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Our ref KPMG submission – PUB00367: Partnerships general guidance

28 May 2024

Dear Sir | Madam

KPMG submission – PUB00367: Partnerships general guidance

We welcome the opportunity to comment on the draft interpretation statement providing Inland Revenue's guidance on the income tax treatment of partnerships (including limited partnerships).

We appreciate the additional time for making our submissions.

The draft item covers a wide array of topics relevant to the taxation of partnerships. We have not attempted to comment comprehensively on the item. Rather, our submission focuses on select items we consider important to raise with the Tax Counsel Office ("TCO") for consideration in updating and finalising the item.

Our submissions are set out in the **Appendix** to this letter.

We also note TCO's decision to delay the withholding tax item given the policy implications of the issues identified, which we understand have been referred to IR's Policy and Regulatory Stewardship ("PaRS") for legislative resolution. Given our experience dealing with these issues we would be pleased to provide feedback to PaRS (and TCO) on the practical considerations.

Further information

Please do not hesitate to contact Robert Grignon on 09 304 5295, should you wish to discuss this submission in greater detail.

Yours sincerely

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APPENDIX – DETAILED SUBMISSIONS

The draft interpretation statement provides general guidance on the income tax treatment of partnerships, including limited partnerships, under the Income Tax Act 2007 (the "Act").

We make the following submissions on the item.

1. Determining purpose or intention and analysis in example 3

Paragraphs [36] to [45] consider the implications of s HG 2(1)(a) of the Act, which provides that a partner is treated as having a status, intention and purpose of the partnership, and the partnership is treated as not having the status, intention or purpose. In effect, s HG 2(1)(a) imputes the partnership's purpose or intention to all partners, in respect of property owned by the partnership but which is treated as being held by the partners under s HG 2(1)(b). This is relevant in the context of taxing provisions such as ss CB 4 and CB 6, which apply based on a person's purpose or intention at the time property is acquired.

The item notes that the partnership can only have a single purpose or intention (e.g., as applied to the holding of a particular asset), and that purpose or intention is imputed to all partners, despite the fact there may be differences between individual partners as to their personal purposes or intentions. The item states that to the extent the partnership's purpose or intention is inconsistent with a purpose or intention that a partner holds personally, the partnership's purpose or intention will prevail. Examples 2 and 3 are intended to illustrate this.

However, the conclusion in example 3 appears to run contrary to this principle, and in our view illustrates the potentially limited relevance of s HG 2(1)(a) where there have been changes in partners after the date a partnership acquires land (or other property in the case of s CB 4).

In example 3, a partnership originally acquired land for the purpose of leasing and the land is held on capital account. This purpose and intention of the partnership, as at the date the land was acquired, should accordingly be imputed to all partners under s HG 2(1)(a), regardless of their individual purposes or intentions (e.g., a desire of a partner(s) from the outset that the partnership might dispose of the land for a gain).

One of the partners (Partner 1) thinks that the partnership should sell the land, so they buy-out another partner's interests in the partnership to secure majority ownership. This allows Partner 1 to cause the partnership to dispose of the land. The item concludes that, if the safe harbour rule in s HG 5 does not apply, Partner 1 should be taxable under s CB 6 in relation to the interest in the land that was indirectly acquired from the exiting partner (applying s HG 2(1)(b) transparency provision as to ownership interests in the land). This is despite the fact that the *partnership's purpose or intention* at the time the *partnership acquired the land* was to hold it long term for rental purposes which, pursuant to s HG 2(1)(a), should then be imputed to *all* partners.

The imputation principle holds true, however, in respect of the portion of the partnership land Partner 1 was treated as holding at the date the partnership acquired the land (regardless of

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Partner 1's intention at that time), meaning Partner 1 should not be taxed under s CB 6 on their interest in the land they indirectly acquired at the time the partnership acquired it.

While the item states that example 3 is intended to illustrate that the *partnership's* purpose or intention will prevail (and be imputed to all partners), it appears to illustrate that the opposite may be true, to the extent a partner increases their interests in the partnership, or a new partner enters the partnership, after the date on which the partnership acquires property. It is not clear to us that this is the intended policy outcome (at least not in all circumstances).

At a minimum, the example highlights a tension between subsections HG 2(1)(a) and (b) and the limits of subsection (a). The conclusion suggests that when applying s CB 6 to a partner who is deemed to dispose of a share of the partnership's assets (due to the transparency provisions in s HG 2(1)(b) to (d)), they may be treated as having different acquisition dates, with distinct purposes or intentions on each of those acquisition dates.

Accordingly, despite the fact that s HG 2(1)(a) might impute the partnership's original capital account purpose or intention to all partners, under the interpretation in the draft statement, s HG 2(1)(a) *only* applies to impute the partnership's purpose/intention insofar as persons were partners in the partnership at the time the partnership acquired the asset (or where the safe harbour in s HG 5 applies to treat them as though they were a partner at the time the land was acquired).

This conclusion appears consistent with TCO's analysis in relation to s CB 9 in paragraphs [245] to [275]. That is, the "person" referred to in s CB 9 must be the partner, not the partnership, because the partner is the person who derives an amount from the disposal of land. The same must be true for s CB 6 (and for other land taxation provisions, s CB 4, etc.). Because transfers of partnership interests after the partnership acquired land may result in different deemed acquisition dates for portions of the land, each separate interest in land held by a partner can have a different acquisition date and the partner's purpose or intention on that date must be ascertained in relation to that interest in land.[1] However, again, it is not clear to us whether there is coherence from an overall policy perspective with such outcomes.

Section HG 2(1)(a) therefore appears to only be of relevance to a disposal of partnership land insofar as there are partners who had indirect interests in the land at the date of acquisition (at which point in time all partners will be imputed to have the partnership's single purpose or intention on that date). To the extent there are changes in partnership interests over time, s HG 2(1)(a) may become largely irrelevant, or possibly completely irrelevant if all partners are different at the time the partnership disposes of land (subject to the safe harbour in s HG 5 applying).

This leaves, in our view, considerable uncertainty around when a partnership's purpose or intention can, and cannot, be imputed to a new partner. For example, is it only where a new partner is able to exercise considerable influence over the activities of a partnership (such as acquiring a majority interest in the partnership), that their purpose is imputed instead? Presumably a distinction can be drawn between partners in a general partnership and a limited partnership where, in the case of the latter, changes in limited partners (or existing limited

[1] This is also consistent with the fact the partner would have a different cost base in the distinct interests in the land acquired on different dates, where the s HG 5 safe harbour did not apply.

partners increasing their partnership interests) should not impact application of s HG 2(1)(a). That is, because limited partners cannot be involved in the operations of the limited partnership, the purpose or intention of the limited partnership should be imputed in all cases to the limited partners, including new partners?

In our view the discussion of s HG 2(1)(a) in the item and the analysis in example 3 should be updated and expanded to clarify these issues.

2. Non-standard balance dates

Paragraphs [84] to [86] and example 5 consider how partners, when filing their separate returns, should return their share of partnership income where the partnership has a non-standard balance date. The item concludes that a partner does not *have to* reallocate income based on their separate balance dates, and they *can* return their share of partnership income to the same balance date as the partnership in their tax return for the same income year (despite the partner's balance date differing from the partnership's balance date).

While we appreciate the Commissioner's confirmation this is an acceptable approach (noting this approach is frequently applied in our experience), we consider the item needs to comment on other potential approaches. The brief discussion in the item of non-standard balance dates suggests this is a permissive approach (e.g., a partner "can" do this, they do not "have to" take an alternative approach), without citing any legislation or commenting on alternatives which may or may not be acceptable to the Commissioner.

We consider the approach discussed may be problematic in some cases, and alternative options should be acceptable to the Commissioner and should be addressed in the item.

For example, assume a limited partnership with a 31 March balance date has two 50/50 limited partners. Partner A has a 31 December balance date and Partner B has a 31 March balance date. Partner A sells their 50% interest in the LP to a third-party, Partner C (who has a 31 March balance date), on 30 December 2024. On 1 March 2025, the LP sells a piece of partnership land which is held on revenue account, resulting in a $10 million taxable gain.

If the approach suggested in the item is applied, Partner A will potentially be allocated $5 million of taxable gain in their tax return for the year ended 31 December 2024, despite the fact the gain arose on 1 March 2025, more than two months after Partner A exited the partnership. This is challenging to reconcile with the transparency provisions in s HG 2, given Partner C should be treated as owing 50% of the land on the date it was disposed of. Partner A had no interest in the land on the date of disposal and, given they had already exited the partnership, may not even have been aware the land was (or was even likely to be) sold. Moreover, Partner A may have already been subject to tax on their deemed disposal of the underlying land as a result of their sale of LP units to Partner C (assuming the safe harbour in s HG 5 did not apply).

In our view, it should also be permissible for a partnership to prepare part-year accounts to more accurately allocate income/expenditure to partners in scenarios similar to our example, if so desired, particularly as this more closely aligns with the transparency provisions in s HG 2.

The allocation of income and expenditure to partners may also be addressed in the partnership agreement, and we generally consider the legal agreement should be respected (subject to the

anti-streaming rule in s HG 2(2)). We discuss this further in the following submission on the attribution of income and expenditure.

3. Attribution of income and expenditure where partners' interests change during the year

Paragraphs [54] to [71] consider the attribution of income and expenditure based on a partner's "partnership share in partnership income" and the anti-streaming provision in s HG 2(2). The analysis (and illustration in example 4) address the Commissioner's view on how s HG 2 applies to attribute income (and expenditure, credits, etc.) to partners in a partnership where there are no changes in partners during the year.

However, there is no discussion of how these provisions are to be applied to the extent there are changes in partnership interests throughout the year. For example, there is no discussion of s HG 2(3) (which relates to the allocation of expenditure or loss between entering and exiting partners) in this context, nor how items of income may be allocated as between entering and exiting partners.

Paragraphs [92] to [139] discuss the income tax consequences of changes in partners, including where a new person joins a partnership, or an existing partner increases their partnership share. The discussion in this section focuses on the tax consequences of deemed disposals of partnership property and the various safe harbour provisions, but also does not address how income/expenditure may be allocated between entering and exiting partners. The exception to this is the summary of s HG 2(3) in paragraph [139], although this simply paraphrases the legislation without any commentary or analysis.

As discussed above in relation to non-standard balance dates, the approach to allocation of income and expenditure between partners, including as between entering and exiting partners, is typically addressed in the partnership agreement between partners. In our view, the legislation is generally permissive and suggests the legal arrangements between the partners should be respected (subject to the anti-streaming rule in s HG 2(2) and other anti-avoidance provisions). Subsection HG 2(3) explicitly contemplates that partners may choose how to allocate expenditure or loss for the year between entering and exiting partners (provided there is no double-counting of such amounts). There is no equivalent provision relating to allocation of income in the legislation, but in our view a similar approach can be taken, consistent with the legal arrangements agreed between partners.

We consider the item should be updated to provide the Commissioner's views on this issue.

4. Application of s HG 5 to diluted partners where capital is contributed to partnership

As Inland Revenue previously considered in *QB 17/09: Is there a full or partial disposal when an asset is contributed to a partnership as a capital contribution*, the item discusses why a capital contribution made by a person to a partnership gives rise to a deemed partial disposal of partnership assets for all existing partners whose partnership interests are diluted. This is illustrated in Diagram 2 and Table 1.

The discussion of the general de minimis rule does not address how the formula in s HG 5(1) applies to such a dilution scenario. While there is a reasonable argument that diluted partners

should be considered "exiting partners" as that term is defined in s YA 1[2], we are aware of an alternative view that the "disposal payment" as defined in s HG 5(2)(a) should be nil and that the safe harbour in s HG 5 should typically apply in a dilution scenario (other than for partners of a "small partnership" if s HG 3(2) applies). This alternative view is on the basis that there is no "consideration paid or payable" to the exiting partner, because the total value of the diluted partner's property has not changed. Taking the figures in Table 1 on page 27 for example, the total value of each of Partner 1's and Partner 2's property is $60 both before and after Partner 3's capital contribution. Accordingly, under this alternative view, Partners 1 and 2 have not received any consideration and there is no disposal payment.

Given the different views likely to be adopted in practice, we consider the discussion of s HG 5 should be expanded to comment on how the provision applies to a capital contribution (dilution) scenario, ideally with an additional example added after example 6 (which concerns a sale of partnership units) to contrast with that scenario.[3] We also recommend updating the figures in Table 1 given the s HG 5 safe harbour almost certainly would apply in that scenario such that Partners 1 and 2 would not have income from the disposal.[4]

5. Application of the purchase price allocation rules to changes in partnership interests

The discussion of changes in partnership interests illustrates the various circumstances under which an exiting partner may be deemed for income tax purposes to dispose of an interest in all existing partnership property to an entering partner. In most cases, this will involve a deemed disposal of various assets (and liabilities) of the partnership which have differing tax treatments, e.g., trading stock, depreciable property, land held on capital or revenue account.

There is no discussion in the item of how the purchase price allocation ("PPA") rules in ss GC 20 and GC 21 apply to such transactions.[5] These provisions apply where, for consideration, a person ("person A") disposes to another person ("person B") of items of property that, for either person, fall into two or more classes of purchased property as set out in ss GC 20(1)(a) and GC 21(1)(a). Exiting partners and entering partners will clearly constitute "person A" and "person B", respectively, in relation to any deemed disposal of partnership property arising due to a change in partners. In fact, there may be *many* separate disposals to which the PPA rules apply. For example, every existing partner will potentially be a "person A" to the extent their interests in a partnership are diluted due to a new partner entering the partnership (the new partner being "person B").[6]

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[2] An "exiting partner", for a partnership, means a person who disposes of interests in the partnership held by the person as a partner. Because the dilution of a partner is viewed as being a disposal of some of their interest in the partnership, a diluted partner would prima facie be an "exiting partner" per the definition (albeit somewhat unintuitively given the plain meeting of the word "exiting").
[3] We note that "gross tax value" less "liabilities" in example 6 is exactly $50,000. We suggest this example be updated so that the net of these exceeds $50,000 (e.g., by reducing the liabilities figure) and the same figures could be used in the new capital contribution example to illustrate why s HG 5 still potentially does not apply in a dilution context.
[4] Alternatively, it could be explicitly stated that the partnership in the Table 1 qualifies as a "small partnership" to which s HG 3(2) applies, meaning the safe harbour in s HG 5 does not apply.
[5] With the exception of one sentence included within example 6, which states, "[t]he question of how a global purchase price is allocated to particular assets is a separate topic outside the scope of this statement".
[6] We acknowledge that the "if no agreement" PPA rules in s GC 21 do not apply where the total consideration for the purchased property is less than $1 million (or $7.5 million if only residential land and chattels), so in practice is may frequently be the case that s GC 21 does not end up applying, despite the potential ignorance of the parties as to the

The implications of this do not appear to be addressed in any Inland Revenue commentary to date (including not being considered in the *Special Report* on the PPA rules released in April 2021 following enactment of ss GC 20 and GC 21).

While practitioners are generally aware of this issue, it would be helpful for taxpayers if Inland Revenue were to highlight it, so that it is not overlooked. Taxpayers reading the commentary on the implications of a transfer of partnership interests in this item may easily overlook the PPA implications given the item is effectively silent on this point.[7] This potentially has significant implications, for example s GC 21(8) could potentially apply to deny all deductions for the entering partner, if no allocation has been agreed under s GC 20 and an allocation has not otherwise been notified to the Commissioner and other party under s GC 21 within the prescribed timeframes in that section.

6. Foreign investment fund rules and partnerships, and related issues

Paragraphs [276] to [283] and example 16 illustrate the transparency of partnerships using the foreign investment fund ("FIF") rules. The discussion demonstrates how the FIF rules apply to the partners of a partnership, not the partnership, consistent with the transparency provisions of s HG 2.

Example 16 concerns a partnership with three New Zealand resident partners, where the partnership holds shares in an overseas company (which pays a dividend in the income year). Based on the facts in the example, each partner has a different income tax treatment for their indirect interest in the overseas company. The FIF rules do not apply for Partner 1 and their share of the dividend is assessable income. The FIF rules do apply for Partner 2, so they must calculate FIF income applying the applicable FIF rules and their share of the dividend is excluded income. Partner 3's interest in the overseas company is subject to the CFC rules rather than the FIF rules.

We generally agree with the analysis in Example 16 and the conclusions in this section. However, we consider the item would benefit from a discussion of compliance implications for a partnership. For example, does the partnership need to include the gross dividend in its tax return and, accordingly, the IR7P partnership statements for each partner, with each partner then required to make the appropriate adjustments in their individual returns? In our experience there is uncertainty and differing views applied in practice, so further guidance from the Commissioner in the draft statement would be welcomed.

We note that Inland Revenue's IR7G (*Partnership and look-through company (LTC) return guide*) states on page 14 that each partner in the partnership is required to advise the partnership of their individual amount of either FIF income or loss (or their FIF calculation method), or the dividend amount if the FIF rules do not apply, to be included on the IR7 return for the partnership. I.e., it is suggested that in the partnership's return an aggregated amount, taking into account the specific facts and circumstances of, and taxing regimes applicable to, every individual partner, is

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application of the PPA rules. For completeness we note that if there is a written agreement between partners which complies with s GC 20 then the PPA provisions in s GC 20 should apply regardless of the consideration value.

[7] We do not consider the single sentence in example 6 to be adequate or helpful.

to be included in the partnership return. Each individual partner's IR7P should then include the amount calculated for that partner.

This approach in the IR7G is highly impractical for a variety of reasons.

Firstly, it is potentially very time consuming and costly for a partnership to make such inquiries of every individual partner (particularly for a widely-held partnership such an LP fund, which could have a myriad of investors, potentially holding through additional limited partnerships at higher tiers, etc.). It has the potential to delay finalisation of the partnership return, pending receipt of this information. Moreover, individual partners may not know whether the FIF rules apply to them in an income year, or which FIF method they might choose to apply for a year (e.g. FDR or CV) until they have received information from all of their investments and are able to finalise their own tax returns. They would also need information from the partnership, for example as to dividends received, shares in FIFs acquired and disposed of, etc., to perform their own FDR or CV calculations.[8] This becomes circular, as the partnership cannot finalise the IR7P statements until every partner has finalised their own tax returns and vice versa. In our view, there should be no requirement on the partnership to report investors' FIF income (in aggregate and for each partner) as this is simply not practical and the IR 7G should be updated accordingly. That is, the reporting of the these amounts should correctly happen at the partner level, not the partnership level for the reasons outlined below. For amounts such as foreign dividends, it should be made clear, that if the partnership reports the actual dividends received in the partnership return, that partners may need to make adjustments as required in their personal returns.

The same issues arise in respect of other taxation regimes applying at the partner, rather than partnership, level. Take for example the thin capitalisation rules, which apply at the partner level. There is no mention of the thin capitalisation rules in the draft item, nor in the IR's IR7G guide. It is expected that the partnership's total interest expenditure is included in the partnership's tax return, and this is allocated to the partners in accordance with their share of partnership income and expenditure. Adjustments are then made in each partner's individual return to the extent the thin capitalisation rules (or any other applicable rules which may limit the deductibility of interest) result in denial of interest deductions. In our view, the same approach should apply to how foreign-sourced dividends and FIF interests are addressed in partnership returns (and any other rules which apply at the partner rather than partnership level). Further guidance from the Commissioner on this in the item would be welcome.[9]

Lastly, in relation to FIF interests held by partnerships, we consider the discussion of the anti-streaming provision in s HG 2(2) (at paragraphs [36] to [45] in the item, discussed in our third submission point) should be updated to confirm how the partner's "partnership share of partnership income" is intended to be calculated where individual partners' incomes under the Act differ from the partnership's income (e.g., because FIF rules apply to a partner but do not apply to the partnership). For example, whether in the Commissioner's view a partner's "partnership share of partnership income" should be calculated by reference to actual dividend income received by the partnership, without regard to the taxable income that might actually arise

[8] The partner's individual FDR calculation would need to consider any "quick sale" adjustments, the CV calculation would need to consider dividends received and gains/losses made, etc.
[9] In addition to addressing in the item, we consider an update to the IR7G would be required.

for individual partners applying different taxation regimes.[10] The FIF dividend adjustment rule in s HG 11(7)(ab) applicable to a partner's basis calculations, as discussed at paragraphs [336] to [343] and example 26, suggests to us the legislative intent is that the partner's "partnership share of partnership income" for s HG 2(2) purposes should be based on entitlement to actual dividend income, rather than the amount of income that arise for partners individually (under FIF rules or otherwise) and/or the amounts which are potentially included in the partnership's tax return (see also comments above on how foreign-sourced dividends and FIF income are to be reported in a partnership's return).

[10] To illustrate this, Example 4 (no streaming rule) could be updated such that the "income from investments" amount includes both NZ-sourced and foreign-sourced dividends. Alternatively, this issue could be drawn out in the discussion of FIF interests currently in paragraphs [276] to [283].