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PUB00258: Whether full or partial disposal where a person contributes an asset to a partnership as a capital contribution

Introduction and general comments

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on draft Question We've Been Asked: *Whether full or partial disposal where a person contributes an asset to a partnership as a capital contribution* (exposure draft).
2. The Law Society welcomes initiatives to provide certainty in the area of capital contributions to partnerships. It is however unfortunate that such a fundamental aspect of the partnership rules has not been resolved sooner.
3. Given the significance of the issue, it would be preferable for it to be clarified through legislative amendments to the partnership rules, with appropriate grandparenting provisions that preserve tax positions adopted by taxpayers before 16 August 2017, in reliance on the partial disposal approach.

Submission summary

4. The Law Society agrees that, at law, the nature of a partner's ownership interest in property changes upon contribution to a general partnership. This outcome is even more evident in relation to a limited partnership.
5. However, section HG 2 is critical in determining the treatment of a capital contribution of property to a partnership for tax purposes, and the exposure draft adopts a narrow interpretation of the effect of that provision. There are other considerations (outlined below) impacting the effect of section HG 2, that are not covered in the exposure draft's analysis. Accordingly, the Law Society considers that further explanation of IRD's interpretation of section HG 2 should be included in the exposure draft.
6. The Law Society also considers that the broader schematic arguments put forward in the exposure draft to support the full disposal view are incomplete, and should be rationalised with other statements in the exposure draft concerning the ability to dispose of property to oneself.

7. These points are explained further below. Statutory references are to the Income Tax Act 2007, unless stated otherwise.

Transparency provision – section HG 2

8. Accepting that the legal nature of a partner's interest in property that is contributed to a partnership changes upon contribution, such a contribution will (in the absence of a statutory override in the Act) give rise to a full disposal for the contributing partner. In that regard, section HG 2(1) of the Act provides:

HG 2 Partnerships are transparent

Look-through in accordance with share

- (1) *For the purposes of a partner's liabilities and obligations under this Act in their capacity of partner of a partnership, unless the context requires otherwise, —*

- (a) *the partner is treated as carrying on an activity carried on by the partnership, and having a status, intention, and purpose of the partnership, and the partnership is treated as not carrying on the activity or having the status, intention, or purpose:*
- (b) *the partner is treated as holding property that a partnership holds, in proportion to the partner's partnership share, and the partnership is treated as not holding the property:*
- (c) *the partner is treated as being party to an arrangement to which the partnership is a party, in proportion to the partner's partnership share, and the partnership is treated as not being a party to the arrangement:*
- (d) *the partner is treated as doing a thing and being entitled to a thing that the partnership does or is entitled to, in proportion to the partner's partnership share, and the partnership is treated as not doing the thing or being entitled to the thing.*

9. The exposure draft concludes (at paragraph 14) that the above provision is “not directly relevant to whether there is a full or partial disposal where a person contributes an asset to a partnership as a capital contribution”. Critical to this view is the proposition that section HG 2(1) applies for limited purposes, being for the “purposes of determining a partner's liabilities and obligations under the Act in their capacity as partner of a partnership”. The suggestion in the exposure draft is that the income tax consequences arising from a disposal of property to a partnership arise for the partner in some other capacity than as a partner.
10. This narrow view of section HG 2(1) would lead to absurd consequences, indicating that section HG 2 must provide for a broader concept of transparency than that put forward in the exposure draft. Taken to its logical conclusion, the narrow interpretation would lead to the partners of a limited partnership and the limited partnership itself being taxed on the same income. This is because, based on IRD's interpretation:

- Section HG 2(1) would apply only for the narrow purpose of determining the rights and obligations of the partners of a limited partnership.
 - Section HG 2(1) would not apply on its terms to determine the rights and obligations of the limited partnership itself, which is acknowledged is a separate legal person and which is capable of deriving income.
 - The clear wording in section HG 2(1) which deems a partnership to not hold property or carry on activity etc. would therefore not apply to relieve the partnership from deriving income as a separate legal person. Those provisions simply would not apply for the purpose of determining the tax position of the partnership (only the partners).
11. The lead-in wording in section HG 2(1) can be contrasted with the statement of transparency in section HR 9 of the Act (relating to financial institution special purpose vehicles), which provides as follows:
- For the purposes of the liabilities and obligations under an Inland Revenue Act of a financial institution described in the definition of financial institution special purpose vehicle, paragraph (b), and the relevant financial institution special purpose vehicle, —*
12. The above language is notable in that the transparency provisions expressed in section HR 9 apply for the purposes of determining the income tax position of the financial institution (the partner equivalent) *and* the financial institution special purpose vehicle (the partnership equivalent). That provision therefore achieves the outcome of:
- the financial institution (the partner equivalent) being taxed on income from the financial institution special purpose vehicle; and
 - the financial institution special purpose vehicle (the partnership equivalent) not being taxed on the same income.
13. Section HR 9 achieves the outcome indicated in the heading to the section, being that “financial institution special purpose vehicles are transparent”. A consequence of this is that the partial disposal outcome would arise. Although there is a difference in language between section HR 9 and section HG 2(1), both provisions include a heading that is indicative of a similar underlying intention with regards to transparency - both provide that the relevant entity, being the partnership and the financial institution special purpose vehicle, is “transparent”.
14. The narrow interpretation of section HG 2(1) proposed by IRD would leave the position of the partnership unclear, indicating that such an interpretation may not align with Parliament’s intention. The Law Society considers that section HG 2(1) could well be a broader statement of transparency, which provides scope for a partial disposal view to be adopted or at least considered more closely.
15. It is also worth noting that IRD’s view would have significant flow-on consequences for the look-through company (LTC) regime. Section HB 1(1) adopts similar language to section HG 2(1), providing that section HB 1(4) applies for the purpose of the Act (other than excluded regimes) “for a person in their capacity of owner of a look-through interest for a look-through company”. Applying IRD’s view expressed in the exposure draft, the position of the LTC itself (clearly a

separate legal person) would be left unclear if the transparency provisions were intended to be applied only in determining the position of the shareholder of the LTC. It is also doubtful that a person has a separate legal capacity as shareholder in a company, which brings into question the emphasis that IRD places on the concept of a person's capacity as a partner versus their personal capacity, when applying section HG 2(1).

Schematic arguments

16. At paragraph 42 of the exposure draft, IRD suggests that a partial disposal approach would give rise to unintended consequences where a partner holds property on revenue account, and contributes that property to a partnership that will hold the property on capital account. The consequences that are suggested as arising involve a contributing partner not being taxed on a future disposal of their retained interest in the revenue account property, due to the attribution of capital account status from the partnership to the partner under section HG 2(1).
17. IRD expresses the following view about this situation at paragraph 39 of the exposure draft:

*The Commissioner also notes, for completeness, that it is well-settled law that the principle that a person cannot dispose of property to themselves is in any event qualified for income tax purposes. **For example, it is settled law that where a taxpayer transfers an asset from a (taxable) trading account to a (non-taxable) private account, or vice versa, the taxpayer is treated as disposing of, or acquiring, the asset for market value:** Sharkey (Inspector of Taxes) v Wernher [1955] 3 All ER 493 (HL); Bernard Elsey Pty Ltd v FCT (1969) 121 CLR 119 HCA; Case A27 (1974) 1 NZTC 60,245; and CIR v Farmers' Trading Co Ltd [1982] 1 NZLR 449 (CA). [emphasis added]*
18. It is not clear why the principle outlined above, which IRD has described as well settled, would not apply to cause a partner to be treated as having fully disposed of property contributed to a partnership due to the change from revenue to capital account status, in spite of the partial disposal approach being applied under section HG 2(1). The non-taxation outcome outlined at para 42 simply would not arise if this principle, which operates independently of the transparency provision in section HG 2(1), is well settled.
19. It is at least possible that the correct analysis is that the partner continues to hold the relevant property for tax purposes in proportion to their partnership share, but is nevertheless separately treated as having income because of the difference in classification of the asset that arises from the transaction. This casts doubt over the relevance of the schematic arguments raised by IRD in support of the full disposal view.

Additional comments

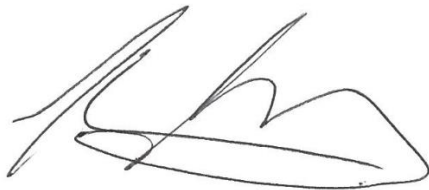
20. Regardless of the view adopted in relation to the transfer of property to a partnership by way of capital contribution, the Law Society considers that there would be value in the exposure draft addressing the tax treatment of a transfer of property by a partner to a partnership by way of sale.

21. It is likely that many taxpayers will have applied the partial disposal approach, not only in the partnership context but also in the context of the LTC rules. Given the uncertainty in this area, the Law Society is of the firm view that historical positions should be grandfathered, but if IRD continues to advocate the full disposal approach despite the issues outlined above, that approach should apply prospectively to contributions made after 16 August 2017. As noted at the beginning of this submission, it would be preferable for the position to be clarified by legislative amendment with appropriate transitional rules.

Conclusion

22. This submission was prepared with the assistance of the Law Society's Tax Law Committee. If you wish to discuss this further, please contact the committee's convenor, Neil Russ, via the committee secretary, Jo Holland at jo.holland@lawsociety.org.nz, (04) 463 2967.

Yours faithfully

A handwritten signature in black ink, appearing to be 'K. Beck', written in a cursive style.

Kathryn Beck
President