


Cover sheet for: TR 2017/D4

Generated on: 6 December 2019, 02:01:56 AM

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Draft Taxation Ruling

Income tax: when does a corporate limited partnership ‘credit’ an amount to a partner in that partnership?

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Summary – what this ruling is about

1. This draft Ruling sets out the Commissioner’s preliminary, but considered view on when a Corporate Limited Partnership (CLP) ‘credits’ an amount to one of its partners within the meaning of section 94M of the *Income Tax Assessment Act 1936*.¹
2. This draft Ruling does not deal with:
 - whether an amount credited to a partner in a CLP is against the profits or anticipated profits of the CLP, or
 - how the anti-overlap provisions apply to avoid double taxation where an amount credited is subsequently paid or distributed.

Ruling

3. A CLP ‘credits’ an amount to one of its partners within the meaning of section 94M if, in substance, it applies or appropriates its resources to confer a benefit on the partner that:
 - (a) is not subject to a condition precedent and is legally enforceable by the partner, and

¹ All legislative references in this draft Ruling are to the *Income Tax Assessment Act 1936* unless otherwise indicated.

- (b) is separate and distinct from the partner's existing interest in the CLP and its assets.
4. A mere credit entry in a CLP's accounts is not a crediting within the meaning of section 94M unless it records an underlying act or transaction that meets the requirements in paragraph 3 of this draft Ruling.
5. A CLP does not need to make a distribution or pay an amount to a partner in order for it to credit an amount to that partner.
6. If the requirements in paragraph 3 of this draft Ruling are satisfied a partner of the CLP is 'credited' with that amount, even if a future event may occur which requires the benefit to be relinquished or returned to the partnership.

Applying the principles in this Ruling

Step 1

Has the CLP, in substance, applied or appropriated its resources to confer a benefit on one or more of its partners?
Paragraphs 16–18, 24-25
Example 2

Note 1: It is not necessary for an amount to be paid or distributed in order for there to be a crediting.
Paragraphs 11– 12

Note 2: A mere credit entry is not sufficient; there must be an underlying act or transaction which satisfies the criteria in steps 2 and 3 below.
Paragraphs 13 – 15,
Example 1

Step 2

Is the benefit conferred on the partner legally enforceable?
Paragraphs 19 and 24-25,
Example 3, 6 and 7

Is the benefit conferred on the partner subject to a condition precedent?
Paragraph 20
Examples 4 and 5

Note 3: A crediting may still occur even if a future event may occur which requires the benefit to be relinquished or returned to the partnership.
Paragraphs 21 – 23

Step 3

Is the benefit conferred on the partner separate and distinct from the partner's existing interests in the CLP and its assets?
Paragraphs 28 – 29

Taxation of Corporate Limited Partnerships under the ITAA 1936

7. CLPs and their partners are taxed according to the rules set out in Division 5A of Part III (Division 5A).² The object of Division 5A is to tax partners in CLPs as if they were shareholders in a company³, rather than as partners in a partnership (who are taxed under Division 5 of Part III).

8. Sections 94L and 94M deem certain distributions, payments and credits made by a CLP to a partner to be dividends. These deemed dividends are included in the partner's assessable income by subsection 44(1).

The meaning of credits in section 94M

9. 'Credits' is not defined for the purposes of section 94M. Nor is there any case law that has considered its meaning in that context.

10. The Oxford and Macquarie Dictionaries relevantly define 'credits' as credit entries in books of accounts that represent a right to obtain funds, record a payment made or a sum due.⁴

'Credits' does not mean 'pays' or 'distributes'

11. 'Credits' is one of three events used in sections 94L and 94M to define when a dividend is deemed to be paid to a partner in a CLP. Those events are when an amount is distributed, paid or credited to a partner by the partnership. It follows that credits means neither paid nor distributed.⁵

12. This is consistent with the case law on the meaning of 'credits'.⁶ The context⁷ and case law, do however suggest that a crediting involves something akin to a payment or distribution.⁸

'Credits' requires more than a mere credit entry in a CLP's accounts

13. For an amount to be credited within the meaning of section 94M, there must be more than a mere credit entry in the CLP's accounts.

² Section 94P

³ Section 94A; Explanatory Memorandum to the Taxation Laws Amendment Bill (No.6) 1992 (Cth).

⁴ Shorter Oxford Dictionary 2nd Edition, Credits, meanings 10 and 12; Macquarie Dictionary meanings 12, 14 and 15.

⁵ *Project Blue Sky v. ABA* (1998) 194 CLR 355 at [71]

⁶ For example *Commissioner of Taxes (Victoria) v. Nicholas* (1938) 59 CLR 230 confirmed on appeal to the Privy Council: *Nicholas v. Commissioner of Taxes (Vic)* [1940] 3 All ER 91; [1940] AC 740 (*Nicholas*); and *Lonsdale Sand & Metal Pty Ltd v. C of T* (1998) 162 ALR 220 (*Lonsdale*) at 228 to 229 which discussed the leading cases on credits.

⁷ *Avondale Motors (Parts) Pty Ltd v. FCT* (1971) 45 ALJR 280 at 283.

⁸ For example *Nicholas* at 244 per Rich J; *Lonsdale*.

14. If the position were otherwise, it would create a tax treatment in respect of the profits of a CLP that is substantively identical to that created under Division 5. It would effectively mean the partners in CLPs are taxed on their individual interest in the net income of a CLP as if it were a normal partnership.⁹ This is inconsistent with the object of Division 5A to tax partners in a CLP as if they were shareholders in a company.¹⁰

15. Such an approach would also mean that a partner in a CLP may be taxed on amounts they have not received in fact or substance, may never receive, and may have no right to demand payment of from the CLP. This is inconsistent with how shareholders in a company are taxed under section 44.

Example 1: Mere credit entry in a CLP's accounts

A is the general partner in AB & Co LP an unincorporated CLP. At the end of the financial year, AB & Co LP prepares a Statement of Financial Performance, showing a profit of \$100,000. A's share of the profit is \$20,000 which is credited to A's retained profit account in AB & Co LP's accounts.

Under AB & Co LP's partnership agreement, the general partner has the discretion to retain any profits AB & Co LP makes. The general partner makes that election and notifies the partners in writing.

The law governing AB & Co LP does not give partners in CLPs a legally enforceable right to receive or demand payment of the profits credited to them in a CLP's accounts.

The credit entry of \$20,000 to A in AB & Co LP's accounts does not confer any legally enforceable benefit on A separate or distinct from A's existing interest in AB & Co LP. It is therefore not a crediting within the meaning of section 94M.

There must be, in substance, an application or appropriation by the CLP of its resources to confer a benefit on one or more of its partners

16. The case law shows that the first element required for there to be a crediting is that there must be an in substance appropriation or application of the resources of the CLP to confer a benefit on a partner.¹¹

⁹ subsection 92(1).

¹⁰ Op Cit n2.

¹¹ *Lonsdale* at 228 to 229; *Nicholas*; *FCT v. WE Fuller Pty Ltd* (1959) 101 CLR 403 at 419; (1959) 12 ATD 85; (1959) 7 AITR 559 (*Fuller*); Cf *Commissioner of Taxation v. McNeil* [2005] FCAFC 147 (*McNeil*).

17. This distinction can be seen by contrasting McNeil's case, where the conferral of a proprietary right on a shareholder was found not to be a crediting, with cases in which the conferral of benefits was found to be a crediting.¹² In contrast to those cases, the benefit conferred on the shareholder in McNeil's case did not require, or involve, as a matter of substance, any application or appropriation of the company's resources.

18. The 'benefit' conferred on the partner which results from a crediting may be any type of legally enforceable right. For example, it may be a debt,¹³ new property right¹⁴, a right to receive a distribution or payment,¹⁵ or a release from a liability.¹⁶

Example 2: Application of a partnership distribution to increase a partner's investment in the partnership

B is a limited partner in Old Co LP. By written agreement, B agrees to contribute an additional \$100,000 in capital to the partnership and thus increase their interest in the profits and capital of the partnership. It is agreed that B will contribute this by way of \$50,000 in cash and by forgoing their entitlement to receive a \$50,000 profit distribution from Old Co LP out of retained profits. B pays Old Co LP \$50,000 and signs a release in respect of their entitlement to receive the \$50,000 profit distribution.

Under the relevant state partnership law, such additional investments of capital by partners are permitted, but to be legally enforceable must be recorded in the partnership's statutory record.

The agreement is executed and the change in B's liability to contribute is notified to the relevant statutory authority and recorded in Old Co LP's statutory record. As the statutory requirements are satisfied it follows that B's interest in Old Co LP is increased by \$100,000.

In substance Old Co LP has applied its resources to confer a legally enforceable benefit of \$50,000 on B, which is separate and distinct from B's existing interest in Old Co LP. B has been credited \$50,000 by Old Co LP.

¹² For example *Fuller, Nicholas, and Lonsdale*.

¹³ *Brookton Cooperative Society Ltd v. Federal Commissioner of Taxation* (1998) 162 ALR 220 (*Brookton*).

¹⁴ For example *Nicholas, Webb v. FCT* (1922) 30 CLR 450 (*Webb*), *Fuller*, and *James v. FCT* (1924) 34 CLR 404 (*James*).

¹⁵ *Brookton*.

¹⁶ *Lonsdale*; TD 2015/20 *Income tax: Division 7A: is a release by a private company of its unpaid present entitlement a 'payment' within the meaning of Division 7A of Part III of the Income Tax Assessment Act 1936?*

The benefit conferred on the partner must be legally enforceable and not subject to a condition precedent

19. The benefit conferred on the partner must be legally enforceable for there to be a crediting.¹⁷

Example 3: Creation of a debt owing

B is a limited partner in ABC LP, an incorporated CLP. On finalising its accounts for the year, B's share of ABC LP's profits is calculated to be \$400,000. ABC LP credits \$400,000 to B in its accounts.

Under ABC LP's partnership agreement the finalisation of its accounts for a financial year causes 50% of each partners' share of the profits for the year to become a debt unconditionally payable on demand to the partner. Any distribution of profits beyond this is entirely at the discretion of the general partner.

The finalisation of its accounts for the year confers a legally enforceable benefit upon B: a debt of \$200,000. This is separate and distinct from B's existing interest in the partnership.

ABC LP has credited \$200,000 to B within the meaning of section 94M.

Benefit subject to conditions precedent

20. If the benefit is subject to a condition precedent that prevents the partner from enforcing it, it will not be credited until the condition is satisfied and it becomes legally enforceable.¹⁸ For example, where the 'benefit' is revocable by unilateral action of the CLP prior to it becoming enforceable by the partner, this will not be a legally enforceable benefit sufficient to amount to a crediting until it is no longer revocable.¹⁹

Example 4: Conditional right to receive profits

B is a limited partner in ABC LP, an incorporated CLP. On finalising its accounts for the year, B's share of ABC LP's profits is calculated to be \$400,000. ABC LP credits \$400,000 to B in its accounts.

Under ABC LP's partnership agreement, the general partner may elect to retain all or part of a partner's share of the profits within 30 days of the finalisation of its accounts. If it does not do so, 50% of each partner's share of the profits becomes an immediately enforceable debt payable on demand.

¹⁷ *Lonsdale; Nicholas; Webb; FCT v. WE Fuller Pty Ltd* (1956) 101 CLR 403; (1959) 12 ATD 85; (1959) 7 AITR 559 (*Fuller*); cf *Brookton* at 4355; *Jolly v. FCT* (1934) 50 CLR 131 (*Jolly*).

¹⁸ *Brookton*; Cf *Bluebottle UK Ltd v. DFCT & Ors* [2007] HCA 54 (*Bluebottle*)

¹⁹ *Brookton*.

On the finalisation of the accounts, B obtains a conditional right to receive a distribution of \$200,000 from ABC LP. As it is contingent on the general partner not electing to retain them, B has no legally enforceable right to demand payment of any part of the \$400,000 credited to them in ABC LP's accounts. There is no crediting to B on the finalisation of ABC LP's accounts.

20 days after the finalisation of accounts, the general partner waives, in writing, the right to retain the \$200,000 of B's share of the profits. At this time, a legally enforceable debt of \$200,000 payable on demand becomes owing to B by ABC LP.²⁰ The debt is separate and distinct from B's existing interest in ABC LP. ABC LP has credited B \$200,000 within the meaning of section 94M.

Example 5: Partially exercised right to make drawing

Under D Co LP's partnership agreement, on the third day of each month the general partner (GP) is entitled to make a drawing of up to 70% of their share of the partnership's estimated profits for the preceding month. In July, GP's share of the estimated profits of D Co LP is estimated to be \$100,000. GP is entitled to make a drawing of up to \$70,000.

GP draws \$30,000 of his entitlement. Being paid to the partner out of anticipated profits, the \$30,000 is deemed to be a dividend under subsection 94M(1).

Whether the unexercised entitlement to draw \$40,000 is a crediting will depend on whether GP has a legally enforceable right (which is not subject to a condition precedent) to demand payment of the \$40,000.

If after the day on which the entitlement can be exercised passes, the partnership agreement provides that any undrawn entitlement becomes a debt owing to GP payable on demand, an unconditional and legally enforceable right (a debt), is created in GP's favour. D Co LP will have credited \$40,000 to GP.

If the partnership agreement gives the partnership the right to refuse to pay the undrawn amount of \$40,000 even if called for, the entitlement is conditional and no legally enforceable right will have been conferred on GP. No amount is credited to GP.

²⁰ *R v Brown* (1912) 14 CLR 17.

Benefits subject to a condition subsequent

21. Section 94M deems payments out of anticipated profits to partners to be dividends when they are paid to the partner. This is so, whether or not the amount of the profits or anticipated profits is ascertainable or the amount may be required to be repaid if a future event occurs. For example a partnership agreement of a CLP may provide that payments of interim distributions of profits are to be repaid in some circumstances. For example, if the final annual profits are less than a specified level.²¹

22. Section 94L similarly deems a dividend to have been paid at the time that property is distributed by the partnership.

23. There is no reason why this treatment should not apply in relation to amounts credited under section 94M. This means that once a benefit is actually conferred on or received by the partner that meets the requirements in paragraph 3 of this draft Ruling there is a crediting to the partner within the meaning of section 94M. This is so even if the benefit is subject to a condition subsequent that may require it to be to be relinquished or returned to the CLP on the occurrence of a future event.

Has a legally enforceable benefit been conferred on a partner?

24. When determining whether a legally enforceable benefit has been conferred on a partner by the CLP it is necessary to consider:

- (a) the partnership agreement²²
- (b) the laws governing:
 - i. the partnership²³, and
 - ii. the benefit in question.²⁴

25. These laws and agreements may contain restrictions that mean no legally enforceable benefit has been conferred on a partner. For example, where a partner's right to receive a distribution of profits from the CLP is said to be offset against the partner's unpaid obligation to contribute to the partnership liabilities. Such transactions may not satisfy the rules governing how limited partners may discharge their liability to make contributions towards the liabilities of the CLP and consequently confer no legally enforceable benefit on the partner.²⁵ This may be as a result of the transaction not being recorded in the CLP's statutory record.²⁶

²¹ *Lindley & Banks on Partnership*; Roderick l'Anson Banks, 19th edition, 2010 at p233

²² For example *Rowe v FCT* [1982] FCA 93; (1982) 60 FLR 475, *Rowella Pty Ltd v. Abfarm Nominees Pty Ltd* (1989) 168 CLR 301; *Brookton*; *Bluebottle*.

²³ *Brookton*; *Bluebottle*.

²⁴ *Lonsdale*; *Nicholas*; *Jolly's case*; *James* per Isaacs J; *Fuller* per Fullagar and Menzies JJ

²⁵ For example section 65 of the *Partnership Act 1892* (NSW); Cf *Partnership Act 1958* (Vic); and the *Partnership Act 1963* (ACT).

²⁶ For example sections 60, 61 and 66 of the *Partnership Act 1892* (NSW).

Example 6: Discharge of running loan account

A is a partner in Loan Co LP. Under its partnership agreement, A has a running loan account under which A may borrow amounts from the partnership during a financial year.

Over the 2012 income year, A borrows \$100,000 from Loan Co LP under this loan facility.

At the end of the financial year, Loan Co LP may offset all or part of A's share of the profits for the year against the amount owing by A to the partnership under their loan facility.

At the end of the 2012 income year, Loan Co LP calculates A's share of the profits for the year to be \$100,000. Under the terms of the partnership agreement governing its right to do so, Loan Co LP elects to and applies A's share of the partnership's profits for the year to discharge the \$100,000 A owes it under the loan facility. Loan Co LP elects to retain the balance of A's share of the profits for the year for use in its business. Loan Co LP sends A an advice in writing that it has done so.

Loan Co LP records the transactions in its books of account, crediting \$100,000 to A's retained earnings account and applying the remaining \$100,000 of A's share of the profits to discharge the \$100,000 debt owed by A to it.

Loan Co LP has allocated and applied \$100,000 of its profits to confer an unconditional and legally enforceable benefit on A distinct from A's existing interest in Loan Co LP. Loan Co LP has credited \$100,000 to A.

Has there been, in substance, an application or appropriation by a CLP of its resources to confer a legally enforceable benefit on a partner?

26. In considering whether a CLP has in substance applied or appropriated its resources to confer a legally enforceable benefit on a partner, relevant considerations include:

- (a) the legal result of the act or transaction²⁷
- (b) how the act or transaction was recorded in the CLP's accounts, or what would have been recorded if the substance of the act or transaction was properly recorded²⁸, and
- (c) either:
 - i. acts or transactions that, while not actually occurring, would necessarily have to have occurred as a matter of fact and law in order for the legal result to be achieved²⁹, or

²⁷ Jolly, Brookton; Webb.

²⁸ Lonsdale; Brookton; James.

²⁹ Nicholas; Fuller at 419; James.

- ii. alternative acts or transactions by which the benefit in question could have been conferred on the partner.³⁰

27. The following involve an in substance application by a CLP of its resources to confer a legally enforceable benefit on one or more of its partners:

- (a) an act or transaction that creates an irrevocable and legally enforceable debt owing from the CLP to the partner³¹
- (b) a legally enforceable forgiveness by the CLP of a debt owed to it by one of its partners³², and
- (c) where permitted by the relevant partnership law, a limited partner giving up a right to receive a distribution of profits from the CLP:
 - i. in return for a legally enforceable discharge of their unpaid obligation to contribute to the CLP's partnership liabilities³³, or
 - ii. as a means of making an additional contribution of capital to and increasing their interest in the CLP's capital and profits.³⁴

Example 7: Application of partnership profits to discharge an obligation to contribute to the liabilities of the CLP

C is a limited partner in ABC LP; an unincorporated CLP. C has agreed to contribute \$100,000 to the partnership liabilities, of which \$40,000 remains unpaid.

The law under which ABC LP is formed allows a limited partner's unpaid obligation to contribute to the partnership's liabilities to be satisfied by applying the partner's share of retained profits to discharge that obligation.

Under ABC LP's partnership agreement, its general partner (GP) may, at any time, call on the limited partners to pay any unpaid obligations to contribute to the partnership's liabilities. It also provides that it may at its option apply a partner's share of retained profits to discharge a limited partner's unpaid obligation to contribute to its liabilities.

Under the law, the partnership is required to maintain a statutory record of the partnership with a government authority. This record includes the amount limited partners are liable to contribute to the partnership, and how much of their obligation is unpaid. The discharge of a partner's obligation is only enforceable if recorded in the partnership's statutory record.

³⁰ Lonsdale.

³¹ Brookton.

³² Lonsdale.

³³ Nicholas; James; Fuller.

³⁴ Nicholas; James; Fuller.

C's share of ABC LPs retained profits is \$40,000. C does not have a right to receive any part of their share of ABC LPs accumulated profits unless GP exercises their discretion to make a distribution of profits.

GP exercises its discretion to apply C's share of ABC Co's accumulated retained profits to discharge C's unpaid obligation to contribute \$40,000 to its liabilities. GP notifies C in writing that it is doing so. ABC LP records the discharge of C's obligation in its accounts and notifies the relevant government authority which records it in ABC LP's statutory record.

ABC LP has allocated and applied \$40,000 of its profits to discharge C's obligation to contribute \$40,000 to the partnership's liabilities. The discharge of C's obligation has conferred an unconditional and legally enforceable benefit that is separate and distinct from C's existing interest in ABC LP. ABC LP has credited \$40,000 to C.

The benefit conferred on the partner must be separate and distinct from the partner's existing interest in the CLP

28. The benefit that is conferred on a partner must be separate and distinct from their existing interest in the partnership.³⁵ For example, a new interest in the partnership and its profits³⁶ or the extinguishment of a debt owing.³⁷

29. In order to identify whether a benefit received by a partner is separate and distinct from their existing interest in a CLP, it is necessary to identify what the partner's interest in the CLP and the partnership property was, immediately before the act or transaction.

Date of effect

30. When the final Ruling is issued, it is proposed to apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

17 May 2017

³⁵ *Nicholas* at 244 per Rich J; *Lonsdale* at 229: See also *Webb* per Knox CJ, Gavan, Duffy, and Starke JJ.

³⁶ *Nicholas* per Rich J at 244; *Fuller and James*.

³⁷ *Lonsdale*.

Appendix 1 – Your comments

31. You are invited to comment on this draft ruling, including the proposed date of effect. Please forward your comments to the contact officer by the due date.

32. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments;
and
- be published on the ATO website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date: 30 June 2017
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10; TD 2015/20

ATO references

NO: 1-9G6RBVB

ISSN: 2205-6122

ATOlaw topic: Income tax ~~ Assessable income ~~ Other types of
income ~~ Other

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