$

152 (days in the spreading period when ACo was a member but P was not)

366 (days in the spreading period)

= $249

(The spreading period is 366 days, since ACo was a partner for the whole of the 2003–04 income year.→ section 716-100, ITAA 1997)

HCo is therefore entitled to deduct under subsection 716-80(1)(b):

50% x ($6,400 + 249) = $3,325

HCo's share of BCo's partnership income

HCo must include in its assessable income BCo's share of partnership P's assessable income. It is also entitled to deduct BCo's share of partnership P's deductions that relate to the period when BCo was a subsidiary member of the consolidated group but partnership P was *not*. → subsection 716-80(1)

Since there is no period when BCo was a subsidiary member of the consolidated group but partnership P was not, there are no amounts of assessable income or deductions that HCo must include or can deduct.

HCo's share of partnership P's borrowing expenses

Since partnership P has a non-membership period and, but for consolidation, would have been entitled to a deduction for borrowing expenses spread over two or more income years under a provision of the Act, special provisions apply to apportion the deduction between partnership P and HCo. → section 716-25, ITAA 1997

HCo's deduction is a proportion of the amount partnership P could have deducted if it had not joined the group (or that HCo could have deducted if partnership P had been a member of the group for the whole income year). The proportion of the $600 amount that is deductible by HCo is worked out under subsection 716-25(4):

$$\$600 \quad \times \quad \frac{122 \text{ (days in both the income year and the spreading period when P was in the group)}}{366 \text{ (days in both the income year and the spreading period)}}$$

$$= \$200$$

HCo is therefore entitled to deduct $200 for the borrowing expenses under subsection 716-25(3).

Table 2: Allocation of borrowing expenses deductible over the full 2003–04 income year

Deductible by	Relevant period	Calculation	Deduction ($)
ACo	1.7.03 – 30.9.03	50% x $150	75
BCo	1.7.03 – 29.2.04	50% x $400	200
HCo (ACo is a member, P is not)	1.10.03 – 29.2.04	50% x $249	125
HCo (P is a member)	1.3.04 – 30.6.04	100% x $200	200
Total			**600**

HCo's income and deductions under the single entity rule

→ section 701-1, ITAA 1997

For the period 1 March–30 June 2004, partnership P is a subsidiary member of the consolidated group. It loses its individual identity on entry into the group and is treated as part of the head company. → section 701-1, ITAA 1997

From 1 March, HCo is taken to earn all assessable income and to incur all expenditure arising from partnership P's contribution to the group's income-producing activities.

Calculation of partnership P's net income

Partnership P joins the consolidated group on 1 March 2004, part-way through its income year. Because it has a non-membership period, it must work out its income tax position and lodge an income tax return for the 2003–04 income year. → section 701-30, ITAA 1997; C9-5-110

Section 701-65 modifies the operation of section 701-30 to allow it to apply to a partnership or a trust. → section 701-65, ITAA 1997

Partnership P must allocate each relevant item to either the non-membership period or to another period in the income year. Amounts that cannot be allocated are apportioned between periods. → paragraph 701-30(3)(c); 'Calculating taxable income, income tax and losses for non-membership periods', C9-5-110

On the facts provided, partnership P allocates a total of $11,000 in assessable income and $9,400 in deductions to its non-membership period. A further deduction of $600 must be apportioned between periods. A deduction that is spread over two or more income years by a provision of the Act (such as borrowing expenses under section 25-25) is apportioned between partnership P and HCo under a specific provision. → section 716-25, ITAA 1997

The proportion of the $600 amount that is deductible to partnership P is worked out under subsection 716-25(6):

$$\$600 \times \frac{244 \text{ (days in both the non-membership period and the spreading period)}}{366 \text{ (days in both the income year and the spreading period)}}$$

$$= \$400$$

The net income of partnership P for the 2003–04 income year is its assessable income less deductions (with certain exceptions). → section 90, ITAA 1936:

$11,000 – ($9,400 + $400) = $1,200

Table 3: Reconciliation of taxable income or losses returned against the net income of partnership P

Entity	Assessable income ($)	Deductions ($)	Taxable income or loss included ($)
ACo	2,500	(1,575)	925
BCo	5,500	(4,900)	600
HCo	3,000	(3,325)	(325)
Total	**11,000**	**(9,800)**	**1,200**

References

Income Tax Assessment Act 1997, sections 25-25, 701-1, 701-30, 701-65, 716-25, 716-75 to 716-100, as amended by *New Business Tax System (Consolidation) Act (No. 1) 2002* (No. 68 of 2002); *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (No. 117 of 2002)

Income Tax Assessment Act 1936 sections 90, 92

Explanatory Memorandum to New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, paragraphs 4.27 to 4.39