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Determination Compendium – TD 2015/19

This is a compendium of responses to the issues raised by external parties to draft TD 2015/D2 *Income tax: if a retiring partner receives an amount representing their individual interest in the net income of the partnership for an income year, is the amount assessable under section 92 of the Income Tax Assessment Act 1936?*

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft Determination.

Summary of issues raised and responses

Issue No.	Issue raised	ATO Response/Action taken
1.	The draft TD seems to confuse or conflate the conceptual amount which is assessable under section 92 with the cash payment of that amount (or in respect of the interest which that amount represents).	The amount in question represents both a receipt and a partner's individual interest in the net income of the partnership. As such, it is covered by section 92 of the <i>Income Tax Assessment Act 1936</i> ¹ but may also represent capital proceeds for capital gains tax purposes. The wording in the TD has been adjusted to remove any doubt.
2.	The draft TD places too much emphasis on the accounting treatment in determining each partner's share of partnership profit. It is necessary to determine a retiring partner's legal rights by reference to the terms of the relevant partnership deed and the facts of each case. A partnership deed will generally define a partner's share in the profits or net income of the partnership.	Additional references to the partnership agreement have been inserted into the TD for the avoidance of doubt. The partnership deed may provide no specific definition of a partner's share in the profits or net income of the firm. In the absence of a clear statement in the partnership deed, it may be necessary to determine the partner's entitlement by reference to other documents; for example, accounting records, minutes of the firm's remuneration committee.

¹ All legislative references in this Compendium are to the *Income Tax Assessment Act 1936*.

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3.	A partnership deed may provide for retirement payments based on a graduated entitlement reflecting the years of a partner's service (as used in the example in the TD), without necessarily incorporating this entitlement into the definition of a partner's share in the profits or net income of the partnership. Unless the retirement entitlement is clearly subsumed into the profit entitlement, as a matter of legal construction the basis on which the retirement payment can be universally considered to be an allocation of the net income of the partnership is questionable.	The TD is premised on the partner having an individual interest in the net income of the partnership. The TD is not designed to address whether a partner has such an interest. This depends on the facts in each case, including the terms of the relevant partnership agreement. See paragraph 23 of the TD.
4.	The position in the draft TD is inconsistent with <i>Federal Commissioner of Taxation v. Galland</i> (1986) 162 CLR 408 (<i>Galland</i>). There, the High Court affirmed the common law principle that the partnership profits in a particular period can only be determined upon the drawing of accounts either on the balance date or on another relevant event, such as the dissolution of the partnership. Thus in <i>Galland</i> it was held that the disposition of a partnership interest prior to the accounting balance date resulted in the alienating partner not having any entitlement to the net income of the partnership for the accounting period during which the disposal occurred.	The position in the TD is considered to be consistent with the judgment in <i>Galland</i> . See further, paragraph 24 of the TD. The factual scenario covered by the TD differs from that in <i>Galland</i> . The TD is premised on the partner having an individual interest in the net income of the partnership. See the response to issue 3. In contrast, the taxpayer in <i>Galland</i> was not entitled to the profits and capital attributable to 49% of his former interest in the partnership, since that interest had been assigned to another entity. In that case, the assigned interest included the right to share in partnership profits which arose both before and after the date of assignment. ²
5.	In <i>Galland</i> , Dawson J merely observed that those partners who are partners as at the balance date cannot defer their liability merely by ensuring that the accounts are not drawn up on that very day. This is consistent with the High Court's unanimous view that a partner cannot have a tax liability in respect of the profits of the financial year unless they were a partner in the partnership as at the end of the financial year.	The Court in <i>Galland</i> did not deny that a partner could have a tax liability in respect of the profits of the financial year unless they were a partner in the partnership as at the end of that year. Rather, the court held that the assignment of a share of an interest in a partnership carries with it the income attributable to that share, unless the assignment limits the entitlement to income. ³

² *FC of T v. Galland* 86 ATC 4885 at 4888.

³ *FC of T v. Galland* 86 ATC 4885 at 4888.

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6.	In <i>Federal Commissioner of Taxation v. Happ</i> (1952) 9 ATD 447; [1952] ALR 382, the retiring partner was a partner as at the date of the dissolution of the partnership and thus the partner was entitled to a share of the profits in the period up to dissolution.	This is consistent with the position in the TD, where the taxpayer is a partner as at the date of retirement, and thus is entitled to an amount representing their individual interest in the net income of the partnership for the relevant year. The position in the TD is consistent with the view that a partnership dissolves each time its membership changes. However, it is considered to apply equally if the partnership is treated as continuing. ⁴
7.	<i>Rose v. Federal Commissioner of Taxation</i> (1951) 84 CLR 118 (<i>Rose</i>) dealt with the application of the livestock and depreciation provisions of tax legislation in the context of a formation of a partnership. It is not relevant to the issues at hand, other than it affirms that the allocation of income is separate to the actual disbursement of funds.	The decision in <i>Rose</i> is cited in the TD as authority for the proposition that the collective income earned by the partnership belongs to the partners according to their shares in the partnership. Mason and Wilson JJ cited the decision in this context in <i>Galland</i> . This proposition is considered to support the position in the TD. See response to issue 4 above.
8.	The draft TD refers to <i>McNally v. FC of T; FC of T v. McNally</i> 2007 ATC 4150 (<i>McNally</i>) where it was stated that the relevant partners could bind themselves as to the distribution of the net income of the partnership. This is consistent with the core proposition in <i>Galland</i> . Indeed in <i>McNally</i> , the Court found in respect of work in progress that the retiring partner had to be treated in the same manner as the continuing partners.	This finding from <i>McNally</i> inherently recognises the need to determine a retiring partner's interest in the net income of the partnership. As such, it directly supports the position in the TD. Jessup J stated: ⁵ The fact that the taxpayer was a partner for part only of the year in question cannot affect the legally correct approach to the matter of the determination of Deloitte's assessable income, to the extent that the taxpayer had an interest in it. If a set of accounts for taxation purposes was struck when the taxpayer left on 17 July 1997, necessarily work-in-progress would have been taken out. That was not done, the result of which may create practical difficulties in the way of calculating the taxpayer's interest. However, that may be, it provides no reason to calculate that interest in a way that unarguably includes work-in-progress.

⁴ See GSTR 2003/13, *Goods and services tax: general law partnerships*, paragraphs 148-166.

⁵ *McNally v. FC of T; FC of T v. McNally* 2007 ATC 4150 at [54].

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9.	Partnership funding sources are fungible and there is no direct link between profits and retirement payments. In any event, the economic equivalence doctrine was rejected by the Federal Court in <i>Galland</i> .	The position in the TD applies where the partner has an individual interest in the net income of the partnership. This is essentially a question of fact; see response to issue 4 above. However, a partner who has an entitlement to receive an amount funded from partnership profits is likely to have an individual interest in the net income of the partnership.
10.	There should be symmetry between the positions taken by continuing and retiring partners, in the sense that continuing partners should not be assessed in a manner which does not reflect the actual disbursement of partnership funds. However, symmetry should be achieved by taking positions which are based on a correct legal construction of the relevant partnership deed.	The ATO agrees that the position must be based on a correct construction of the partnership deed. The TD is consistent with this approach. It is noted that an approach based on the submission on issue 4 above is likely to produce a result where continuing partners are assessed under section 92 on amounts which are paid to retiring partners.
11.	Given the complexity of the issues involved, the draft TD should be withdrawn and replaced with a comprehensive public ruling which addresses alternative partnership deed provisions and resulting tax consequences.	The purpose of the TD is to advise taxpayers of a change in the ATO's view in relation to the taxation of partnership net income and to establish a date of effect for that change. The TD is considered to be an appropriate means of achieving this purpose. The TD is not designed to address the circumstances in which a partner will have an interest in partnership net income, since this is essentially question of fact, to be determined in each case.
12.	In view of the ATO's previous practice, the ATO is bound, as a minimum, to respect pre-existing assessments as proposed. However, this 'grandfathering' is not extended to events other than those on which the ATO has issued a private binding ruling. This approach is normally applied to relatively egregious practices of which this is not. The ATO should consider a date of effect provision which does not disturb any retirement payments that have been made prior to the date of the draft TD, if not the Final Determination.	The existing date of effect is considered to be appropriate. The former position referred to in paragraph 13 of the TD is erroneous and was not consistently applied by taxpayers prior to the issue of the draft TD.