

**THE REFORM OF PARTNERSHIP LAW AND TAXATION
IN NEW ZEALAND**

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ABSTRACT

The Reform of Partnership Law and Taxation in New Zealand

While New Zealand law has provided for both general and special (limited) partnerships for many years, their use has gradually declined as limited companies have become the preferred vehicle for most business activities. This is presumably due to the limited liability afforded to the shareholders of companies. Possibly due to their declining use, New Zealand legislators have not given much priority to reform and modernisation of partnership law. As a consequence, New Zealand's partnership law (particularly with respect to "special" partnerships) is now outdated and not commensurate with international norms.

The venture capital industry is one industry that usually favours limited partnerships as a vehicle for investment due their combination of limited liability and the ability to pass through losses to investors. As existing the rules for "special" partnerships in New Zealand are restrictive and outdated, the absence of a more suitable vehicle for venture capital has hindered the industry in New Zealand. To encourage the development of the venture capital industry, the Government has recently released proposals to amend New Zealand partnership law to allow for limited partnerships to be formed in New Zealand similar to those found in other jurisdictions.

In tandem with the limited partnership proposals, the New Zealand Government has recently released a Discussion Document containing proposals to reform the taxation of general partnerships and rules for taxing the new limited partnerships. The objective of this paper is to review these proposals for the reform of partnership law and the new partnership tax regime.

The Reform of Partnership Law and Taxation in New Zealand

1.0 INTRODUCTION

New Zealand, in common with many jurisdictions, allows two or more persons to carry on business jointly by way of a partnership. The humble partnership, once a common vehicle for many business ventures, has long fallen out of favour with the limited liability company becoming the preferred vehicle for most business ventures. This is presumably because of the limited liability afforded investors through the company structure and the attraction of legal separation between a business venture and its owners.

The taxation rules applying to partnerships have not attracted much attention from New Zealand legislators for decades possibly due to their declining use. Apart from the removal of the flow-through of tax losses to special partners in special (limited) partnerships in the 1986 and their reintroduction in 2005, the manner in which partnerships are taxed has been left untouched, in marked contrast to the substantial revision to the New Zealand income tax laws that have occurred over the past two decades. As a consequence, the rules applying to partnership taxation are long overdue for revision.

In June 2006 the New Zealand Government released a discussion document titled *General and limited partnerships –proposed tax changes*¹ (“*Discussion Document*”) containing proposals for the reform of partnership taxation and for a new taxation scheme to apply to a new form of partnership known as a limited partnership which will be introduced pursuant to new legislation in 2007. The objective of this paper is to review these proposals.

2.0 THE EXISTING STATE OF PARTNERSHIP LAW AND TAXATION IN NEW ZEALAND

2.1 General Partnerships

Partnerships in New Zealand are governed by the Partnership Act 1908 which is closely modelled on the UK Partnership Act of 1890. This UK Act superseded earlier enactments there and codified the common law relating to partnerships.

Under section 4(1) of the Partnership Act 1908, a partnership is defined as a relationship “between persons carrying on a business in common with a view to profit”. The term “business” is further defined in section 2 as “including every trade, occupation or profession” which is largely similar to the definition of a “business” for income tax purposes in section OB 1 of the Income Tax Act (ITA) 2004. Under section 4(2) of the Partnership Act 1908, membership of a joint stock company is specifically excluded from being a partnership.

The Partnership Act 1908 provides for two types of partnerships –general and special. All partners in a general partnership have joint and several liability for the

¹ Cullen, Hon Dr Michael and Hon Peter Dunne, *General and limited partnerships –proposed tax changes –A Government discussion document*, Policy Advice Division of the Inland Revenue Department, Wellington, New Zealand, June 2006.

partnership's debts, while special partnerships have two types of partners being general and special ones, the latter enjoying limited liability in respect of their share of the partnership's debts.

Unlike the law relating to the taxation of companies which is substantially codified, there are relatively few provisions in the ITA 2004 covering the taxation of partnerships. This is probably due several reasons. Firstly, the partnership is not a separate legal entity from the individual partners that comprise the partnership and therefore it can be viewed almost as a collection of sole traders. The second reason is that the partnership has fallen out of favour as a business vehicle towards closely-held private companies and presumably the smaller number of them has resulted in less attention of tax law reformers over the years. Thirdly, because the company is an artificial creation of statute, it is more necessary to have extensive codified law to deal with its taxation.

Partnerships are not defined in the ITA 2004 for income tax purposes except for the purposes of the resident withholding tax rules in section NF 10.² As a partnership is not a separate legal entity, it is not regarded as a taxpaying entity although partnerships are required to file a separate return of income annually to provide information as to how each individual partner's income has been calculated.

Partnerships have several characteristics which make them both attractive and unattractive as a business vehicle. Because partners are taxed on their individual shares of partnership income, they are treated as a "pass-through" for tax purposes (i.e. "fiscally transparent"). Therefore any losses derived by the partnership can be offset against any other income individual partners may derived from sources outside the partnership. This is in contrast to the position for most companies where losses must be carried forward to future income years.³ The downside of this "pass-through" is that each partners' share of partnership income is taxed at rates applying to individuals which at higher income levels will be at rates above the company tax rate.⁴ The ability of companies to retain earnings that have borne tax at a rate less than the top individual marginal rate (33% vs 39%) is likely to favour companies as a business vehicle.

Another consequence of the "pass-through" treatment of partnership income is that the income retains its classification in the hands of individual partners as opposed to companies where income distributed to shareholders is a dividend. This treatment allows particular types of income to be streamed to specific partners if so desired. This subject to only one constraint being an anti-avoidance provision under the dividend imputation regime which prevents partnerships being used for imputation credit streaming arrangements.⁵

² Under section NF 10(6) the terms "partnership" and "partner" are given the same meaning as they have under the Partnership Act 1908.

³ Except for a special class of company known as a "loss-attributing qualifying company" (LAQC).

⁴ Unless the partner is a company where the company tax rate will then apply.

⁵ Section LB 1(4) and (4A).

One major problem of the partnership is that if there is any change in the composition of the partners in the partnership (or even if existing partners vary their interests in a partnership) for tax purposes the existing partnership is deemed to have been dissolved and a new one formed. This results in the realisation of the partnership's revenue and depreciable assets potentially giving rise to taxable income.⁶ This is in contrast to that of a company where a change in the shareholding does not result in any realisation of the company's assets.⁷ On the other hand, such treatment for partnerships means that the partnership's depreciable assets are more closely aligned to prevailing market values allowing corresponding depreciation claims to be more closely based upon current costs. Companies do not enjoy the same advantage.

The position in common law is that any amount paid as salary or wages to a partner is non-deductible for income tax purposes as the partner is working for the partnership as a part-owner not an employee. This was modified in 1985 with an amendment to the Income Tax Act 1976 which permitted a deduction for a partner's salary or wages (now section DC 4 of the ITA 2004). A deduction is permitted for salary or wages paid to a working partner for amounts payable under a written contract of service provided the services are required for the carrying on of a business by the partnership. Deductions are not permitted where the partnership is carrying on some type of investment business or activity.⁸ This provision was made to assist partnerships where there were difference between the contributions of partners such as with agricultural businesses where one partner may contribute labour and expertise while other non-working partners contribute capital.

2.2 Special Partnerships

Special partnerships are provided for in Part II of the Partnership Act 1908 and have two types of partners –general and special. The liability of special partners in respect of the partnership's debts is limited to the amount of their capital contributions.⁹ General partners still have unlimited liability in respect of the partnership's debts and may actively participate in the partnership's management, while special partners may not participate in the management of the partnership if they are to retain their status as special partners.¹⁰ A written partnership certificate is required which must be registered at the High Court and available for public inspection.¹¹ In common with limited liability companies, there are requirements to keep books of account¹² and special partners can be required to repay any amounts withdrawn from the partnership should the special partnership's assets be insufficient to meet its debts.¹³ Unlike with general partnerships, special partnerships cannot be formed for an indefinite duration

⁶ Changes in the composition of a partnership affects revenue assets such as trading stock, bad debts, depreciable capital assets and valuation of any work-in-progress.

⁷ Changes in shareholding may result in any tax losses carried forward from prior income years being forfeited and/or loss of credit balances in the company's imputation credit account if the change of shareholding is of sufficient magnitude.

⁸ Section DC 4(2), ITA 2004.

⁹ Section 50, Partnership Act 1908.

¹⁰ Section 52, Partnership Act 1908.

¹¹ Sections 51, 54 to 56 Partnership Act 1908.

¹² Sections 64, 66 and 67 Partnership Act 1908.

¹³ Section 60, Partnership Act 1908.

and are limited to an initial period of seven years, although they can be “renewed” at the end of the seven year period.¹⁴

There are also limitations upon the type of business a special partnership may undertake. Under section 49 of the Partnership Act 1908 they can be formed for “agricultural, mining, mercantile, mechanical, manufacturing or other business” but not for “banking or insurance” purposes.

Special partnerships became popular during the 1970s and early 1980s as a vehicle for tax shelter schemes involving agriculture, horticulture and film-making activities. Their popularity stemmed from their unique combination of limited liability for special partners and the ability to pass through tax losses. It is for the latter reason that, from 1 August 1986, the ability to pass through losses was removed and instead any losses were required to be carried forward in a similar manner to companies.¹⁵

Somewhat incongruously, new rules were introduced in 1993 which allowed certain closely-held companies (known as “qualifying companies” or QCs) to be taxed as partnerships (including the attribution of company losses to shareholders).¹⁶ Despite the introduction of this QC regime, the requirement for special partnerships to carry-forward losses was not reviewed despite the QC regime creating a “pass-through” entity with limited liability.

As part of a package to improve the climate for foreign participation in New Zealand venture capital investments, the requirement for special partnerships to carry forward tax losses was removed with effect from 1 October 2005. Losses from special partnerships can now be offset against a partner’s other income but with one restriction. Any special partnership loss cannot be carried forward to any future income years by a partner. Therefore if the partner does not have sufficient assessable income from other New Zealand sources in the same income year as the loss was derived from the special partnership, the loss is effectively forfeited.

The policy reason for this treatment is not clear (as it does not apply to losses attributed to shareholders of QCs) but may be designed to prevent double dipping of special partnership losses where the partner was a non-resident and obtained offset of the losses against foreign-sourced income offshore.¹⁷

¹⁴ Section 57, Partnership Act 1908.

¹⁵ There was a “grand-fathering” provision for existing special partnerships provided no new capital was introduced into the partnership and its initial period of duration was not extended. Refer section HC 1 of the ITA 2004.

¹⁶ Explained in the next section.

¹⁷ Losses attributed to shareholders of LAQCs are able to be carried forward to future income years by the shareholders and are not forfeited as is the case for special partnerships. Similarly losses from general partnerships can also be carried forward despite the scope for “double-dipping” of tax losses across borders.

2.3 Qualifying Companies (QCs)

As a result of a recommendation from the Consultative Committee on the Taxation of Income from Capital,¹⁸ in 1993 the Government enacted special rules for the taxation of closely-held companies. Until then, closely-held companies had been taxed in a similar way to widely-held ones which conceptually was not necessarily appropriate. The Consultative Committee took the view that closely-held companies were more akin to partnerships and recommended that special rules be introduced for shareholders of such companies to elect for them to be taxed in a manner similar to partnerships. Such companies are known as “qualifying companies” (QCs) and the tax regime applying to them is an elective one.¹⁹

Against the recommendations of public officials at the time, the Government also provided for a sub-set of qualifying companies (known as “loss-attributing qualifying companies” or LAQCs) to be able to attribute tax losses to their shareholders rather than requiring them to be carried forward to future income years as is required for all other companies.

The QC election has become very popular, especially for LAQCs which have become a common component in many tax planning arrangements. LAQCs have been widely used in many mass-marketed forestry plantation investment schemes (providing investors with limited liability and the ability to access tax losses) as well as for holding passive investments such as rental property. In the latter case it is difficult to see what a LAQC adds as limited liability is not usually an important issue for property investors.

Because a company is always a separate legal entity to its shareholders, the ability to distribute losses to shareholders has created some interesting tax planning opportunities with combined with the gross/global schema of the New Zealand ITA. Provided a gross receipt is assessable income, any expenditure or loss in producing that income is deductible irrespective of whether the amounts of taxable income and allowable deductions are grossly disproportionate. This creates tax planning opportunities such as the sale of an owner-occupier residential property to a LAQC which is rented back to the shareholder.²⁰ A rental loss is produced which is then attributable to the shareholder and can be offset against their other sources of income. What was previously a private expense (i.e. the cost of ownership of a private residential house) becomes tax deductible.²¹

¹⁸ A. Valabh, *The Taxation of Distributions from Companies*, Report of the Consultative Committee on the Taxation of Income from Capital, Government Printer, Wellington, November 1990.

¹⁹ Refer Holmes, K; “The Taxation of Closely-held Companies: Concepts, Legislation and Problems in New Zealand”, *Australian Tax Forum*, Volume 9, Number 3, 1992, pp 323-353.

²⁰ The fringe benefit tax rules may also provide similar benefits where a LAQC provides a motor vehicle to one of its shareholders. What was previously a private motor vehicle now is a company one, and all the running costs become tax deductible even though the vehicle may be used entirely for private running. A tax advantage will arise where the deemed value of the fringe benefit is less than the actual costs of its provision. This typically occurs when the capital value of the car is low.

²¹ The Commissioner has stated that the general anti-avoidance provision section BG 1 could apply to the sale and rent back of a private residential dwellinghouse, although the grounds upon which he could seek to invoke the section in such situations has not been made clear. If the

3.0 EARLIER PARTNERSHIP TAX REFORM PROPOSALS

Difficulties associated with the taxation of partnerships were first highlighted by the Valabh Committee in their report *Key Reforms to the Scheme of Tax Legislation*²² in 1991. In their report they highlighted a number of ambiguities arising with partnership taxation including:²³

- What constitutes a partnership for income tax purposes;
- How partnerships with both resident and non-resident partners are to be taxed including the tax status of payments made by such partnerships;
- Whether different types of income must be allocated proportionately to all partners or whether certain types of income can be streamed to certain partners;
- The tax status of foreign-sourced income derived by non-resident partners;
- The tax status of certain transactions between one partner and the partnership such as asset transfers and payment of interest on capital contributions and loans to the partnership;
- The tax treatment arising from changes in the composition of the partnership (including entry and exit of partners) and the manner in which it is calculated;
- The grounds for allowing a partnership to adopt a non-standard balance date which may be different to that of the individual partners.

The Committee noted that, in practice, many of the above problems did not arise due “to the adoption of a pragmatic approach to dealing with these issues by taxpayers and the Inland Revenue Department”.²⁴ However, they noted that having practice at variance with law was “not appropriate”, and if the IRD’s current practices were appropriate then they should be provided for in legislation. The Committee recommended that the tax treatment of partnerships should be largely continued as it was but with some minor changes to address some of the “technical inconsistencies in the legislation”. Areas they felt needed to be addressed included a modification to the existing requirement to make an income tax adjustment in respect of revenue and depreciable assets when there was a variation in the composition of the partnership, the method of income allocation among partners, the tax status of interest paid to partners in respect of loans and capital contributions to the partnership, the treatment of partnerships with both resident and non-resident partners and the treatment of the existing special partnerships. Submissions were sought from interested parties.

Relatively few submissions were received in response to the 1991 report, and those few received supported relatively minor amendments to give statutory backing to existing practice. The Valabh Committee recommended in *Final report of the consultative committee on the taxation of income from capital*²⁵ that a limited number

house was purchased initially by the LAQC and then leased to the shareholders it is more difficult to see upon what grounds section BG 1 could be invoked.

²² Consultative Committee on the Taxation of Income from Capital (Valabh Committee), Government Printer, October 1991.

²³ *Discussion Document*, paragraph 12.3, page 90.

²⁴ *Ibid.*

²⁵ Consultative Committee on the Taxation of Income from Capital (Valabh Committee), Government Printer, October 1992.

of amendments be made to the rules applying to partnership taxation pending a more fundamental review of partnership taxation. These recommendations were limited to modifying the rules regarding recognition of income upon the reconstruction of a partnership, providing the CIR with statutory authority to approve non-standard balance dates and for a definition of a partnership to be included in the ITA. Surprisingly, they did not recommend the introduction of any income allocation rule as manipulated income allocation between partners was not thought to be a major problem and that the existing anti-streaming provisions²⁶ for dividend imputation credits through partnerships were sufficient.

Despite these recommendations, no amendments were made to the ITA, nor was this suggestion for a fundamental review of partnership taxation acted upon until recently, nearly 15 years later.

The Tax Review Committee (McLeod Committee) in its 2001 review of New Zealand's income tax regime²⁷ considered partnerships briefly and in general terms only. In considering entity taxation, the Committee recommended that, in principle, the income of all entities should be taxed at the marginal tax rates of its owners but tempering this recommendation was the recognition of the difficulty and complexity in achieving that objective with widely-held entities. In conclusion, it recommended that all widely-held entities be taxed as companies, and all closely-held entities (fewer than six owners) as partnerships. A consistent treatment was recommended to prevent "entity shopping" and as a policy rule to minimise the number of general entity treatments and ensure they have clearly defined boundaries to minimise compliance costs.

4.0 LIMITED PARTNERSHIPS FOR VENTURE CAPITAL INDUSTRY

As a result of representations from certain sectors of the investment banking community (primarily the New Zealand Venture Capital Association), the New Zealand Government has recently reviewed the New Zealand law relating to special (limited) partnerships and decided to amend the existing special partnership legislation.²⁸ The objective of these changes is to reduce barriers for venture capital investment in New Zealand by non-resident investors by making available a more suitable vehicle for such investment than the existing special partnership structure. This reform of partnership law is in addition to two earlier amendments made to the ITA 2004 in December 2004 to enhance venture capital investment.²⁹

²⁶ Section LB 1(4), (4A) and (4B) ITA 2004.

²⁷ R McLeod (Chairman), *Tax Review 2001 –Final Report*, Wellington, New Zealand, 2001.

²⁸ Hon Lianne Dalziel, Minister of Commerce, "Special Partnerships Need Updating", Media Release, 10 December 2003.

²⁹ The first is the reinstatement of loss offsets from special partnerships to special (limited) partners from 1 October 2005. The second is an exemption in section CW 11B from New Zealand income tax for any gains derived from the sale of shares in certain New Zealand resident companies by any "qualified foreign equity investor". A "qualified foreign equity investor" is defined in section CB 11(4) and is effectively an investor who is exempt from tax in the jurisdiction in which they are resident.

The main problem being addressed is that the existing New Zealand special partnership rules are not consistent with those found in other jurisdictions (particularly the United States and NSW in Australia) and as a consequence create a barrier to foreign participation in New Zealand venture capital investments. The New Zealand special partnership structure is unfamiliar to foreign investors and its status as a separate legal entity outside of New Zealand is uncertain. Therefore the new limited partnership vehicle will be closely modelled upon “an internationally recognised limited partnership model” such as found in New South Wales.

The major differences between the existing special partnership rules and the new limited partnership ones are:

- The vehicle will be called a “limited partnership” and the title of the partnership will be followed by the letters “LP” being consistent with international practice.
- There are doubts whether special partners in a special partnership formed pursuant to Part II of the Partnership Act 1908 may be recognised as having limited liability outside of New Zealand. These doubts will be addressed by explicitly providing that limited partnerships will be a separate legal entity to that of its partners and on a basis that is consistent with the Delaware limited partnership model.
- Existing special partnerships have cumbersome registration requirements with significant risks arising to special partners if not carried out correctly. The limited partnership rules will have simplified registration procedures which will be administered by the Companies Office instead of the High Court.
- The Companies Office will maintain a limited partnership register which will disclose details of the general partners but not the limited partners.
- The limited partnership rules will contain “safe harbour” provisions outlining what activities limited partners may undertake in respect of the limited partnership without deeming to participate in the management of the limited partnership with the result that they become general partners.
- The existing special partnership rules are unclear on whether a general partner can become a special partner or vice-versa. Under the new limited partnership rules any person with legal capacity will be able to be a limited or general partner and both types of partners will be able to change their status from general to limited partners or vice-versa as well as hold interests in the partnership as both limited and general partners at the same time.
- Limited partnerships would have an indefinite life unlike with special partnerships which are currently limited to an initial period of seven years.

As the flow through of losses to investors is an essential feature of any venture capital investment, it is important that the vehicle used to make such investment is recognised as fiscally transparent in both New Zealand and offshore. In this regard, LAQCs are unsuitable to attract offshore investors into New Zealand venture capital investments as such companies are uniquely a New Zealand creation by statute and are highly unlikely to be recognised as being fiscally transparent outside of New Zealand. The limit of five shareholders for QCs could also be a secondary impediment for offshore investors in such companies.

As a result, the decision to enact new rules for limited partnerships has required a formulation of new tax rules for such entities which is the second objective in the release of the *Discussion Document*.

5.0 PROPOSALS FOR REFORM OF PARTNERSHIP TAXATION

5.1 Aggregate Versus Entity Approaches to Partnership Taxation

The Valabh Committee in its earlier work on partnerships had identified two approaches to partnership taxation. The first is termed the “aggregate approach” under which each partner is treated as a fractional owner of all partnership assets. Therefore the partnership would not exist as an independent entity from its owners.

The second approach is termed the “entity approach”. Under this approach, each partner has an interest in the partnership (as opposed to a fractional interest in each of the partnership’s assets) which is similar to an interest in a company. Income is calculated at the partnership level and each partner’s share of the net income flows to them. Under this approach, complicated adjustments would not arise when there is a change in the composition of a partnership.

Existing New Zealand partnership taxation practice is closest to the “aggregate approach”, although some aspects of it reflect the “entity approach”. In comparable jurisdictions such as Australia, the US and the UK both approaches are in use, sometimes in a hybrid manner. The *Discussion Document* proposes that a hybrid approach be adopted which is not too dissimilar to existing practice. This would represent a:

“reasonable balance between the integrity and accuracy of the ‘flow-through’ mechanism afforded by the aggregate approach and the administrative and compliance convenience of the entity approach”.³⁰

The key aspects of the *Discussion Document’s* proposals are reviewed in the following sections. The *Discussion Document* recommends a comprehensive codification of partnership taxation rules and practice and fulfils the role of a fundamental review of partnership taxation first recommended by the Valabh Committee back in 1992.

5.2 RECOMMENDED CHANGES TO PARTNERSHIP TAXATION

5.2.1 Application and Scope of Changes

The proposed new partnership tax rules will apply to four categories of partnership:

- Any partnership that is recognised as one under the Partnership Act 1908;
- A limited partnership that is registered as a “limited partnership” under the Limited Partnership Bill currently under consideration;
- All New-Zealand resident partners of foreign general partnerships;
- All New Zealand resident partners of a foreign limited partnership providing the partnership has at least one general partner; is not publicly traded and does not have a separate legal personality.³¹

³⁰ *Discussion Document*, paragraph 3.11, page 12.

Any partnerships falling within one of the four categories above will be accorded a “flow-through” treatment for New Zealand tax purposes. In the case of the new limited partnerships, they will be accorded the “flow-through” treatment despite being regarded as a separate legal entity. This is on grounds of consistency with prevailing international practice.³² This treatment for the new limited partnership represents a departure from the current New Zealand treatment where any entity that has a separate existence from its owners is taxed as a company.³³ It is proposed that this “flow-through” treatment will be restricted to only New Zealand limited partnerships and any foreign entity that has a separate legal personality will not be eligible for “flow-through” treatment under New Zealand tax law. This different treatment is justified on grounds of consistency with new provisions governing foreign tax credits for hybrid entities in section CD 10C.

5.2.2 Flow-Through of Income and Expenditure

As the reform proposals are based upon the “aggregate approach”, one of the key recommendations is for specific rules as to how income and expenditure can be allocated among partners. Currently, while there exist doubts as to the legal basis for doing so, it appears possible that different types of partnership income can be allocated in an uneven manner to minimise New Zealand income tax payable. For example, taxable income can be allocated to exempt partners or partners with accumulated tax losses, while foreign-sourced income or interest, dividends and royalties can be allocated to non-resident partners with capital gains being streamed to resident partnerships facing high marginal tax rates.

It is proposed that for tax purposes all partners in a partnership will share proportionately in the partnership’s income and deductions according to their interest in the partnership thereby preventing tax efficient streaming of income and deductions as outlined above. This proportionate allocate will also apply to non-taxable income as well as taxable income. Any foreign taxes paid will be allocated proportionately on the same basis. This approach is consistent with that proposed by the Valabh Committee in 1991.

When there is a change in the composition of a partnership, expenditure incurred by the existing partners is not deductible to an incoming partner. Any expenditure incurred by an incoming partner from the date they enter the partnership will be deductible, however, this will require appropriate quantification. Two methods to deal with such quantification are proposed. The first, termed the “closed-off approach” would require income and expenditure to be calculated up to the date of change in the composition in the partnership being in effect preparation of part-year financial statements. This approach, while allowing accurate apportionment of income and deductions to incoming and outgoing partners, could have high

³¹ *Ibid*, page 13.

³² *Ibid*, paragraph 4.15, page 16. It is noted in paragraph 4.16 that this will require a change to the definition of “company” for tax purposes to specifically exclude New Zealand-registered, limited partnerships.

³³ Under section OB 1, a “company” is defined as “a body corporate or other entity that has a separate legal existence separate from that of its members, whether it is incorporated or created in New Zealand or elsewhere”.

compliance costs, and for this reason a second alternative, termed the “simplified apportionment approach” will be offered as an option.

Under this second option, a weighted average would be taken based upon the existing partner’s interest in the partnership for the part of the year they were a partner. Deductible expenditure would be calculated on this basis. This method would be less costly to apply and in many circumstances would not be likely to produce materially different results to the other method.

5.2.3 Transactions Between Partners and Partnerships

This issue was one highlighted by the Valabh Committee where existing practice was inconsistent. Interest paid on loans by a partner to the partnership have always been deductible to the partnership as has rent paid in similar circumstances, while interest paid on a partner’s capital contributions was not as were salaries paid to partners. The latter category of expenditure became deductible to partnerships from 1985 provided certain conditions were met as are now found in section DC 4. These conditions include:

- A written contract of service exists;
- The amounts payable are specified in the contract of service (other than by way of bonus);
- The business of the partnership must not be one of investment of money of the holding of or dealing in shares, securities, estates or interests in land.³⁴

It is proposed to retain these rules. There is an anti-avoidance rule in section GD 10 that where a partner rents a property they own to the partnership, the rental must be commensurate with market rates. It is proposed that a “market value” rule be introduced so that all transactions between partners and their partnerships must be conducted at prevailing market rates for tax purposes.

This rule would apply where a partnership asset is sold to a partner or where an asset is introduced to the partnership by a partner. A deemed disposition would occur and any gain or loss would be required to be brought to account for tax purposes.

5.2.4 Changes To Partnership Composition

One of the biggest problems with the existing tax regime for partnerships is the need to make a tax adjustment each time there is a change in the composition of the partnership. In many cases, the resulting compliance costs will be disproportionate to the amount of income arising from the change in composition in the partnership. This issue is probably more problematic for larger partnerships (as found in some professions) than for smaller ones.³⁵

It is also unclear whether the current tax practice upon the dissolution or reconstitution of a partnership is supported by current legislation. This is because it is uncertain whether in a reconstitution the assets of the old partnership are being sold in

³⁴ There is also an anti-avoidance provision in section DC 3 which limits a tax deduction for pensions paid to a former partner or their surviving spouse to “reasonable amounts”.

³⁵ Many large professional partnerships use a service company to hold depreciable assets to overcome the need to undertake deemed part disposals and acquisition of such assets each time there is a change in the composition of the partnership.

their entirety to the new partnership or whether there is only a partial disposition of partnership assets between those partners retiring and entering the partnership. The *Discussion Document* proposes a solution which could best be described as a “*deminimis* compromise” using again using a hybrid of the “aggregate” and “entity” approaches to partnership taxation.

It is initially proposed that the “entity” approach be adopted and that changes in the composition of a partnership be treated as a transfer of an interest in the net assets of the partnership rather than individual interests in each of the partnership’s assets. This would overcome the need to recognise income or losses upon reconstitution of the partnership. This would be subject to a *deminimis* test so that where partnership assets had appreciated significantly, income would still have to be calculated upon the retirement of a partner. The amount of income to be recognised upon the retirement of a partner will be known as a “revenue account adjustment”.

A “revenue account adjustment” will be mandatory if the difference in the consideration received by the partner for their interest in the partnership and their share of net partnership assets exceeded \$20,000.³⁶ If the difference between the two amounts is below \$20,000, the retiring partner will be able to elect to calculate a “revenue account adjustment”.

In addition to the \$20,000 test, the Valabh Committee in 1992 also suggested that where there was a substantial change in the composition of a partnership (more than a 50% change in the composition of the partnership in any 12-month period) a revenue account adjustment would also be required. The *Discussion Document* makes no recommendation on this issue but instead seeks submissions.³⁷

The “revenue account adjustment” is to be calculated according to the exiting partner’s share in the gains/losses if all revenue account assets were sold directly to the new partner. This would include the disposition of assets such as financial arrangements, trading stock and depreciable assets. It should be noted that the “revenue account adjustment” is not the same as the calculation for the \$20,000 *deminimis* test, as the latter also includes non-taxable capital gains while the former only revenue amounts.

When a new partner joins a partnership, any property they contribute to the partnership is to be treated as a disposition at market value to the partnership and thus any revenue amounts arising upon such disposition must be recognised. If the new partner acquires an interest in existing partnership assets, then the revised cost of those assets to the partnership must be recalculated.

Under the separate entity approach, there would not be any adjustment to the carrying value of partnership assets. This could present a problem for the incoming partner as when a revenue account asset was subsequently sold they would be liable to tax upon

³⁶ *Discussion Document*, paragraph 9.19, page 47. Anti-avoidance provisions are proposed to prevent the sale of a partnership interests through a series of partial sales to take advantage of the \$20,000 limit. It would also be required that the partnership interest is held by the partner on capital account.

³⁷ *Ibid*, paragraphs 9.19-9.20, page 50.

the gain including that portion which was derived prior to them entering the partnership. In essence part of their capital contribution to the partnership would become taxable to them –something that most taxpayer would find highly undesirable unless the amounts were trivial.

To overcome this problem, it is proposed to allow taxpayers a “cost base allocation election”. This would allow the opening values of the partnership assets to be apportioned to among each partner at the effective amounts they individually acquired them for. Thus where a share in a depreciable asset was acquired at a higher price than that paid for by continuing partners, the new partner would be able to claim higher depreciation in respect of their share of income from the partnership than would the continuing partners. This election could only be made if a “revenue account adjustment” had been undertaken by the retiring partner (whether mandatory or by election). If no such adjustment was made the partnership’s assets would continue to be valued at their existing book values.

While this election will address the problem where the incoming partner risks having their capital contributions being converted into taxable income, the resulting complexity in having to track each partner’s separate interests in the partnership’s individual revenue assets suggests that very high compliance costs will arise.

5.2.5 Distributions and Dissolutions of Partnerships

Distributions of amounts to individual partners from partnership assets are not currently a taxable event and would continue to be treated as such sums represent either previously taxed income or withdrawal of capital from the partnership. This treatment is one that distinguishes the partnership from companies.

In regard to the proposed limited partnerships, distributions to partners would be treated in the same way. Where limited partners in such partnerships had guaranteed the partnership’s debts, any reduction of that guarantee would be treated as a distribution to the partner of the same amount.

Under current partnership law, there is automatic dissolution of a partnership upon the death or bankruptcy of a partner unless the partnership deed provides otherwise.³⁸ It is proposed that this approach be changed to be consistent with the entity approach for partnership taxation and other grounds be specified such as upon court order or unanimous agreement between the relevant partners. Upon dissolution the partnership’s assets would be deemed to be disposed of at prevailing market value and revenue account adjustments would be required.

5.2.6 Limited Partnership Tax Losses

It is proposed that the new limited partnerships will be accorded flow-through of tax losses to both limited and general partners despite it being regarded as a separate entity. However, the amount of tax losses that can flow through to the limited partners will be limited to their investment in the partnership. This is proposed on the grounds that the amount they have invested in the partnership is the amount they have at risk in the entity given that they have limited liability and thus the amount of loss offset is limited to the economic loss of the partner. Any limited partner’s share of partnership

³⁸ Section 36, Partnership Act 1908.

losses in excess of their investment in the partnership cannot be passed-through but instead must be carried forward and offset against any assessable income the partnership may derive in future income years. This treatment is further justified:

“The absence of loss limitation rules is likely to distort efficient risk-bearing decision-making and efficient resource allocation by encouraging investors to enter arrangement or schemes whereby small amounts of capital are invested to get access to larger net tax losses. This could result in abuse of the limited partnership rules and in actions that are contrary to their intent. This may potentially create large fiscal costs to the government.”³⁹

It is also noted that the rules are “consistent with the treatment provided by other countries” such as Australia and the US.⁴⁰

The issue which seems to be driving the limitation upon the flow-through of losses is to effectively prevent the flow-through for deductible expenditure financed by money borrowed by the partnership in which the limited partners have limited responsibility for. Many abusive mass-marketed tax avoidance schemes have relied upon the use of limited-recourse financing to artificially inflate deductible expenditure. Concerns about such arrangements have already led the New Zealand Government to introduced deferred deduction rules in 2003 to limit such abuses.⁴¹ The deferred deduction rules limit deductibility of expenditure where it has been funded by limited-recourse loans. These rules aim to prevent a deduction unless a taxpayer has borne an economic loss and are not specific to any type of business vehicle.

The restoration of flow-through of losses derived by special partners under the existing special partnership rules from 1 October 2005 is limited to offset against other assessable New Zealand-sourced income in the same income year only and any remaining balance cannot be carried forward to future income years. It is proposed to repeal these rules and replace them with tax loss limitation and offset rules which are allegedly consistent with international practice.⁴²

The *Discussion Document* outlines how the loss flow-through limitation will apply. It will apply only to the limited partner’s “basis” (or adjusted investment) in the partnership. The method proposed to calculate it is as follows:⁴³

	Original Investment	\$A
<i>plus</i>	Value of Additional Contractual Guarantees and Indemnities	B
<i>plus</i>	Share of Partnership Income Previously Recognised	C
<i>plus</i>	Prior Equity Injections	D
<i>less</i>	Share of Net Limited Partnership Loss Previously Recognised	E

³⁹ *Discussion Document*, paragraph 8.2, page 34.

⁴⁰ *Ibid*, paragraph 8.3, page 34.

⁴¹ Refer sections GC 29 – 31, ITA 2004.

⁴² *Ibid*, paragraph 8.8, page 35.

⁴³ *Ibid*, paragraph 8.12, page 36.

less	Prior Distributions	F
	Limited Partner's Interest	\$G

An alternative method is also proposed that takes into account non-taxable capital gains and losses. This has been developed to “accurately reflect a partner’s net investment in the partnership that is at risk” and to “decrease the disparity between the tax treatment applying to a partner investing through a partnership vehicle and an individual investing directly”.⁴⁴

Given that capital gains and losses are a feature of New Zealand’s income tax regime since New Zealand does not comprehensively tax capital gains, it is probably necessary for this latter approach to be adopted even though it results in greater complexity. Recognition of capital gains when determining a limited partner’s “basis” is likely to increase the capacity to flow-through losses to the limited partners. Recognition of capital losses is likely to have the opposite effect. The *Discussion Document* leaves it open for submissions as to how this issue should be resolved.

If a partner’s status changes from general to limited (or vice-versa), it is proposed that the “basis” calculation would only be required when the partner was a limited partner. Similarly the loss limitation rules would only apply during that time. It is suggested that some form of anti-avoidance rule may be required to prevent abuses from partner’s shifting their status back and forward between these two categories.

The *Discussion Document* gives some brief consideration as how the proposed rules could interact with the existing loss-attributing qualifying company rules. It is recognised that the proposed loss limitation rules for the new limited partnerships could be side-stepped if loss-attributing qualifying companies (LAQCs) were to be general partners in a general partnership. In such an arrangement limited liability could be enjoyed along with full flow-through of losses. In this regard it is noted:

“The government recognises that these structures could be used to circumvent the policy intent behind the proposed loss limitation rules. The issue may be considered further in a future review of the LAQC rules.”⁴⁵

While the potential for the above arrangement to achieve the same as the proposed limited partnership but with full loss flow-through, it will be only likely to work where all investors are New Zealand resident. New Zealand law can only prescribe for LAQCs to have their losses offset against a non-resident shareholder’s other New Zealand-sourced income (other than non-resident withholding income). There is little to suggest that outside New Zealand the same tax treatment will be accorded and therefore the proposed limited partnership structure could not easily be replaced by the LAQC-general partnership structure. The limited partnership rules are being designed to facilitate offshore investment into New Zealand and that is the reason for enacting the new limited partnership rules to ensure that the partnership will be accorded the same status offshore.

⁴⁴ *Ibid*, paragraph 8.16, page 38.

⁴⁵ *Ibid*, paragraph 8.30, page 42.

5.2.7 International Aspects of the Flow-Through Treatment

As partnerships will continue to be taxed as “flow-through” entities, there are a number of flow on issues arising in respect of cross-border transactions where the partnership derived foreign-sourced income and/or some of the partners are non-resident.

Where a partnership derives foreign-sourced income, all partners would have any foreign tax credits allocated to them in proportion to their share of income. If a partner happens to be a New Zealand company, they will be liable to make dividend withholding payments in respect of any foreign dividends they may receive and may also be eligible for underlying foreign tax credits (UFTC) if they are eligible.

If the partnership has an interest in a controlled foreign company (CFC), the CFC attribution rules (branch-equivalent regime) will apply. In applying the CFC control (shareholding) tests, the partnership is treated as one entity. However, when CFC income is attributed to individual partners, they are only required to account for their proportionate share of attributed CFC income.

Where a partnership has both resident and non-resident partners, the ability to that portion of partnership income allocated to the non-resident partners is dependent upon New Zealand’s source rules in section OE 4. If the non-resident partner is entitled to protection under one of New Zealand’s DTAs, the general position is that the activities of the partnership in New Zealand will constitute a permanent establishment for the business profits article of the DTA. This approach is supported by paragraph 19.1 of the Commentary to Article 5 of the *OECD Model Tax Convention on Income and on Capital* which recognises that the activities of a fiscally transparent entity such as a partnership may constitute a permanent establishment in respect of income derived by non-resident partners.

A non-resident partner’s share of New Zealand sourced interest, dividends and royalties are subject to non-resident withholding tax (NRWT) or the approved issuer levy (AIL), and to tax relief in respect of New Zealand-sourced dividends under the foreign investor tax credit (FITC) regime.⁴⁶ Consistent with international principles, a non-resident partner would not be subject to New Zealand tax on foreign-sourced income derived by the partnership.

Because under New Zealand tax law partnerships are “fiscally transparent”, it is not possible to classify them as resident or non-resident as that classification is applicable only to their individual partners. Therefore in determining whether DTA benefits are applicable, the DTA has to be applied to each individual non-resident partner’s share of income. The absence of a residence status for partnerships does make it difficult in applying some of the sources rules in particular section OE 4(1)(n), (r) and (s).⁴⁷ The Vallabh Committee had considered the option of introducing a rule that where resident partner’s aggregate interests in the partnership were 50% or more, the partnership would be treated as being a wholly resident entity for the purposes of the

⁴⁶ Refer subpart LE, ITA 2004.

⁴⁷ Applying to interest in respect of money lent outside New Zealand, royalties and lease payments in respect of leases for personal property.

source rules only. The *Discussion Document* leaves this matter open for submissions and makes no recommendation as to whether it should be adopted.

5.3 Future of Loss-Attributing Qualifying Companies

In the *Discussion Document*, it is noted that the proposed loss limitation rules for the new limited partnerships could be circumvented if LAQCs were used in combination with a general partnership. In a media release dated 6 September 2006,⁴⁸ it was announced that legislation covering partnership taxation will be introduced and passed next year (i.e. 2007) after consideration of submissions received in respect of the *Discussion Document*.

It was acknowledged that the Government had received many submissions about the possibility that the status of LAQCs may be reviewed at some future point when the new limited partnership rules were enacted in 2007. The release said:

“While this is clearly a live issue, it would be premature to consider the future of the LAQC rules until we know the final legislative form of the partnership tax changes. Once that is clear, there will be consultation on the LAQC rules.”⁴⁹

This announcement will do little to allay fears that the future of LAQCs is uncertain and fuels suspicion that the introduction of the limited partnerships will be used as an excuse to repeal the LAQC regime, when the two vehicles are likely to be used by different categories of taxpayer.

6.0 ANALYSIS

The proposals outlined in the *Discussion Document* have been formulated for two reasons. The first is in response to the Valabh Committee’s recommendation from the early 1990s for a comprehensive review of partnership taxation and the second from the proposed introduction of new legislation permitting the formation of limited partnerships in New Zealand.

6.1 Clarification of General Partnership Tax Rules

In respect of the first, the proposals if enacted will address the concerns the Valabh Committee raised about partnership taxation, particularly that many of the CIR’s existing practices with respect to partnership taxation are not supported by legislation. A number of the proposals such as defining what constitutes a partnership for tax purposes and confirming that they are “fiscally transparent” entities are unremarkable and will improve certainty for taxpayers. Two proposed changes that warrant more careful examination are the proposals to clarify income allocation between partners and relief proposed from the need to make income adjustments when there is change in the composition of a partner in some circumstances.

While there are opportunities for income streaming under the existing tax treatment of partnerships to create a tax advantage, it is only in certain situations where it is likely

⁴⁸ Hon Peter Dunne, Minister for Revenue, “Partnership tax changes planned for 2007 bill”, Media Release, 6 September 2006.

⁴⁹ *Ibid.*

to occur. This is where a partner is exempt from tax or is a non-resident. A tax advantage only arises for the non-resident if the partnership has non-resident withholding income such as interest or royalties.⁵⁰ It is suggested that relatively few partnerships are likely to have partners falling within either category and that the additional compliance costs arising by introducing an income allocation rule is not warranted when compared to the aggregate tax avoidance risk. Income allocation rules for partnerships may also interfere in a partnership's ability to organise its affairs in the most efficient manner.

The proposal to exempt certain gains arising from the reconstitution of a partnership is not attractive. Firstly, the *deminimis* limit of \$20,000 is low and in many situations will require the partnership to incur significant compliance costs to determine whether the limit has been breached or not. This seems to undermine one of the objectives of having such a provision.

If a partnership qualifies for the exemption from income calculation, the subsequent income tax consequences are not attractive for the new partner. Part of the consideration they will pay to enter the partnership will end up becoming taxable due to unrealised gains on partnership assets existing at the time they enter the partnership. Therefore unless the consideration they pay to enter the partnership is discounted for the tax payable on unrealised gains, they will be worse off. To make such a calculation will require some form of calculation which would appear to undermine the objective in having a *deminimis* limit on grounds of compliance cost reduction.

If a partnership is above the *deminimis* limit of \$20,000 (or makes an election for an adjustment if below) there is the consequence that the partners will have different carrying values for the partnership's individual assets.

There is no easy solution to this problem unless the partnership is taxed on a separate entity basis (as opposed to the hybrid basis used in the *Discussion Document*). It has been suggested that larger partnerships (such as with 6 or more partners) use an entity approach, and ignore any income effects upon the reconstitution of a partnership, with smaller ones having scope for an election.⁵¹

6.2 Flow-Through For New Zealand Limited Partnerships

One strange anomaly in the *Discussion Document* is the proposal not to extend the flow-through treatment to New Zealand resident partners of foreign-registered, limited partnerships where those partnerships are separate legal entities in the jurisdiction where they are resident, even though New Zealand-registered limited partnerships will be treated as "flow-through" entities despite their separate legal personality. The reason for this treatment is given in terms of consistency with changes made to the ITA in 2006 for foreign hybrids and foreign tax credits in section CD 10C.

⁵⁰ While dividends are also non-resident withholding income, an advantage is not likely to arise to a non-resident partner because of the FITC regime. In addition, there are anti-streaming rules for imputation credits applying to partnerships already.

⁵¹ *Discussion Document*, paragraph 9.7, page 44.

It seems incongruous to treat New Zealand-registered limited partnerships with a separate legal entity as a “flow through” and expect foreign jurisdictions to do the same when New Zealand treats similar registered limited partnerships with the same characteristics as companies. It remains open whether foreign jurisdictions may decide to discriminate against New Zealand-registered limited partnerships in the same way. This issue has not been picked up by commentators and could prove a barrier to the new special partnerships becoming a suitable vehicle for foreign participation New Zealand venture capital investments.

6.3 Limited Partnership Loss Offset Rules

One of the most controversial parts of the *Discussion Document* is the loss limitation rule proposed for the new limited partnerships. The underlying principle of the proposal is that taxpayers should not be able to obtain a deduction for an amount they are economically at risk for. Therefore it is proposed that deductions financed by borrowed money are not able to be passed through because the partners have limited liability to repay that borrowed money under the limited partnership structure.

If that principle is to be applied properly, the partner’s interest would need to be valued at market values on a regular basis. This is because any unrealised gains (whether taxable or not) are essentially at risk in the partnership. To make such an allowance for tax purposes could give rise to very high compliance costs, however, there are precedents elsewhere in the ITA where unrealised gains are taken into account (as for example with the thin capitalisation rules).

The proposal to include in the partner’s “basis” calculation the amount of any guarantees for debts owed by a limited partnership is also problematic on practical grounds.

Of the arguments advanced in the *Discussion Document* for limiting the loss flow-through to limited partners, only the consistency with overseas practice has any validity. The proposals overlook that there are already two tax provisions that address the issue of deductibility of expenditure where it has been financed by borrowed money. The first is the deferred deduction rule (sections GC 29 to 31, ITA 2004) which applies where limited-recourse loans are used to finance deductible expenditure in certain situations. Secondly, under the financial arrangement rules (in subpart EX) where debt is forgiven, income is triggered under the base price adjustment (section EX 31). Therefore the effect is that where expenditure has been financed by a loan which is not repaid, the amount of the deduction is effectively reversed. This provision appears to adequately address the mischief already and further provisions do not seem necessary.

6.4 The Future of LAQCs

As mentioned earlier, the release of the proposals for limited partnerships and the *Discussion Document* on partnership taxation have contained several references regarding the continuation of the LAQC, which has become a popular vehicle for many New Zealand taxpayers.

It is unfortunate that the proposed enactment of the new limited partnership rules is being used as grounds to review the existence of the LAQC structure. Limited partnerships and LAQCs are vehicles for different types of ventures. Limited

partnerships require two different types of investor –being general and limited partners. The limited partners receive limited liability only if they do not directly participate in the management of the partnership. Shareholders in a company do not have their limited liability revoked if they also participate in the management of the company, although directors can become liable for a company's debts if they allow it to trade insolvent irrespective of whether they are also shareholders or not. Therefore the new limited partnership structure (with its limitation upon the pass-through of losses) is not a perfect substitute for the LAQC. The limited partnership is a risky entity to operate a small business through where the limited partner could possibly participate in the management of the partnership's business.

The LAQC is based on the premise that a closely-held company is not that dissimilar to a general partnership and should be taxed as such, while the limited partnership is more suitable where there is explicit separation of investors and management. The fact that there is no proposal to limit the number of limited partners in a limited partnership where there are tight limits upon the number of shareholders in a LAQC is proof that the two vehicles are aimed at different circumstances.

The alleged mischiefs arising with LAQCs stem from the adoption of the new core provisions in 1993 where the New Zealand income tax regime was placed explicitly on a gross/global basis. Provided any gross receipt received by a taxpayer is taxable income, then it automatically follows that any expenditure incurred in producing that income is deductible irrespective that the expenditure is disproportionately large in comparison to the gross income and that the activity may never produce net taxable income. Because of the global nature of the New Zealand income tax regime, any loss can be automatically offset against other sources of income (e.g. employment income). Revision of the gross-global basis underpinning the New Zealand income tax regime would appear to be a more appropriate area to review rather than discontinuing LAQCs.

The typical situation where LAQCs have been used is as a vehicle for rental property investment. The risks associated with owning rental property are usually fairly low other than the servicing costs of money borrowed to acquire the property. Withdrawal of the LAQC regime will lead to LAQC shareholders winding-up these companies and placing rental properties in their own names. While this may lead to some claw-back of depreciation and attendant transaction costs, the problem of rental property loss offsets will remain due to the gross/global nature of the New Zealand income tax regime.

7.0 CONCLUSION

The proposals in the *Discussion Document* provide a welcome clarification of the taxing regime applying to partnerships and for an internationally consistent basis for the taxation of the new limited partnerships. The restrictive rules proposed for pass-through of losses to limited partners of limited partnerships are complex and probably unnecessary given existing provisions of the ITA (such as the deferred deduction rules) to address with the problem of artificially created losses. It also is incongruous to not extend the same flow-through treatment to New Zealand limited partners of foreign registered limited partnerships where they are separate legal entities.

The proposals for the tax consequences upon the reconstruction of a partnership need further review as they are unlikely to be sufficiently broad to address the existing problems in this area.