

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 ?

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This document has been finalised by TD 2015/19.

! There is a Compendium for this document: **TD 2015/19EC** .



Draft Taxation Determination

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 publication provides you with the following level of protection:

This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the following way. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

Ruling

1. Yes. Subject to paragraph 3 of this draft Determination, the amount is included in the partner's assessable income for the income year under section 92 of the *Income Tax Assessment Act 1936* (ITAA 1936).¹
2. This is the case regardless of:
 - how the payment is labelled or described (including whether the payment is expressed to be consideration for something provided or given up by the partner), and
 - the timing of the partner's retirement (including whether they retire before the end of the income year), and
 - the timing of the payment.
3. However, an amount is not assessable under section 92 to the extent that it represents net income of the partnership which is attributable to both:
 - a period when the partner was not a resident of Australia, and
 - sources outside of Australia.

¹ All legislative references in this draft Determination are to the ITAA 1936, unless otherwise indicated.

Example

4. *ABC is a professional partnership carrying on business in Australia. Paul was a partner in ABC and an Australian resident throughout year 1. Paul retired from the ABC on 1 January, year 1. He received a payment of \$500,000 from ABC on 30 July, year 2.*

5. *ABC's financial accounts indicate that partnership's profit for year 1 was \$200,000,000, of which \$500,000 (0.25%) was allocated to Paul. This is consistent with ABC's Statement of Distribution, which indicates that ABC's net income was \$205,000,000 of which \$512,500 (0.25%) was allocated to Paul.*

6. *ABC's working papers indicate that Paul's 0.25% interest comprised:*

- *Paul's base profit share for year 1, apportioned to reflect his retirement before 30 June*
- *an additional amount expressed to be in respect of 'unused leave', and*
- *an additional amount described as a 'retiring allowance', calculated by reference to the number of years Paul served as a partner in the firm.*

7. *There is no evidence to suggest that ABC's financial accounts or Statement of Distribution are false or misleading.*

8. *In Paul's Retirement Deed, the \$500,000 payment is expressed as being in respect of Paul disposing of his interest in the partnership.*

9. *\$512,500 is included in Paul's assessable income under section 92. Objectively, the amount represents Paul's individual interest in the net income of ABC for year 1. It does not matter that the amount is expressed to be in respect of Paul disposing of his interest in the partnership or is, in part, calculated by reference to his past service.*

10. *Any capital gain which Paul might otherwise make as a result of a CGT event happening to his interest in ABC is reduced to the extent that it is reflected in the amount which is assessable under section 92.*

Date of effect

11. In a number of private rulings, issued over several years, the Commissioner accepted that a payment of the kind covered by this draft Determination is not assessable under section 92 but instead is taken into account in working out a capital gain under the capital gains tax (CGT) provisions.

12. Therefore, the ATO proposes not to seek to disturb favourable assessments made before the date of issue of this draft Determination, in relation to the issue covered by the Determination.

Appendix 1 – Explanation

① *This Appendix is provided as information to help you understand how the Commissioner’s preliminary view has been reached. It does not form part of the proposed binding public ruling.*

13. Where a partner receives a payment upon their retirement or exit from the partnership, the payment might be described as relating, in a general sense, to the disposal of the partner’s interest in the partnership. However, this does not mean that the payment (or any part of it) is taken into account in determining a capital gain (or loss) from such a disposal.

14. For income tax purposes a more specific characterisation is required. It is necessary to identify whether (or the extent to which) the payment to the partner:

- is attributable to their share of partnership net income,
- is assessable in their hands on revenue account on another basis, or
- otherwise relates to the disposal of the partner’s interest in partnership assets.

15. It is therefore necessary to characterise the payment by reference to what it relates to or is attributable to. If the payment relates or is attributable to more than one thing it is necessary to apportion the payment between each thing on a reasonable basis and determine a character for each portion of the payment.

Individual interest in partnership net income

16. To the extent that the payment or portion of the payment is attributable to a partner’s individual interest in the net income of the partnership and meets the necessary residency and source requirements, it is brought to account as assessable income of the partner under section 92.²

17. Section 92 provides:

The assessable income of a partner in a partnership shall include:

- (a) so much of the individual interest of the partner in the net income of the partnership of the year of income as is attributable to a period when the partner was a resident; and
- (b) so much of the individual interest of the partner in the net income of the partnership of the year of income as is attributable to a period when the partner was not a resident and is also attributable to sources in Australia.

18. For resident partners there are therefore 2 basic steps involved in applying section 92:³

- determining the net income of the partnership, and
- determining the partner’s individual interest in that net income.

19. The net income of the partnership is to be determined from the perspective of the partnership, as if the partnership were a taxpayer.⁴

² A further amount may be assessable under section 92 where the partner’s individual interest in the net income of the partnership exceeds their distribution from the partnership; see the Example, paragraph 9 of this draft Determination.

³ *McNally v. FC of T; FC of T v. McNally* 2007 ATC 4150 at [42].

⁴ Section 90.

20. The partner's share of that net income is then a question of fact, to be determined by reference to the partnership's accounting records and any other relevant documents.

21. The net income of a partnership is determined by reference to the taxation law rather than any act or statement of the partnership.⁵ However, once the net income has been determined in accordance with the taxation law, any agreement between the partners as to the allocation of that amount is binding upon the partners for the purposes of section 92.⁶

22. Once it has been concluded that an amount represents all or part of a partner's interest in partnership net income, the amount is assessable under section 92. It is unnecessary to further characterise that amount by reference to how it is labelled by the parties or what it is expressed to be consideration for.⁷

23. For this reason, the principles which apply to determine the income or capital character of undissected lump sums⁸ are not relevant. By definition, a share in the net income of a partnership is capable of separate identification; and, moreover, is assessable without regard to its income or capital character in the hands of the recipient.

24. The treatment of such an amount is also unaffected by the timing of the partner's retirement (including whether they retire before the end of the income year) or the timing of any payment made to them.⁹

25. In practice, an amount received by a partner upon retirement from a professional partnership will commonly be brought to account under section 92 only. This reflects the fact that:

- most or all identifiable assets used in the partnership may be held by a service entity, and
- the partners may agree that nothing will be paid or received in respect of partnership goodwill upon entering or exiting the partnership.¹⁰

Other matters

26. To the extent that the payment or portion of the payment is not attributable to the partner's individual interest in the net income of the partnership it is necessary to consider what else it is attributable to.

27. In characterising such an amount it is necessary to have regard to the terms of any agreement between the parties, including the partnership agreement and any retirement deed.

28. Such an amount would be assessable on revenue account, for instance, to the extent that it relates to partially completed work of the exiting partner, or represents consideration for services rendered or a return on the investment of capital.¹¹

⁵ *Stapleton v. FC of T* 89 ATC 4818 at 4827; *FC of T v. Grant & Ors* 91 ATC 4608.

⁶ *McNally v. FC of T*; *FC of T v. McNally* 2007 ATC 4150 at 4164 at [47].

⁷ *McNally v. FC of T*; *FC of T v. McNally* 2007 ATC 4150 at [42], [47], [59] and [60]

⁸ *McLaurin v. Federal Commissioner of Taxation* (1961) 104 CLR 381; *Allsop v. Federal Commissioner of Taxation* (1965) 113 CLR 341; Taxation Ruling TR 95/35, paragraphs 188-209.

⁹ *Federal Commissioner of Taxation v. Happ* (1952) 9 ATD 447; [1952] ALR 382; *Rose v. Federal Commissioner of Taxation* (1951) 84 CLR 118 at 124; *McNally v. FC of T*; *FC of T v. McNally* 2007 ATC 4150 at [42] and [59]; *Federal Commissioner of Taxation v. Galland* 86 ATC 4885 at 4893.

¹⁰ See further, Taxation Ruling IT 2540.

¹¹ See sections 15-50 and 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997).

29. In rare cases, an undissected compensation receipt may be incapable of apportionment, in which case the entire amount may be treated as capital.¹² However, the facts and circumstances surrounding the receipt may enable the apportionment of such a lump sum on a reasonable basis into its constituent elements.¹³

30. An amount attributable to an individual interest in partnership net income may also represent capital proceeds from a CGT event. However, any capital gain which would otherwise arise is reduced to the extent that it is assessable under other provisions.¹⁴

31. In this regard, a partner's exit from a professional partnership will commonly have no CGT consequences, by virtue of arrangements for the holding of CGT assets of the firm; see paragraph 24 of this draft Determination.

¹² See footnote 8.

¹³ TR 95/35, paragraph 190.

¹⁴ See section 118-20 of the ITAA 1997.

Appendix 3 – Your comments

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

33. 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
- 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: 3 July 2015
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

IT 2540; TR 95/35; TR 2006/10

Subject references:

- Partnerships

Legislative references:

- ITAA 1936
- ITAA 1936 90
- ITAA 1936 92
- ITAA 1997 6-5
- ITAA 1997 15-50
- ITAA 1997 118-20

Case references:

- Allsop v. Federal Commissioner of Taxation (1965) 113 CLR 341

- Federal Commissioner of Taxation v. Galland (1986) 162 CLR 408; [1986] HCA 83; 86 ATC 4885; (1986) 18 ATR 33
- Federal Commissioner of Taxation v. Grant & Ors 91 ATC 4608; (1991) 22 ATR 237
- Federal Commissioner of Taxation v. Happ (1952) 9 ATD 447; [1952] ALR 382
- McLaurin v. Federal Commissioner of Taxation (1961) 104 CLR 381
- McNally v. Federal Commissioner of Taxation; Federal Commissioner of Taxation v. McNally [2007] FCA 51; 2007 ATC 4150; (2007) 65 ATR 738
- Rose v. Federal Commissioner of Taxation (1951) 84 CLR 118
- Stapleton v. Federal Commissioner of Taxation 89 ATC 4818; (1989) 20 ATR 996

ATO references

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