Chapter 14

# DISPOSAL OF PARTNERSHIP ASSETS AND INTERESTS


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# A case for reform

## How are disposals by partnerships and partners taxed at present?

### General treatment of partnerships

14.1 For purposes other than capital gains tax (CGT), a partnership is treated as if it is a taxpayer, in the sense that it is required to calculate its net income or loss as if a taxpayer. However, a partnership itself is not liable to tax. Rather, partners are taxable on their share of partnership net income and deduct their share of partnership losses. Under that approach, partnerships claim deductions for capital expenditure on depreciable assets and account for any balancing gain or losses on their disposal.

**Example 14.1: Partnership sells asset**

The partnership of A and B acquires a depreciable asset for a cost of $120. The partnership is able to claim depreciation deductions each year in working out its net income or loss for the year. The partnership later sells the asset for $200, at a time when its tax written down value is $30. The partnership would be required to include $90 as assessable income (calculated as the difference between the $120 cost of the asset and its tax written down value of $30). The excess of the $200 sale price over the $120 cost would be brought to tax under the CGT provisions (discussed below).

14.2 A special rule applies where there is a partial change in the ownership of a depreciable asset, as occurs where partnerships are formed or dissolved, or partners join or leave partnerships. In those situations, the person or persons who owned the asset before the change are treated as disposing of the whole of the asset to the person or persons who owned the asset after the change. So, for example, when a partner sells out to a new partner, the old partnership is treated as disposing of the asset to the new partnership, at its market value.

**Example 14.2: Partner sells interest in partnership**

The partnership of A and B has an only asset that cost the partnership $120 with a tax written down value of $30. If A sold his/her 50 per cent interest in the partnership to C for $100, the partnership of A and B would be taken to have disposed of the asset to the partnership of B and C for $200 (calculated as twice the price obtained by A for the disposal of a 50 per cent interest in the asset).

The partnership of A and B would be required to include $90 as assessable income (calculated as the difference between the $120 cost of the asset and its tax written down value of $30). The depreciable cost of the asset to the partnership of B and C would be $200. (The CGT implications for the transaction are discussed below).

14.3 Where such disposal is taken to occur, there is an option for all of the owners of the asset before and after the partial change to elect for balancing adjustment rollover relief. Where balancing adjustment rollover relief is taken, the disposal is ignored and balancing adjustments are not required until the asset is disposed of to a third party. As a consequence, deductions for the new partnership are calculated on the tax written down value rather than market value.

**Example 14.3: Balancing adjustment rollover relief**

In the preceding example, the deemed disposal of the asset from the partnership of A and B would be ignored. The partnership of B and C would be treated as acquiring the asset at its depreciated value of $30.

If the partnership of B and C subsequently sold the asset to a third party, it would be taken to have been allowed the depreciation deductions of $90 allowed to the earlier partnership of A and B. So, if the asset was sold for $200 and its tax written down value was zero, the partnership of B and C would include $120 as assessable income (calculated as the difference between the $120 cost of the asset to the partnership of A and B and its tax written down value of $0). The CGT implications of the transaction are discussed below.

14.4 The availability of balancing adjustment rollover relief means that partners who are not selling their interest in the asset are not liable for any tax on the excess of the value of their interest over their share of the undeducted

purchase price at that time. This tax liability is further deferred until the partner sells their interest or the partnership disposes of the asset.

14.5 Of course there would be no valuation difficulties associated with taxing the excess at the time of the transaction. On the other hand it might be argued that there could be cash flow difficulties as the partners not selling the asset will not have realised the excess value on which they are being taxed.

## Capital gains tax treatment of partnerships

14.6 Partnerships do not account for disposals of assets for CGT purposes. Rather, CGT adopts what is known as the 'fractional interest' approach. Under that approach, a partner's interest in a partnership asset is taken to be itself an asset. When a partnership sells an asset, partners are treated as disposing of their respective interests in the asset.

**Example 14.4: Fractional interest approach — sale of asset by partnership**

If A and B are equal partners, each would be deemed to own a 50 per cent interest in each and every partnership asset. Their partnership acquires an asset for $120. A and B are each treated for CGT purposes as acquiring an asset with a cost base of $60. If the partnership were to sell the asset for $200, A and B would each be treated as disposing of their interest in the asset for $100. Ignoring indexation, each would be taken to have derived a capital gain of $40.

## Capital gains tax treatment of acquisitions and disposals of interests in a partnership

14.7 When a partner disposes of an interest in a partnership, the partner is taken to have disposed of assets corresponding with the partner's interests in the assets of the partnership.

**Example 14.5: Fractional interest approach — sale of interest in partnership**

The partnership of A and B has an only asset that cost the partnership $120. If A sold his/her interest in the partnership to C for $100, A would be taken to have disposed of his/her 50 per cent interest in the partnership asset for $100. Ignoring indexation, A would be taken to have derived a capital gain of $40 (that is, $100 less 50 per cent of $120). Correspondingly, C would be taken to have acquired an asset consisting of a 50 per cent interest in the partnership asset for a cost of $100. B, the continuing partner, would be unaffected.

After the sale from A to C the cost base of B's 50 per cent interest in the partnership asset would remain at $60 whereas C's would be $100.

14.8 The purpose of this approach is to avoid taxing the partner or partners not selling their interests on unrealised capital gains. As there are clearly no valuation problems associated with valuing the interests this treatment has to be justified on other grounds. It could be argued that to apply tax to unrealised capital gains would cause cash flow problems. Alternatively it might be argued that it was inequitable to tax partners on unrealised capital gains when other owners of assets were not taxed until realisation. The fact that the triggering of the tax liability was not of their doing would add some weight to that argument.

14.9 This treatment has some parallel with allowing balancing adjustment rollover relief in respect of wasting assets. There the motivation also seems to be a concern about cash flow or that an action by one partner could trigger a tax liability for all other partners.

## What problems arise from the current treatment?

### Complexity inhibits compliance

14.10 The fractional interest approach under CGT has been subject to criticism because of its complexity and compliance costs. It requires each partner to keep separate records of their respective interests in partnership assets. In the case of depreciable assets, it largely negates the advantage to partnerships of being allowed to prepare a single depreciation schedule. Many taxpayers either have difficulty in complying with the CGT record keeping requirements or are unaware of their responsibility to do so.

## Deficiencies in the law lead to inappropriate outcomes

14.11 However, despite the administrative advantages of the partnership based approach to depreciation it also has some problems. As discussed in more detail below, the current treatment of partnership assets for depreciation purposes can lead to inappropriate outcomes because it allows:

- an unrealised loss to transfer with a depreciable asset and yet allows the vendor of the asset to obtain a corresponding capital loss; and
- an asset to be disposed of for more than its tax-written-down value without tax ever being paid on the gain.

14.12 The Review understands that the Commissioner of Taxation has identified instances involving hundreds of millions of dollars where the current weaknesses in the law have been exploited. For example, assignors of finance leases have been able to avoid tax on balancing adjustments by taking advantage of the balancing adjustment rollover relief. Lease assignments are discussed in more detail in Chapter 8.

### *Transfer of unrealised losses*

14.13 Currently, the balancing adjustment rollover relief is available where the market value of an asset is less than its tax written down value. So, where the rollover relief is taken in that situation, the purchaser of the interest in the asset is effectively taken to acquire the interest at its tax written down value. The purchaser is thus entitled to depreciation deductions in excess of the actual cost of the interest acquired.

14.14 That outcome would appear to be inappropriate, as the general scheme of income tax law is that a deduction for losses should accrue to those who suffer the economic loss. Rollover relief can allow such losses to accrue to others.

14.15 The problem is exacerbated because the vendor can obtain a capital loss equal to the amount of the loss transferred to the purchaser under the rollover relief. This occurs because the cost base of the vendor's interest in the asset is not reduced by the amount of the unrealised loss that is transferred to the purchaser. The following illustrates the problem.

**Example 14.6: Transfer of unrealised losses**

The partnership of A and B acquires an only asset for $120. A subsequently sells his/her interest to C for $20, representing 50 per cent of the market value of the asset; $40. The tax written down value of the asset at the time is $80 (that is, depreciation allowed to date was $40).

The appropriate treatment would be for A to be debited with a loss of $20 (the excess of the written down value of 50 per cent of the asset over the sale price) and for C to be able to depreciate the asset on the basis of the price paid for it. The sale has also identified that B has an accrued loss of $20 relating to his or her share of the asset. If this is not bought to tax then B and C will have different bases for depreciation for the same asset which would be similar to the current system under capital gains tax.

Under the current system, if balancing adjustment rollover relief was taken, the partnership of B and C would be taken to have acquired the asset from the partnership of A and B at its tax written down value of $80, even though its market value is only $40.

For CGT purposes, A would be taken to have disposed of an asset comprising a 50 per cent interest in the partnership asset. The cost base of the asset would be $40 (calculated as 50 per cent of the $120 cost of the asset less 50 per cent of the $40 depreciation deductions allowed). A would therefore incur a capital loss of $20 (that is, $40 cost base less $20 received for the sale of the interest to C). However, B and C would have cost bases of $40 each for the asset and so C could deduct $20 more than he or she paid for the asset.

If balancing adjustment rollover relief was not taken then both A and B could claim a $20 loss and C would only be able to deduct what he or she paid for the asset.

### *Transfer of unrealised balancing charges*

14.16 As well, taxpayers can use the balancing adjustment rollover relief to permanently avoid or reduce tax otherwise payable on balancing charges. Rather than selling the whole of an asset and being taxed on the balancing charge, the taxpayer instead sells a significant interest in the asset (say 99 per cent) to a tax-preferred entity with whom they form a partnership. If rollover is taken, the 99 per cent interest transfers to the purchaser at its tax written down value. The whole of the asset can then be sold to a third party with 99 per cent of the gain accruing for tax purposes to the tax-preferred entity. Once again the problem is that the balancing adjustment rollover relief

allows a purchaser to obtain an asset with a tax value markedly different to its market value.

### Problems are not limited to partnerships

14.17 The problems described above arising from the treatment of partial changes in the ownership of depreciable assets can also occur in respect of assets owned by companies and trusts, for much the same reasons.

# *A strategy for reform*

## Balance the objectives of greater integrity and reduced cost of compliance through greater consistency

14.18 Full integration should be the basic principle behind the taxation of partnerships. This would mean that all the income of the partnership was allocated to the partners in accordance with their interests in the partnership. The partnership itself would have no tax liability but all its income would be taxed in the hands of the partners, whether distributed to them or not.

14.19 The current tax treatment of partnerships is broadly in accordance with that approach, but as noted above the concern about partners being taxed on unrealised income has led to some deviations from that approach and some opportunities for tax minimisation.

# *Reform options*

## Option 1: Extend the fractional interest approach to the depreciation provisions

14.20 Broadly, this option would require each partner to separately account for their respective interests in an asset for depreciation purposes. Given that they are already legally required to do so for capital gain purposes, this approach would amount to treating each partner on an individual basis in respect of their interests in the partnership's assets.

14.21 Each partner would separately calculate their depreciation deductions according to either their share of the cost of an asset or the price they paid for acquiring an interest in the asset. Similarly, they would separately

account for disposals of their interests in assets in the same way that they are presently required to do so under CGT.

14.22 This approach would remove the need for rollover relief because only those selling an interest would be required to take account of disposals for tax purposes.

14.23 In theory, the fractional interest approach should impose little additional record keeping obligations on taxpayers, as they already have to keep such records for CGT purposes. Indeed, it could reduce compliance costs as a single set of records could be used for both depreciation and CGT.

14.24 In practice, the reverse is likely to be the case because many partners experience considerable difficulty in complying with the fractional interest approach for CGT purposes. To require them to do the same for depreciation purposes would exacerbate matters for them.

## Option 2: Apply an entity treatment to partnerships

14.25 A consistent approach for both depreciation and capital gains could be achieved by applying an entity approach to partnerships.

14.26 Under an entity approach the partnership would be regarded as the owner of all the assets as is currently the case for depreciation purposes. The partners' ownership interest would be in the partnership as a whole.

14.27 Where the partnership sells an asset for less than its tax written down value, the balancing adjustment would be reflected in the partners' income in accordance with their interest in the partnership.

14.28 Where the partnership sells an asset for more than its purchase price the difference between its depreciated value and its purchase cost would be treated as a balancing adjustment and then taxable capital gains calculated in respect of the excess of the sale price over the purchase price, adjusted for indexation. Both amounts would be included in the partners' taxable incomes in accordance with their interests in the partnership.

14.29 Where a partner sells his or her interest in the partnership to a new partner the sale would subject to capital gains tax but other partners would not be affected.

14.30 Where a new partner is admitted any consideration paid to the partnership would be allocated for tax purposes to the existing partners and treated as a part sale of their interest and subject to capital gains tax at the partner level.

### Accounting principles

For financial reporting purposes an interest in a partnership is treated by a partner as an asset in its own right. The underlying assets of the partnership are accounted for as assets of the partnership. Accordingly, the sale of an interest in a partnership gives rise to revenue equal to the proceeds from sale and an expense equal to the carrying amount of the interest. This is consistent with the approach proposed in Option 2.

*Australian Accounting Standards AASB 1006: Interests in Joint Ventures* and *AASB 1016: Accounting for Investments in Associates* require a partner in joint venture entity that is a partnership to increase the carrying amount of its interest in the partnership by its share of partnership profits that are not distributed to the partner. This is consistent with the approach taken in Option 2 of increasing the cost base of the partnership interest by the partner's share of undistributed profits. For taxation purposes the undistributed share of profits would be included in the partner's assessable income. However, this amount does not count towards the partner's income for financial reporting purposes.

AASB 1006 and AASB 1016 require a partner to measure the carrying amount of a partnership interest at the fair value of the partner's share of partnership assets, and to count as goodwill (or discount on acquisition) any difference between the fair value and the consideration paid for the interest. The partner's share of partnership profits in subsequent years is calculated by applying depreciation, and balancing adjustments on disposal, based on the fair values at acquisition and after allowing for amortisation of any goodwill. However, for taxation purposes partnership income would be calculated using depreciation and balancing adjustments on disposal based on the historical cost of the relevant asset to the partnership. Consequently, if at the acquisition of the partnership interest, the tax value of the partnership's assets differs from their fair value, the partner's initial carrying amount will differ from the cost base, and the partner's accounting profit will differ from its taxation profit.

14.31 Where a current partner leaves and is bought out by the remaining partners, the transaction would be treated as the sale of an asset by the departing partner. The departing partner would be subject to capital gains tax and the remaining partners would each have an additional interest with a cost base equal to the price they paid for it.

14.32 This approach would result in partners having a range of different cost bases for different parts of their interest in the partnership. In a way, the fractional interest approach currently used for capital gains would have been moved back from individual assets to the partnership as a whole. The situation

would be analogous to a shareholder who holds shares in a company which have been purchased at different times and at different prices. There are some record keeping costs associated with such a system but they appear to be manageable in the case of share ownership and could be readily adapted to partnership interests.

14.33 This approach would eliminate the need for balancing adjustment rollover relief. It would also avoid the complex record keeping requirements of Option 1.

14.34 The disadvantage relative to Option 1 is that it allows a situation to arise where the aggregate cost base of the partner's interests in the partnership differ from the aggregate cost base of the assets owned by the partnership. This opens up opportunities for tax minimisation practices. The problem of dual cost bases can also arise for companies and other entities. This issue is discussed in more detail in Chapter 28.

14.35 Appendix A to this chapter provides examples illustrating the operation of Option 2.

# Revenue implications

14.36 The objective of the reform options outlined in this chapter are predominantly directed towards improving the operation of the law as it applies to the tax treatment of partnership assets. However, to the extent to which the reforms remove anomalies in the law, there are likely to be revenue positive consequences. However, as the partnership measures would complement other measures, such as those relating to lease assignments and the possible general removal of the balancing charge offset, it is not practical to ascribe particular revenue gains to the partnership measures alone.

Appendix A

# Example of how the Option 2 'entity' approach could work for partnerships

A.1 This appendix provides some further illustration of how the entity approach would apply in particular situations.

A.2 Assume a partnership between A and B where each partner initially contributes $100 of capital. The partnership buys an asset for $200. In the first year the partnership earns $300 and the asset depreciates by $120. Its operating profit is thus $180 and each partner is allocated $90. At the time of the following scenarios, the partners have not withdrawn any of the profit. So the cost base for each partner's interest in the partnership is therefore $190 (the original $100 plus half of the $180 profit from the first year's trading).

## Scenario 1

A.3 The partnership sells the asset for $120. This gives rise to a positive balancing adjustment of $40 (sale price of $120 less depreciated value of $80). Each partner is allocated a further $20 of assessable income.

## Scenario 2

A.4 The partnership sells the asset for $300. This gives rise to a positive balancing adjustment of $120 (purchase price of $200 less depreciated value of $80) and, assuming zero inflation, a capital gain of $100. Each partner is allocated a further $110 of assessable income.

## Scenario 3

A.5 Partner B sells his interest in the partnership for $300 to C. The total assets of the partnership are the physical asset valued at $300 and the $300 cash in the bank. Partner B realises a capital gain of $110 ($300 less $190 cost base). This is half of the sum of the balancing adjustment of $120 on the asset and the $100 capital gain so it is an appropriate outcome.

C would enter the partnership with a cost base of $300. The cost base of Partner A would remain at $190 and there would be no immediate tax liability.

## Scenario 4

A.6 Partner C buys into the partnership of A and B. A one third interest would cost $200. It would be treated as each of A and B selling one third of their interest in the partnership. The cost base for each would be one third of $190, that is $63.33. So capital gain for each of A and B would be $36.67. This is one third of the total of the balancing adjustment and capital gain on the asset and so is an appropriate outcome. The remaining cost base of A and B in the partnership would be two thirds of $190, that is $126.67. The cost base for C would be $200, the price paid.

## Scenario 5

A.7 Assume that after Partner C buys in as set out in Scenario 4, Partner A decides to leave and sells his share to B and C. There have been no changes in the underlying value of the partnership assets so A is selling his share for $200. A is subject to capital gains tax on $200 less $126.67, $73.33. C's cost base in the partnership is now $300, the price paid for it. B's cost base has two components; a one third interest in the partnership with a cost base of $126.67 and a one sixth share with a cost base of $100. At this stage B has unrealised capital gains of $73.33. The sum of the unrealised capital gains, B's cost base and C's cost base is $600, the current value of the partnership.

## What transitional arrangements might apply?

A.8 Transitional arrangements for converting from the fractional interest approach to the standardised approach would be required. At the moment a partner has a cost base in each asset of the partnership which sums to the cost base for his or her interest in the partnership as a whole. This is all the information required for the new system to be put into operation.

A.9 Where some of the partner's interests in assets are pre-CGT this would need to be recognised by identifying an equivalent share of his or her interest in the partnership as pre-CGT. Similar arrangements apply for pre-CGT shares in share portfolios. There would be a need to establish a notional cost base for the pre-CGT assets so they could be summed and their value compared with the sum of the cost bases of the post-CGT assets. The proportion of each class of asset would determine how much of the partner's interest in the partnership was pre or post CGT.