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Tax changes proposed for general and limited partnerships

The Government last month released a discussion document on the proposed changes for general and limited partnerships. It calls for submissions on various points, with the closing date set at 11 August 2006. A Bill will be introduced in 2007 based on the proposed changes, to come into effect from the 2008 - 2009 income year.

The main changes are:

- a codification of rules relating to general partnerships - in particular for the allocation of income and expenses to partners;
- the introduction of a new limited partnership regime; and
- new rules relating to the entry and exit of partners from a partnership or a reallocation of interests within a partnership.

Some of the rules, such as entry and exit of partners, are complicated and are likely to be unworkable over the lifetime of a partnership. When entering a partnership the partner will be treated as if he or she is buying a share in the partnership. On exit, the partner will be treated as selling a proportionate share in the partnership. This means that each partner must track their individual cost base and share of retained earnings in relation to the partnership at all times.

In this update we look at four specific points dealing with the effect of the new partnership rules on certain types of businesses carried on in common ownership.

Joint ventures

The new rules will apply to all partnerships - but will they apply to joint ventures? A joint venture is generally seen as something less than a partnership. The most common difference is that a joint venturer normally takes output from the joint venture rather than profit. Joint venturers also continue to own the assets that they supply to, or use in, the joint venture.

The discussion document states that there will be no change to the way joint ventures are taxed, (currently joint ventures take their output and complete their tax returns on their own basis); submissions are requested on whether or not the partnership rules should apply to unincorporated joint ventures. An issue is raised as to whether co-owned businesses with six or more members that are not partnerships should be treated as partnerships for tax purposes in any event.

Reading between the lines, this could be a backdoor way of applying partnership tax law to joint ventures. Conceivably, further

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changes could be made before the Bill is introduced. This would have significant consequences for joint ventures, particularly in the entry and exit of joint venture members.

Special partnerships

Special partnerships are a type of partnership under the Partnership Act 1908 that give the special partners limitation of liability. There are a variety of criteria that must be satisfied before forming a special partnership. Special partnerships do not have separate legal personality.

The proposal in the discussion document is that existing special partnerships may continue as special partnerships but will cease to exist at the end of their prescribed period. (All special partnerships can only last for seven years, but may be renewed at the end of that period.) Under the proposal there will be no ability to renew a special partnership. But the special partnership can register as a limited partnership prior to its expiry.

If a special partnership does not register as a limited partnership it will cease to exist and this will trigger a dissolution at law for tax purposes. The tax rules for dissolution include the apportionment of the underlying assets at market value to the partners leading to taxable income in some cases (such as depreciation clawback).

The new rules relating to income and deduction flow through will apply to special partnerships. Whether the other rules relating to general partnerships apply may depend on the election of the special partnership. There is some discussion that these other rules could also be made mandatory, but the ability to elect whether the general partnership rules should apply gives the special partnerships greater flexibility. This is seen as being appropriate particularly in circumstances where a special partnership may decide not to register as a

limited partnership.

Limited partnerships

Special partnerships are already subject to the deferred deduction rules which prevent special partnerships from deducting expenses that have not actually been incurred. According to the discussion document, these rules do not always work as some partnerships can still access excess losses in certain circumstances.

The new rule is that losses from a limited partnership will flow through to the partners and will be able to be taken against income, but only to the extent of the partner's economic interest in the partnership. The partner's economic interest is the capital contribution, retained earnings and the value of some guarantees and indemnities. If a partnership makes losses that exceed the economic interest of the partners, the loss the partners can take into tax returns is limited to their economic interest. Excess losses can be carried forward. Obviously, those excess losses can only be used if there is further investment by, or allocation of income to, the partner.

There is no discussion of carrying losses backwards to offset income in other years except to the extent that retained earnings are included as part of a partner's economic interest in the partnership.

QCs and LAQCs

The discussion document indicates that qualifying companies (QCs) and loss attributing qualifying companies (LAQCs) will be reviewed, probably sooner rather than later. LAQCs, in particular, can undermine the loss limitation rules set out for limited partnerships. LAQCs can be used as partners in a general partnership. All losses from the general partnership can be flowed through to the shareholders in the LAQC without any limitation on those losses. The shareholders still have a limitation of liability but full flow through of losses.

“Submissions on the discussion document close on 11 August 2006.”

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LAQCs were originally introduced to give small business owners an ability to get the benefits of limitation of liability while still benefiting from sole trader status. Those business owners do not necessarily want to use limited partnerships as an alternative vehicle. Removal of the LAQC entity will undermine this policy intention which will not necessarily be fully offset by the use of limited partnership.

Submissions

Submissions on the discussion document close on 11 August 2006. We would be pleased to assist you in making submissions on any of the points discussed above or the other points in the discussion document. Please contact our specialist tax advisors listed on this newsletter for further information.

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