



Law Council  
OF AUSTRALIA

*Business Law Section*

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Dear Simon

### **TD2015-D2: Assessability of Partner Retirement Amounts**

The Taxation Committee of the Business Law Section of the Law Council of Australia (the **Committee**) welcomes the opportunity to comment on the above Draft Determination (the **TD**), and is particularly appreciative of the extension of time provided to make this submission.

The TD contends that a retirement payment received by a retiring partner will generally constitute an allocation of the net income of the partnership and is thus required to be included in the partner's assessable income pursuant to section 92 of the *Income Tax Assessment Act 1936*.

The TD acknowledges that the position in the TD amounts to a reversal of the ATO's longstanding practice of treating retirement payments as a capital receipt in respect of the disposition of a partner's interest in the partnership. Accordingly, the TD proposes that the ATO's revised position be applied on a largely prospective basis.

This submission urges a broader reconsideration by the ATO of whether a retirement payment represents part of the partner's individual interest in the net income of the partnership.

#### **Outline of submission**

The Committee's view is that the answer to the question posed by the TD should **not** be an unqualified "yes" as is currently proposed.

The Committee is of the view that the TD does not fully align with legal analysis and precedent for two key reasons:

- Firstly, whether an entitlement to a retirement payment forms part of a partner's interest in the net income of the partnership is a matter of fact and requires a consideration of the construction of the partnership deed in each individual case.
- Secondly, the case law is settled that a retired partner cannot have an interest in the net income of a partnership as at the end of the year of income, where that partner does not have an interest in the partnership at the end of the period for which the net income is determined.

The Committee considers that the TD is not the proper administrative solution to ensuring symmetry in tax treatment between continuing and retiring partners.

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Given the complexity of the issues involved, the Committee recommends that the ATO withdraws the TD. We consider that a comprehensive position, which addresses alternative partnership deed provisions and resulting tax consequences, should be provided in the form of a public ruling.

### **Partners' Entitlement to Profit**

An interest in a partnership is a well-established legal concept which comprises a partner's entitlement to capital of the partnership, to share in the profits of the partnership and to a distribution of assets of the partnership in the event of dissolution. These entitlements are generally governed by the terms of the partnership deed and thus it is the terms of the deed which are the principle reference point for the determination of allocation of net income among partners.

The authorities establish that the matter of allocation of partnership profits is entirely separate to the actual disbursement of funds by the partnership (refer High Court in *Rose v. Federal Commissioner of Taxation* (1951) 84 CLR 118 (*Rose*) and *Federal Commissioner of Taxation v Galland* (1986) 162 CLR 408 (*Galland*)).

Nevertheless, the TD states at paragraph 20 that a partner's share of the net income is "to be determined by reference to the partnership's accounting records" as well as "any other relevant documents". The facts presented in the example are also heavily predicated on the accounting treatment being determinative of the partner's legal entitlement to share in the partnership profit (with no reference made in that example to the partnership deed). For example, paragraph 5 clearly indicates that the allocation made to the retiring partner as shown in the financial accounts and the statement of distribution is the reference point for determining the allocation of net income of the partnership.

The Committee notes that the relevant issue is whether the purported allocation in the financial accounts and statement of distribution reflects the partners' entitlements as established in or in accordance with the partnership deed. The Committee further notes that there is also established authority that whilst accounting treatments may assist in legal characterisation in some circumstances, they cannot be substituted for the juristic examination of legal rights.

Thus in each case it will be necessary to determine a retiring partner's rights by reference to the terms of the relevant partnership deed and the facts of each case. A partnership deed will generally define a partner's share in the profits or net income of the partnership. In many large partnerships, this is done by reference to a point or unit system which is used to calculate the proportionate profit share of each partner. In many cases there will also be provision for bonus or similar arrangements which adjust a partner's final income share to reflect actual performance in that year. The adjustment will typically involve a process of committee, senior management or executive review.

A partnership deed may also provide for retirement payments based on a graduated entitlement reflecting the years of a partner's service (as used in the example in the TD), without necessarily incorporating this entitlement into the definition of a partner's share in the profits or net income of the partnership. Unless the retirement entitlement is clearly subsumed into the profit entitlement, as a matter of legal construction we question the basis on which the retirement payment can be universally considered to be an allocation of the net income of the partnership.

## Relevance of timing of the Partner's Retirement

The Committee's second key concern relates to the impact of the retirement occurring prior to the accounting balance date of the relevant year.

The High Court of Australia in *Galland* affirmed the common law principle that the partnership profits in a particular period can only be determined upon the drawing of accounts either on the balance date or on another relevant event, such as the dissolution of the partnership. Thus in *Galland* it was held that the disposition of a partnership interest prior to the accounting balance date resulted in the alienating partner not having any entitlement to the net income of the partnership for the accounting period during which the disposal occurred.

The Committee considers that it is beyond doubt that the authorities cited in the TD do **not** sufficiently support the conclusion in paragraph 24 of the TD that the treatment of the retirement payment is unaffected by the timing of the partner's retirement.

Firstly, in the case of *Federal Commissioner of Taxation v. Happ* (1952) 9 ATD 447; [1952] ALR 382, the retiring partner was a partner as at the date of the dissolution of the partnership and thus the partner was entitled to a share of the profits in the period up to dissolution. The Committee considers that this is entirely consistent with the core proposition in *Galland*.

Secondly, the High Court in *Rose* dealt with the application of the livestock and depreciation provisions of tax legislation in the context of a formation of a partnership. The Committee does not consider that this case is relevant to the issues at hand, other than it affirms that the allocation of income is separate to the actual disbursement of funds.

Thirdly, reference is made to the Federal Court decision in *McNally v. FC of T; FC of T v. McNally* 2007 ATC 4150 (*McNally*) where it was stated that the relevant partners could bind themselves as to the distribution of the net income of the partnership. The Committee agrees that the entitlement to partnership income is a matter of agreement by the partners, which is generally governed by the partnership deed. Again, the Committee considers this to be consistent with the core proposition in *Galland*. Indeed in *McNally*, the Court found in respect of work in progress that the retiring partner had to be treated in the same manner as the continuing partners.

Fourthly, and most importantly, support is sought from comments in *Galland* (citing *Rowe (B. & H.G.) v. F.C. of T.* 82 ATC 4243) that partners cannot delay their liability in respect of the tax year by refraining from drawing up accounts until after 30 June (refer *Galland* at 4893). The Committee considers that in this context Dawson J was merely observing that those partners who are partners as at the balance date cannot defer their liability merely by ensuring that the accounts are not drawn up on that very day. In the Committee's view, the passage cited is consistent with the High Court's unanimous view that a partner cannot have a tax liability in respect of the profits of the financial year unless they were a partner in the partnership as at the end of the financial year.

## Relevance of funding

Whilst this is not covered specifically in the TD, in discussions with the ATO, a contention was raised that retirement payments are funded out of profit and therefore must be an allocation of profit.

Whilst the Committee considers the issue of funding to be moot, in notes that partnerships source funds from a variety of sources including:

- capital contributed by partners (which is often sourced from funding facilities established or facilitated by the partnership or a related entity);
- external debt funding raised directly by the partnership;
- reserves established to deal with long term requirements or inter-generational equity, for example, future deductibles not covered by insurance policies and large lease incentives which are to be amortised over the period of the lease.

Thus the Committee considers that partnership funding sources are fungible and there is no direct link between profits and retirement payments. In any event, for completeness, the Committee notes that the economic equivalence doctrine was rejected by the Federal Court in *Galland*.

### **Equitable considerations - Resolving the mismatch**

The Committee also understands from discussions with the ATO that there is a view that assessing continuing partners in a manner which does not reflect the actual disbursement of partnership funds is “inequitable”, notwithstanding that the authorities have established that the allocation of net income is a matter separate to the actual disbursement of funds. The Committee agrees that there should be symmetry between the positions taken by continuing and retiring partners, and thus supports the ATO's objectives in this regard. However, the Committee considers that symmetry will be achieved where the positions taken are based on a correct legal construction of the relevant partnership deed. Accordingly, the Committee recommends that the ATO formulates a more comprehensive position in the form of a public ruling, which examines the implications of alternative provisions in partnership deeds and provides appropriate guidance to both continuing and retiring partners in different factual scenarios.

### **Date of effect**

The TD recognises at paragraph 11 that the Commissioner has had a longstanding practice of characterising retirement payments in the many private binding rulings issued to date. Accordingly, paragraph 12 states that the ATO proposes not to disturb favourable assessments made before the date of the issue of the TD.

The Committee agrees that, in view of the ATO's previous practice, the ATO is bound, as a minimum, to respect pre-existing assessments as proposed in paragraph 12. The ATO does not apply this 'grandfathering' to events other than those on which they have issued a private binding ruling. We note that this approach is normally applied to relatively egregious practices of which this is not. The Committee requests that the ATO consider a date of effect provision which does not disturb any retirement payments that have been **made** prior to the date of the TD, if not the Final Determination.

\* \* \* \* \*

The Committee would be happy to provide further assistance, or discuss any of the above comments, if that would assist. In the first instance please contact Committee Chair, Adrian Varrasso on 03 8608 2483 (email: [adrian.varrasso@minterellison.com](mailto:adrian.varrasso@minterellison.com)).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'John Keeves', with a long horizontal stroke extending to the right.

John Keeves, Chairman  
**Business Law Section**