


IT 2551 - Income tax: sale of interest in a professional partnership: amounts paid to retiring partners on account of work in progress

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TAXATION RULING NO. IT 2551

INCOME TAX : SALE OF INTEREST IN A PROFESSIONAL
PARTNERSHIP : AMOUNTS PAID TO RETIRING PARTNERS ON
ACCOUNT OF WORK IN PROGRESS

F.O.I. EMBARGO: May be released

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PREAMBLE Where, under the terms of a partnership agreement, an option is given to continuing or surviving partners to purchase the interest of an outgoing or deceased partner and the option is duly exercised and its terms complied with in all material respects, the outgoing partner or the trustee of the estate of the deceased partner, as the case may be, is not entitled to share in the future profits of the partnership. This general rule, stated in Halsbury's Laws of England, 4th Edition, Volume 35, page 108, para 189, is subject to the proviso that it is open to partners to specifically agree that an outgoing partner or the trustee of the estate of a deceased partner may be entitled to a share in future profits of the partnership.

2. This Office has been asked to clarify the income tax implications where amounts are paid to an outgoing partner or the trustee of the estate of a deceased partner in a professional firm in respect of work in progress at the date of dissolution of the partnership.

RULING 3. It is important at the outset to understand what is meant by the expression "work in progress" in the context of this Ruling. In *Henderson v FCT*, 70 ATC 4016, 1 ATR 596, the High Court of Australia had to decide what amounts should be taken into account in the calculation of the assessable income of a large accounting firm. The Court concluded that the assessable income derived by the firm included only those fees which had matured into recoverable debts, i.e., only those fees for which payment could be demanded according to the stage of completion of services provided. The assessable income did not include work in progress, i.e., the value of services performed by the firm during the year of income but for which payment could not be demanded in the year of income. In the context of this Ruling work in progress is to be understood in this sense, i.e., services which, at the date of dissolution, cannot be billed to the client and give rise to a recoverable debt because the services agreed to be provided have not been completed.

4. Although the Court concluded in the *Henderson* Case that the

value of work in progress that had not matured into recoverable debts at the end of a year could not be taken into account as part of the assessable income derived by the firm during an accounting period, the Court recognised that a different result may follow if the value of work in progress is determined for some other purpose (70 ATC 4020; 1 ATR 601 per Barwick CJ, with whom McTiernan and Menzies J J agreed).

5. The expression "some other purpose" used in Henderson's Case was considered by the New Zealand Court of Appeal in Jamieson v C. of I.R. (N.Z.), 74 ATC 6008; (1974) 4 ATR 327. Jamieson's Case concerned the assessability in the hands of a partner of an amount received for work in progress on his retirement from a legal firm. By agreement with the continuing partners the retiring partner was to receive a sum representing the value of work done on incomplete and current files up to the date of his retirement. The payment was to be in full settlement of the retiring partner's share of work in progress and no adjustment was to be made where the fees ultimately charged varied from the settlement amount. The retiring partner was to be paid a single lump sum at or near the time of his retirement rather than as the work in progress was completed and billed. The Court held that the payment to the retiring partner was assessable income to him on the basis that it was a division of profits. In the view of the Court it was an estimation of the value of work in progress for the purpose of arriving at the respective shares of profit of each partner from their practice up to the date of Mr Jamieson's withdrawal. The decision is an illustration of a situation where partners had agreed to pay to an outgoing partner his share of the expected future profit from work in progress at the date of dissolution.

6. The decision in the New Zealand case may be contrasted with the earlier decision of Taxation Board of Review No.3 in Case B60, 70 ATC 284; Case 9 16 CTBR(NS) 38. In that case the amount paid to a retiring partner on his withdrawal from a partnership included an element for work in progress. No attempt had been made, however, to value the profit in the work in progress. It was not a situation where the partners had agreed to pay to the retiring partner his share of future profits represented in the value of work in progress. Rather, the amount in question was an additional amount received by the taxpayer on the disposal of his interest in the business which had in fact no relationship to work in progress and was more properly described as a receipt for the disposal of goodwill. The case represents an illustration of the sort of bargaining that may occur in determining the total value of a retiring partner's interest in a partnership.

7. The first matter that this Ruling seeks to clarify is that, in relation to payments made in respect of work in progress to an outgoing partner or trustee of a deceased partner's estate, this Office does not seek to tax in effect the same amount twice. Rather, the outcome sought is an application of established legal principles that will result in the amount received in respect of work in progress being assessable either in the hands of the outgoing partner or trustee of the deceased

partner's estate, or as part of the net income of the reconstituted partnership in the financial years when the work in progress matures into recoverable debts.

8. The income tax implications attaching to payments made to an outgoing partner or to the trustee of the estate of a deceased partner in respect of work in progress at the date of dissolution or variation of a partnership will depend upon: (i) whether the outgoing partner or estate of a deceased partner is entitled by virtue of the express and implied terms of the partnership agreement to a share of the anticipated profits from work in progress and, (ii) whether the outgoing or deceased partner's share of such anticipated profits has been valued. The true nature of each payment must, therefore, be determined in each case.

9. As a general rule, if separate consideration attaches to the work in progress such that the amount payable to the retiring partner or deceased estate reflects the future profits that the retiring or deceased partner would have expected to have received in respect of the work in progress had he or she remained a partner in the partnership, e.g., as in the Jamieson case, the amount of consideration should be treated as assessable income of the outgoing partner or the deceased estate in the year in which the payment is received. The nature of the payment is that it is a lump sum received in exchange for the future income that the outgoing or deceased partner would have received in respect of past income earning activities if that person had remained a partner (cf F.C. of T v The Myer Emporium Ltd 87 ATC 4363 at 4371; 18 ATR 693 at 703).

10. In some cases it may have been agreed between the partners that the outgoing partner or the trustee of a deceased partner is entitled to be paid a share of the profit in work in progress as and when the work in progress is completed and billed. Amounts payable in these circumstances to an outgoing partner or the trustee of a deceased partner should be included in assessable income of the outgoing partner or estate as and when the relevant amounts are received.

11. Where any amount in respect of work in progress at the date of dissolution or variation is included in the assessable income of an outgoing partner or estate of a deceased partner it should be shown in the accounts of the reconstituted partnership as an advance to the outgoing partner or estate of the deceased partner. No deduction is allowable in respect of that advance. However, as the work in progress is completed and billed, the moneys so billed, to the extent that they are attributable to the advance in respect of work in progress, will not be regarded as income for purposes of calculating the net income or partnership loss of the reconstituted partnership.

12. On the other hand, where an amount paid to an outgoing partner or the trustee of the estate of a deceased partner in respect of the outgoing or deceased partner's interest in the partnership at the date of dissolution or variation includes an element for work in progress without any detailed calculation of

the profit content in the work in progress, e.g., as in the Taxation Board of Review case referred to in paragraph 6, no amount should be included in the assessable income of the outgoing partner. The amount paid for work in progress in situations of this kind is part of the total consideration paid for the disposal of the partnership interest at the date of dissolution or variation and will be regarded as being of a capital nature.

13. However, where there is no agreement for an outgoing or deceased partner to share in the value of unbilled work in progress, the income arising from the subsequent billing will be regarded as part of the assessable income of the reconstituted partnership in the financial years that the work in progress matures into recoverable debts.

14. Since the unbilled work in progress will be brought to account as assessable income of the outgoing or deceased partner or the reconstituted partnership there are no capital gains implications in the situations to which this Ruling is directed.

COMMISSIONER OF TAXATION
10 August 1989