THE REFORM OF PARTNERSHIP LAW AND TAXATION IN NEW
ZEALAND

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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 As a consequence, New Zealand’s partnership law (particularly with respect to “special” partnerships) is now outdated and not commensurate with international norms.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 to 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 As existing the rules for “special” partnerships in New Zealand are restrictive and outdated, the absence of a more suitable vehicle for venture capital has hindered the industry in New Zealand.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.

I 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, appears to have fallen out of favour with the limited liability company becoming the preferred vehicle for most business ventures. This presumably is because of the limited liability afforded to investors by using a company and the advantages of a clear boundary being created between a business venture and its owners when a company structure is used.

The taxation rules applying to partnerships have not attracted much attention from New Zealand legislators for decades possibly reflecting their declining use as a business vehicle. Apart from the removal of the flow-through of tax losses to special partners in special 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 changes1 (“Discussion Document”)

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containing proposals for the reform of partnership taxation and for a new tax regime to apply to a new form of partnership being introduced known as a “limited partnership”. This was subsequently followed with the introduction of the Limited Partnerships Bill to Parliament in August 2007 providing for the enactment of those proposals into law. The objective of this paper is to review these proposals for the reform of partnership law and the new partnership tax regime as contained in the Limited Partnerships Bill.

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

A General Partnerships

Partnerships in New Zealand are currently governed by the Partnership Act 1908 which is closely modelled on the UK Partnership Act of 1890. This UK Act superseded earlier UK enactments 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 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 to be found in the ITA 2004 covering the taxation of partnerships. This is probably due for 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 appears to have fallen out of favour as a business vehicle in favour of closely-held, private companies and presumably the lower number of partnerships has resulted in reduced attention from tax law reformers over the years. Thirdly, because the company is an artificial creation of statute, there is a greater need to have a comprehensive taxing code to deal with company 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. 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.

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.
2 Under section NF 10(6) ITA 2004 the terms “partnership” and “partner” are given the same meaning as they have under the Partnership Act 1908.
3 Section 42(1), Tax Administration Act 1994.
Partnerships have 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 derive 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.\(^4\) The downside of this “pass-through” is that each partner’s 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.\(^5\) The ability of companies to retain earnings that have borne tax at a lower rate than the top individual marginal rate (33% vs 39%) favours the use of companies as a business vehicle.\(^6\)

Another consequence of the “pass-through” treatment of partnership income is that income derived by the partnership retains its character in the hands of the individual partners as opposed to companies where income distributed to shareholders becomes a dividend. A consequence of this is that it currently allows certain types of income to be streamed to particular partners if so desired. 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 and capital gains streamed to resident partnerships facing high marginal tax rates. Such streaming is subject to only one constraint which is an anti-avoidance provision in the dividend imputation regime which prevents partnerships being used for imputation credit streaming arrangements.\(^7\)

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.\(^8\) 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.\(^9\) 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.

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\(^4\) Except for a special class of company known as a “loss-attributing qualifying company” (LAQC).

\(^5\) Unless the partner is a company where the company tax rate will then apply.

\(^6\) The company tax rate is to be reduced from 33% to 30% from 1 April 2008 which widens the gap between the company tax rate and the top individual rate.

\(^7\) Section LB 1(4) and (4A), ITA 2004.

\(^8\) 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.

\(^9\) 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.
or activity. Section DC 4 was enacted to assist partnerships where there were differences in the types of contributions made by particular partners such as with agricultural partnerships where one partner contributed labour and expertise while the other non-working partners contributed capital.

**B 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. 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. A written partnership certificate is required which must be registered at the High Court and available for public inspection. In common with limited liability companies, there are requirements to keep books of account 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. Unlike with general partnerships, special partnerships cannot be formed for an indefinite duration and are limited to an initial period of seven years, although they can be “renewed” at the end of the seven year period.

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. 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 in some cases). 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 the New Zealand venture capital industry, the requirement for special partnerships to carry

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10 Section DC 4(2), ITA 2004.
11 Section 50, Partnership Act 1908.
12 Section 52, Partnership Act 1908.
13 Sections 51, 54 to 56 Partnership Act 1908.
14 Sections 64, 66 and 67 Partnership Act 1908.
15 Section 60, Partnership Act 1908.
16 Section 57, Partnership Act 1908.
17 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.
18 Explained in the next section.
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. Special partnership losses 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.19

C Qualifying Companies (QCs)

As a result of a recommendation from the Consultative Committee on the Taxation of Income from Capital,20 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 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.21

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.

Since the enactment of the LAQC regime in 1993, LAQCs have become very popular and are now a common component in many tax planning arrangements. They 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 also creates tax planning opportunities such as the sale of an owner-occupier residential property to a LAQC which is rented

19 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.
back to the shareholder. 22 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. 23

III 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* 24 in 1991. In their report they identified a number of ambiguities arising with partnership taxation including: 25

- 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 the 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; and
- 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”. 26 However, they noted that having practice at variance with law was “not appropriate”, and if the Inland Revenue Department’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

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22 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.

23 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 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.

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


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 their report *Final report of
the consultative committee on the taxation of income from capital*27 that a limited
number 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 provisions28 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 regime29 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 to ensure they have clearly defined boundaries to minimise compliance
costs.

IV 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 reviewed the existing special partnership regime contained in Part II of
the Partnership Act 1908. In December 2003 the Government announced it would
amend the existing special partnership legislation30 with the objective of reducing the
barriers for foreign investors investing in the New Zealand venture capital industry by
legislating for a more suitable vehicle for such investment than the existing special
partnership structure. This reform of partnership law would be in addition to two

27 Consultative Committee on the Taxation of Income from Capital (Valabh Committee), Government
Printer, October 1992.
28 Section LB 1(4), (4A) and (4B), ITA 2004.
30 Hon Lianne Dalziel, Minister of Commerce, “Special Partnerships Need Updating”, Media Release, 10
December 2003.
earlier amendments made to the ITA 2004 in December 2004 to enhance venture capital investment.31

The key issue being addressed is that the existing New Zealand special partnership rules are not consistent with those found in other jurisdictions (for example, the ones found in the United States and NSW in Australia) and create a barrier to foreign participation in the New Zealand venture capital industry. 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 the one found in New South Wales.

The major differences between the existing special partnerships and the new limited partnerships provided for in the Limited Partnership Bill are as follows:

- The vehicle will be called a "limited partnership" and the title of the partnership will be followed by the letters "LP" to be consistent with international practice.32
- To overcome doubts whether special partners in a special partnership formed pursuant to Part II of the Partnership Act 1908 will be recognised as having limited liability outside of New Zealand, the new limited partnerships will expressly have a separate legal personality to that of their partners33 and thus will be consistent with the Delaware (US) limited partnership model.
- Existing special partnerships have cumbersome registration requirements with significant risks arising to special partners if not carried out correctly. The new limited partnerships 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 both the general and limited partners in addition to other information.34
- Regulations will be issued pursuant to the new limited partnership rules which will provide "safe harbours" specifying what activities limited partners may undertake in respect of the limited partnership without deeming to be liable for the debts of the limited partnership in the same way as the general partners are.
- 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.35

31 The first is the reinstatement of loss offsets from special partnerships to special 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.
34 Clauses 47 to 52, Limited Partnerships Bill 2007. It was earlier proposed that the identity of the limited partners would not be publicly disclosed in the register however that was changed in the Bill and is now consistent with the disclosure requirements for limited liability companies.
35 Clause 21, Limited Partnerships Bill 2007. However, if the limited partnership has only one general partner and one limited partner they cannot be the same person - Clause 8(2), Limited Partnerships Bill 2007.
partners will be prohibited from making a capital contribution to the limited partnership.  

- Limited partnerships will have an indefinite life unlike with special partnerships which are currently limited to an initial period of seven years.
- In common with the current special partnerships, the new limited partnerships will not be able to carry on a banking or insurance business, however, they will have full legal capacity and will be able to do anything that a natural or other legal person can otherwise do.  

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 an unsuitable vehicle to attract offshore participation into the New Zealand venture capital industry as they are uniquely a New Zealand creation by statute and are unlikely to be recognised as being fiscally transparent in offshore jurisdictions. QCs cannot have more than five shareholders which could also limit their usefulness as a suitable vehicle for financing in the venture capital industry.

As a result, the decision to enact new rules for the provision of limited partnerships in New Zealand has required a subsequent revision of the tax legislation applying to partnerships. The tax issues confronting both general and limited partnerships were canvassed in the Discussion Document and the resulting changes that have been decided upon are contained in the second part of the Limited Partnerships Bill.

V PROPOSALS FOR REFORM OF PARTNERSHIP TAXATION

In 1992 the Valabh Committee recommended that a fundamental review of partnership taxation be undertaken with the objective of providing a comprehensive code for the taxation of partnerships. The Discussion Document finally released in 2006 appears to fulfil that recommendation leading to the introduction of the Limited Partnerships Bill introduced in 2007. The Bill provides for the repeal of the existing subpart HD of the Income Tax Act 2004 applying to the taxation of partnerships (currently standing at only one section) and replacing it with a new subpart HD containing 12 sections. The clauses in the Bill appear to cover most of the key issues relating to partnership taxation although it in some parts they are brief and would be improved with greater statutory detail.

A Aggregate Versus Entity Approaches to Partnership Taxation

The Valabh Committee in its analysis of partnership taxation identified two approaches to partnership taxation.

The first was 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 was 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) being 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.

36 Clause 17(2), Limited Partnerships Bill 2007.
37 Clauses 13 and 11 respectively, Limited Partnerships Bill 2007.
Under this approach, complicated adjustments would not arise when there was a change in the composition of a partnership. The current manner in which New Zealand taxes partnerships 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 proposed that a hybrid approach be adopted similar to current practice which appears to have been followed in the Bill.  

B Recommended Changes to Partnership Taxation

1 Application and Scope of Changes

In the Discussion Document it was proposed that the new partnership tax rules would apply to four categories of partnership:

• Any partnership recognised as one under the Partnership Act 1908;
• A limited partnership 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.

Under the Limited Partnerships Bill, partnerships falling within one of the four categories above will be accorded a “flow-through” treatment for New Zealand tax purposes on the same basis as was outlined in the Discussion Document above. The new limited partnerships will be eligible for the “flow-through” treatment despite having a separate legal personality. This treatment is proposed on the grounds of consistency with prevailing international practice and represents a departure from the current New Zealand treatment where any entity that has a separate existence or personality from its owners is taxed as a company. This “flow-through” treatment, however, will be restricted to New Zealand-registered limited partnerships and any foreign entity that has a separate legal personality or is publicly traded will not be eligible for “flow-through” treatment under New Zealand tax law. This differential treatment is justified in the Discussion Document on the grounds of maintaining consistency with new provisions governing foreign tax credits for hybrid entities in section CD 10C.

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. While there are doubts as to the legal grounds for doing so, it

38 Paragraph 3.11, page 12.
40 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.
41 Under section OB 1, ITA 2004, 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”.

104
currently appears possible to allocate different types of partnership income among different partners in a manner that minimises New Zealand income tax payable.

Under the Limited Partnerships Bill all partners in a partnership for tax purposes will share proportionately in the partnership’s income and deductions according to their interest in the partnership and therefore the tax efficient streaming of income and deductions outlined above would no longer be possible. Under the Limited Partnerships Bill all partners in a partnership for tax purposes will share proportionately in the partnership’s income and deductions according to their interest in the partnership and therefore the tax efficient streaming of income and deductions outlined above would no longer be possible. This proportionate allocation rule would also apply to both taxable and non-taxable income as well as to the allocation of foreign taxes credits among partners.

The Discussion Document examined the issue of where there is a change in the composition of a partnership, deductible expenditure incurred by a retiring partner is not deductible to an incoming partner. It is proposed that any expenditure incurred by an incoming partner from the date they enter the partnership would be deductible. This amount, however, would have to be appropriately quantified. Two methods to deal with such quantification were advanced. 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 providing an accurate apportionment of income and deductions to incoming and outgoing partners, would have high compliance costs, and for this reason a second alternative, termed the “simplified apportionment approach” is proposed as an option.

Under this latter 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. Unfortunately the Limited Partnerships Bill does not make it clear which approach is to be followed and merely authorises a deduction to partners of deductible expenditure incurred by the partnerships even if they were not partners at the time the expenditure or loss was incurred. This is an issue which will require further attention before the Bill is passed.

3 Transactions Between Partners and Partnerships

This issue was highlighted by the Valabah Committee as one 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. Salaries paid to partners subsequently became deductible to partnerships from 1985 provided certain conditions were met as specified in section DC 4. These conditions are:

- 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.

In the Discussion Document it was proposed to retain these rules. While there is an existing anti-avoidance rule in section GD 10 where a partner rents a property they own

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44 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”.
to the partnership, the rental must be commensurate with market rates, it was proposed
to introduce a “market value” rule so that all transactions between partners and their
partnerships must be conducted at prevailing market rates for tax purposes. Such a rule
would apply where a partnership asset was sold to a partner or where an asset was
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. This proposal
is followed in the Limited Partnership Bill in a new section GD 16 will deem for tax
purposes that all transactions between partnerships and their partners are transacted at
market rates.

4 Changes To Partnership Composition

One of the biggest problems with the existing partnership tax regime is the need to
make tax adjustments every time there is a change in the composition of the
partnership. In many cases, the resulting compliance costs can be disproportionate to
the amount of income arising. This issue is probably more problematic for larger
partnerships (as found in some professions) than for smaller ones.45

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

The Discussion Document proposed that the “entity” approach be adopted subject to a
deminimis test. If the difference in the consideration received by the partner for their
overall interest in the partnership and their share of net partnership assets was below
$20,00046 the changes in the composition of a partnership would 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. If the deminimis test was not met (i.e.
where partnership assets had appreciated significantly), it would be mandatory to
undertake a “revenue account adjustment” and recognise income upon the retirement of
a partner. If a partner was eligible for the deminimis exemption they would have the
option of being able to undertake a “revenue account adjustment” if they so desired.

The “revenue account adjustment” would be calculated according to the retiring
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” would not be the same as the calculation for the $20,000
deminimis test above, as the latter would also include non-taxable capital amounts
while the former only revenue amounts.

45 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.
46 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.
These proposals are developed further in the Limited Partnerships Bill. A partner will only have to account for tax on retiring from a partnership if the amount of the disposal proceeds exceeds the total tax book value of the partner’s share of partnership property by more than $50,000 (rather than the $20,000 proposed in the Discussion Document). Furthermore, even if the difference is greater than $50,000, a retiring partner will not have to account for tax on specific types of gains if they are below certain specific deminimis limits. These limits are as follows:

(i) Trading stock if the annual turnover of the partnership is $3 million or less.47
(ii) Depreciable tangible property if the historical cost of that property held by the partners of the partnership is $200,000 or less.48
(iii) Financial arrangements, provided the partnership is not in the business of deriving income from financial arrangements and the financial arrangement has been entered into as a necessary and incidental part of the partnership’s business.49

In addition, 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 for all partners. While the Discussion Document made no recommendation on this issue but instead sought submissions from interested parties,50 this proposal has subsequently been incorporated into the Limited Partnerships Bill.

The deminimis provisions outlined above will all be subject to an overriding rule that where there is a change of 50% or more in the ownership of a partnership in any 12-month period, dissolution of the whole partnership is deemed to occur.51 As a result, all partnership property is deemed to have been acquired by the partnership at prevailing market values even for partners who have not retired. The objective of this provision is to “prevent large asset transfers that give rise to significant deferral of tax liabilities”.52 However, this provision appears penal to existing partners and the Bill is likely to attract a number of submissions on this issue.

There is also one further deminimis provision for “small partnerships”. A “small partnership” is defined as a general partnership with five or fewer partners none of which are companies or other partnerships. Such small partnerships can ignore revenue account adjustments in respect of trading stock, depreciable tangible property and financial arrangements even where the $50,000 threshold is exceeded. They are still subject to the 50% change in composition rule, however. Given that a great number of partnerships in New Zealand probably fall within the “small” category, this is a significant concession.

Where a retiring partner is eligible for relief under one of the deminimis exemptions, the incoming partner is deemed to have acquired their share of the partnership property at the retiring partner’s tax book values.53 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 the gain including that portion which was derived prior to them entering the partnership. In essence part of their capital contribution to the partnership

52 Hon Peter Dunne, Minister of Revenue, Limited Partnerships Bill -Commentary on Parts 5 and 6 of the Bill –associated tax changes, at page 16.
53 Sections HD 6(5), 7(5), 8(5) and 9(5); Clause 116, Limited Partnerships Bill 2007.
would become taxable to them—something that most taxpayers would find undesirable unless the amounts were trivial.

Where a “revenue account adjustment” is made upon the retirement of a partner it is subsequently necessary to determine the revised cost of those assets to the partnership. In the Discussion Document it was proposed to allow taxpayers a “cost base allocation election” which would permit the opening values of the partnership assets to be apportioned among the partners at the effective amounts they individually acquired them for. Thus where a share in a depreciable asset was acquired by an incoming partner at a higher price than that paid for by existing partners, the incoming partner would be able to claim higher depreciation in respect of that depreciable asset than would the existing partners. While this would 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 is likely to give rise to high compliance costs.

The provisions of the Limited Partnerships Bill do not explicitly require that each partner’s share in partnership property will have to be tracked separately. However, as section HD 2(1)(b), Clause 116 provides that:

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a partner of partnership 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
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The effect is that each partner’s share in partnership property will have to be tracked separately with the attendant compliance costs. This represents a departure from existing practice whereby if the cost base of a partnership asset is adjusted through the change in the composition of the partnership, the remaining partners enjoy the benefit of that variation (for example through increased depreciation charges) even though they have not been required to undertake a revenue account adjustment in respect of that asset.

5 Distributions and Dissolutions of Partnerships

Under the current tax treatment of partnerships, distributions of partnership assets to individual partners are not a taxable event and this will continue 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. Distributions to partners of limited partnerships will be treated the same way. Where a limited partner had guaranteed a limited partnership’s debts, any reduction of that guarantee will 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.54 While it was earlier proposed that this approach be changed to be consistent with the entity approach for partnership taxation and for other grounds be specified such as upon court order or unanimous agreement between the relevant partners, the Limited Partnerships Bill does not contain any provision to change the current law regarding dissolution of general partnerships. For the new limited partnerships, there is no automatic provision for dissolution of the partnership upon death or bankruptcy of a partner unless the deceased partner was a limited partner and is not replaced in the partnership within a specified period of time. The bankruptcy of a sole general partner

54 Section 36, Partnership Act 1908.
or their legal incapacity is however grounds for the Court to appoint a liquidator, but it is not mandatory for the Court to do so.\textsuperscript{55}

6 \textit{Limited Partnership Tax Losses}

A key part of the \textit{Discussion Document} was the proposal that the new limited partnerships would be accorded flow-through of tax losses to both limited and general partners despite them being regarded as a separate entity. However, the amount of tax losses flowing through to the limited partners would be limited to their investment in the partnership. This was proposed on the grounds that the amount they have invested in the partnership is the maximum amount they have at risk (given that they have limited liability) and therefore the total amount to be offset in respect of their interest in the partnership should be limited to that amount. Any limited partner’s share of partnership losses in excess of their investment would not be passed through, but instead carried forward and offset against any assessable income the partnership may derive in future income years. This treatment was further justified on the grounds that:

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.\textsuperscript{56}

It was also noted that the rules are “consistent with the treatment provided by other countries” such as Australia and the US.\textsuperscript{57}

The issue underlying the decision to limit the flow-through of losses to limited partners is to prevent a flow-through for deductible expenditure financed by money borrowed by the partnership in which the limited partners had limited liability 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 led the New Zealand Government to introduce deferred deduction rules in 2003 to limit such abuses.\textsuperscript{58} These rules limit deductibility of expenditure where it has been funded by limited-recourse loans and aim to prevent a deduction unless a taxpayer has borne an economic loss. The rules are not specific to any type of business vehicle.

The \textit{Discussion Document} contained a formula that would determine how the loss flow-through limitation would apply. It would apply only to the limited partner’s “basis” (or adjusted investment) in the partnership.\textsuperscript{59} The formula ignored any capital gains or losses the partnership may have derived which was unrealistic, although in a subsequent paragraph it was suggested that such amounts should be taken into account when calculating a partner’s “basis” 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”.\textsuperscript{60}

The formula for calculating a partner’s “basis” in the Limited Partnerships Bill\textsuperscript{61} does take into account capital gain and loss amounts and is as follows:

\textsuperscript{55} Clauses 75 to 79, Limited Partnerships Bill 2007.
\textsuperscript{56} \textit{Discussion Document}, paragraph 8.2, page 34.
\textsuperscript{57} \textit{Ibid}, paragraph 8.3, page 34.
\textsuperscript{58} Refer sections GC 29 – 31, ITA 2004.
\textsuperscript{59} \textit{Ibid}, paragraph 8.12, page 36.
\textsuperscript{60} \textit{Ibid}, paragraph 8.16, page 38.
Investments $A
less Distributions $B
plus Income $C
less Deductions $D
less Disallowed Amount $E
Limited Partner’s Interest $F

Where:
Investments = the aggregate of the market values of any contribution of a partner at the time of the contribution, amounts paid by the partner to the partnership for any financial arrangements to which the partnership is a party and any guaranteed amount;
Distributions = the aggregate of the market values of any withdrawals by the partner from the partnership and amounts paid to the partner under financial arrangements to which the partnership is a party;
Income = the aggregate of prior year’s income, capital gains derived by the partnership and assessable income the partner has derived in prior years from goods and services they contributed to the partnership if not accounted for previously;
Deductions = the aggregate amount of any partnerships losses passed through in prior income years, any capital losses suffered by the partnership and deductions taken in prior income years in respect of assessable income from goods and services they have contributed to the partnership if the deduction has not been included with “distributions” earlier; and
Disallowed Amount = any investments made within 60 days of the end of the income year if those investments are distributed or withdrawn within 60 days after the end of the income year.

Recognition of capital gains when determining a limited partner’s “basis” will increase the capacity to flow-through losses to the limited partners while recognition of capital losses will have the opposite effect.

In the Discussion Document it was 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. This has not been followed in the Limited Partnerships Bill, however, there is another anti-avoidance provision to prevent the creation of an artificially high “basis” at year-end when the loss pass through is calculated. A limited partner’s “basis” will be reduced by the amount of any increase that arose within the previous 60 days before year-end which was subsequently withdrawn within 60 days after year-end which is incorporated in the above formula.62

The Discussion Document also considered how the new tax rules for limited partnerships could compare with the existing LAQC rules. It was suggested that the proposed loss limitation rules for the new limited partnerships could be side-stepped if 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. It was 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.63

While there is potential for the above arrangement to achieve the same outcome as the proposed limited partnership but with full loss flow-through, it is only likely to work where all investors are New Zealand resident. This is because it is highly unlikely New Zealand LAQCs will be treated as loss a flow-through entity in an offshore jurisdiction.

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63 Ibid, paragraph 8.30, page 42.
as they are a unique creation of New Zealand statute. The new limited partnership rules are being introduced to facilitate offshore investment into New Zealand for the key reason that such partnerships are likely to be treated as “fiscally transparent” in offshore jurisdictions. There is little assurance that this would occur with an alternative structure using LAQCs and therefore the Government’s concerns do not appear to have much validity.

7 International Aspects of the Flow-Through Treatment

As partnerships will continue to be taxed as “flow-through” entities, there are a number of subsequent 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 will be required to have any foreign tax credits derived by the partnership allocated to them in proportion to their share of partnership income. If a partner happens to be a New Zealand company, the company 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) in some situations.

Where a partnership has both resident and non-resident partners, the scope of New Zealand to tax that portion of partnership income allocated to the non-resident partners is dependent upon New Zealand’s source rules in section OE 4. A non-resident partner’s share of New Zealand sourced interest, dividends and royalties will be 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. Consistent with international tax principles, a non-resident partner would not be subject to New Zealand tax on any foreign-sourced income derived by the partnership.

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 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.

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 makes it difficult to apply some of the sources rules in section OE 4(1) particularly subsections (n), (r) and (s). 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 source rules only. The Discussion Document left this matter open for submissions and made no recommendation as to whether this recommendation should be adopted.

64 Refer subpart LE, ITA 2004.
65 Applying to interest in respect of money lent outside New Zealand, royalties and lease payments in respect of leases for personal property.
The Limited Partnerships Bill however follows the Vallabh Committee’s recommendation and contains provisions to clarify this area of law by providing that for the purposes of New Zealand’s source rules that a partnership will be treated as a resident taxpayer if:

(i) The partnership is a limited partnership registered under the Limited Partnerships Act 2007;
(ii) For a general partnership if 50% or more of the partner’s interests in capital or by value are held by New Zealand residents; or
(iii) The centre of management of the partnership is in New Zealand.

C The Future of LAQCs

As discussed earlier, the Discussion Document 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, announcing that legislation covering partnership taxation would be introduced and passed in 2007 after consideration of submissions received in respect of the Discussion Document, further reference was made to the continuing status of LAQCs. The Government acknowledged that it had received many submissions on the LAQC issue but left it open whether they would give further consideration to revision of the LAQC regime:

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.67

This announcement has done little to allay fears that the new limited partnerships rules will be used as an excuse to repeal the LAQC regime, even though the two vehicles are more mutually exclusive rather than overlapping. The Limited Partnerships Bill contains no references to the LAQC regime and whether the review alluded to above is likely to occur after the Limited Partnerships Bill is passed is not clear.

VI ANALYSIS

A Clarification of General Partnership Tax Rules

The tax provisions contained in the Limited Partnerships Bill will address many of the concerns the Valabh Committee raised about partnership taxation, in particular that many of the CIR’s existing practices with respect to partnership taxation are not supported by current legislation.

One of the changes proposed will make tax-efficient income streaming among partners of a partnership no longer possible. The current opportunities for tax-efficient income streaming arise in fairly limited situations such as where a partner is a non-resident or is tax-exempt. 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.

67 Ibid.
The reform of the tax consequences upon the reconstitution of a partnership are not without problems although it is a complex issue whatever way it is dealt with for tax purposes. While the *deminimis* provisions proposed have their merits, they are not without problems. Firstly, to determine whether a partnership falls within the *deminimis* exemption or not, the partnership will still have to undertake calculations so it is debatable how much compliance costs are reduced through the *deminimis* exemption. If the exemption is claimed, the consequences for the incoming partner are unattractive. 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 adjusted for the tax payable on unrealised gains, they will be worse off. To make such an adjustment will require calculations which again would appear to undermine the objective in having a *deminimis* limit on grounds of compliance cost reduction. If a partnership is ineligible for the general *deminimis* exemption (i.e. the $50,000) but qualifies for one of the specific ones (i.e. trading stock, depreciable tangible property etc.) the incoming partner will be deemed to acquired their share in the partnership assets at mixture of old and current values which must surely increase future compliance costs.

If a partnership is ineligible for above the *deminimis* limit of $50,000 (or makes an election for an adjustment if below the limit or if there is a change in the composition of the partnership of more than 50% in any 12 month period) there is the consequence that the partners will have different carrying values for their individual share in the partnership’s assets. Unfortunately 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*). The only exception made is for “small partnerships” being ones with five or fewer partners.

**B Flow-Through For New Zealand Limited Partnerships**

One anomalous proposal in the *Discussion Document*, which has been subsequently followed in the Limited Partnerships Bill, is to not allow the flow-through of losses from foreign-registered, limited partnerships to New Zealand-resident partners where those partnerships are separate legal entities in the jurisdiction where they are resident, even though almost identical New Zealand-registered, limited partnerships will be treated as “flow-through” entities. It seems almost naive to permit flow-through of losses from New Zealand-registered limited partnerships with a separate legal entity and expect foreign jurisdictions to do the same while denying similar foreign-registered limited partnerships with the same treatment. It remains open whether foreign jurisdictions may decide to discriminate against New Zealand-registered limited partnerships in the same way. This could prove a barrier to the new limited partnerships becoming a suitable vehicle for foreign participation in the New Zealand venture capital industry.

**C Limited Partnership Loss Offset Rules**

Another controversial part of the *Discussion Document* was the loss limitation rule for the new limited partnerships which has been carried over without change to the Limited Partnerships Bill. 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.
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, although there are precedents elsewhere in the ITA 2004 where unrealised gains are taken into account (as for example with the thin capitalisation rules) although they are likely to apply to much larger and more sophisticated taxpayers. 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 rule68 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.

D The Future of LAQCs

It is unfortunate that the introduction of the new limited partnership rules has raised doubts about the continuation of the LAQC regime. 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 insolvently 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 an unsuitable vehicle to operate a small business through where the limited partner could inadvertently participate in the management of the partnership’s business and lose their limited liability.

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 such as with a widely-held company. 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 from the use of 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 any expenditure incurred in producing that income is deductible irrespective that the expenditure is disproportionately large in comparison to the gross

68 Sections GC 29 to 31, ITA 2004.
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. Another option
would be to consider introducing uneconomic business rules that would quarantine
losses from uneconomic activities.

Withdrawal of the LAQC regime will also lead to many LAQC shareholders winding-
up these companies and placing the assets in other vehicles such as trusts and general
partnerships. 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.

VII CONCLUSION

The decision to reform the partnership tax regime was made for two reasons. The first
was in response to the Valabh Committee’s recommendation from the early 1990s for a
comprehensive review of partnership taxation and the second from the decision to
introduce a new limited partnerships regime for the incorporation of limited
partnerships in New Zealand, with the latter in response to lobbying from the venture
capital industry to attract foreign investment into the New Zealand venture capital
industry.

The proposed changes have been widely canvassed over a long period. The proposed
changes to partnership taxation and the new limited partnership rules 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.

There are parts of the Limited Partnership Bill that would benefit from further
consideration. Firstly, it 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. Secondly, the rules for restricting the 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 the
problem of artificially created losses. Lastly, the proposals for the tax treatment upon
the reconstruction of a partnership need further review as they are still likely to give
rise to high compliance costs and complexity.