

# A critical analysis and evaluation of US and Australian partnership taxation rules and their intersection—second instalment

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The introduction of the poorly thought-out foreign hybrid regime marked a transformative turning point in the evolution of partnership taxation rules in Australia. Previously, these rules were domestically focused, often appearing haphazard and poorly coordinated, creating considerable operational uncertainties in practice. Nevertheless, the new regime elevated Australian partnership taxation rules to the forefront as a vanguard in taxing partnerships formed in foreign countries, including the highly complex and flexible partnerships established in the US. Unsurprisingly, this shift has brought enormous complexity and led to the emergence of numerous anomalies. These intricacies have enticed the author to embark on a daunting journey of investigation, exploring US and Australian partnership taxation rules, and their interplay through the Australian foreign hybrid rules. The objective of this article is to serve as a guidepost for business enterprises navigating the intricate labyrinth of operating a US foreign hybrid and ultimately steering clear of potential pitfalls. This is the second of three instalments of the article. The first instalment was published in the October 2025 issue of *The Tax Specialist*. The remaining instalment will be published in the next issue.

## Part IV: Partner-level transactions (US)

In author's view, fundamentally, the taxation of partnerships in the US operates based on two antithetical theories—the aggregate theory and entity theory. The countervailing effect of these two theories is manifestly displayed in taxation rules related to “partner-level transactions”

(ie transactions occurring between partnership and partners, and among partners).

According to the aggregate (or conduit) theory, the partnership is mere a pooling arrangement among the partners, under which partners, not the partnership, own the assets and liabilities, and income, gain, loss, deduction or credit pass through to partners, with their characters.

The entity theory, of course, works in the opposite way. The most notable manifestation of that theory is that a partner's interest in a partnership is treated as a separate intangible asset, detached from the assets of the partnership. It follows that there are two sets of ‘adjusted bases’ under the tax regime of a partnership in the US:<sup>1</sup>

1. the ‘adjusted basis’ of property owned a partnership (“Inside Basis”); and
2. the ‘adjusted basis’ of a partner's interest in the said partnership (“Outside Basis”).

An ostentatious feature of the US rules is that they seem to be crafted to achieve an equilibrium; that is, the equality between the *aggregate* of the partners’ ‘adjusted bases’ in their partnership interests generally and the *aggregate* of the ‘adjusted bases’ of partnership assets (Basis Equilibrium). This equilibrium is recognised by the Congress,<sup>2</sup> which is an essential analytic tool in understanding the various operatives in respect of Partner Transactions.

At first glance, the two levels of ownership structure (ie partners own interests in a partnership and the partnership owns assets) resembles the structure of a corporation (under which the shareholders own shares in a corporation and the corporation owns assets). However, this resemblance is specious. There is no rule, as far as the author is aware, to maintain a constant relationship between the ‘adjusted bases’ of a company's assets and the ‘adjusted bases’ of its shares in both Australia and the US. That is because the taxation rules in respect of a corporation are purely underpinned by the entity theory.

Another aspect of the countervailing effect arising from the operation of these two theories is that partnerships are treated as entities for the purpose of calculating and filing informational returns.<sup>3</sup> In other words, the taxable amount and tax characteristics are determined at the partnership level, and they are then passed through to the partners under the aggregate theory. This interaction between these two theories creates a temptation for partnerships to engage in Partnership Tax Arbitrage, as defined in Part II. It is not surprising that over the years, rules have been successively introduced into the *Internal Revenue Code of 1986* (US) (IRC) and Treasury Regulations (Treas. Reg.), adding significant complexity to the taxation of partnerships in the US.

In the author's view, the tax rules governing Partner Transactions are either driven by Basis Equilibrium or designed to counter Partnership Tax Arbitrage, or both. The following paragraph provides a detailed discussion of these rules.

## Section 1: Contribution and distribution roll-over reliefs

Generally, in situations where property is either contributed to a partnership or distributed to a partner, gains or losses arising from the transaction are deferred, and the transferees inherit the 'adjusted basis' of the transferred property. These roll-over reliefs ensure the initial establishment of the Basis Equilibrium and its continuance upon the further contribution and distribution of property.

The roll-over reliefs in respect of contributions of property from a partner to the partnership at its formation and during its operation have the following three aspects:

1. Generally, no gain or loss is recognised by a partnership or any of its partners as a result of a contribution of property in exchange for a partner's interest in a partnership (§721 IRC).
2. A partner's 'adjusted basis' of her interest in a partnership (ie Outside Basis) received in a §721 exchange is equal to the sum of (§722):
  - a. the amount of any money contributed; and
  - b. the contributor's 'adjusted basis' (determined at the time of the contribution) of any property contributed.<sup>4</sup>
3. The 'adjusted basis' of property contributed to a partnership generally inherits the contributing partner's adjusted basis in the property at the time of the contribution (§723).

### Example 4.1. Initial establishment of the basis equilibrium

1. P1 and P2 come together to form a partnership (PRS). P1 contributes \$100 in cash, while P2 contributes a property (Prop1) with a market value of \$100 and an 'adjusted basis' of \$50. The PRS now has \$100 in cash and a property with an 'adjusted basis' of \$50 (ie Inside Basis), matching the sum of P1's Outside Basis in the PRS (\$100) and P2's Outside Basis in the PRS (\$50).
2. Later, P3 joined the PRS and contributed another property (Prop2) with a market value of \$100 and an 'adjusted basis' of \$200. Thus, the PRS has \$100 in cash, Prop1 with an 'adjusted basis' of \$50, and Prop2 with an 'adjusted basis' of \$200, which matches the sum of P1's Outside Basis in the PRS (\$100), P2's Outside Basis in the PRS (\$50) and P3's Outside Basis in the PRS (\$200).

Thus, as demonstrated by Example 4.1, the roll-over relief in respect of property contributed by the partners to the partnership serves the function of initially establishing the Basis Equilibrium at the formation of the partnership and maintaining it during the operation of the partnership.

Naturally, at some stage, the partnership may decide to distribute property from the partnership to a partner.

Distribution of the property occurs in either non-liquidation or liquidation form. In comparison with the contribution of property to a partnership, the tax implications of distribution are cornucopian and dynamic, and are best analysed by reference to the following example.

### Example 4.2. Tax implications arising in various distribution scenarios

1. A partnership (PRS) has three partners: P1, P2 and P3. The PRS has no liability. A snapshot of its property with their adjusted bases (they are not 'inventory items' or 'unrealised receivables' within the meaning of §751) and the Outside Bases of partners is as follows:

Adjusted basis	
Cash	150
Property 1 (Prop 1)	30
Property 2 (Prop 2)	120
	<b>300</b>
Outside basis	
P1	100
P2	100
P3	100
	<b>300</b>

2. Table 4.1 presents various scenarios in which distributions, in either non-liquidation form or liquidation form, are purportedly made to P3, along with a summary of their tax implications.

In respect of Scenarios 1 and 2, where the amount of cash distribution and/or the 'adjusted basis' of the property (ie Prop 1) distributed is smaller than the Outside Basis of P3, roll-over reliefs are generally available. If the distribution is in a non-liquidated form, the tax consequences are as follows (see the non-liquidation column of Table 4.1 for an arithmetic illustration):

1. there is no recognition of gains/losses;
2. the Outside Basis of P3 is reduced by the money and the 'adjusted basis' of the property (ie Prop 1); and
3. the property (ie Prop 1) distributed inherits the 'adjusted basis' of the property in the hands of the partnership.

Thus, where the amount of cash and/or the 'adjusted basis' of property distributed (as shown in Scenarios 1 and 2 in Example 4.2) is less than the Outside Basis of a partnership in a non-liquidation distribution, the Basis Equilibrium is maintained after the distribution.

An obvious difference between liquidation distribution and non-liquidation distribution is that after the liquidation

**Table 4.1. Tax implications of various distribution scenarios**

Scenario	Distribution	Non-liquidation	Reference	Liquidation	Reference
1	cash \$80	P3's outside basis reduced to \$20	§ 733(1)	capital loss of \$20	§ 731(a)(2)
2	cash \$60	P3 outside basis reduced to \$ 10	§ 733(1) & (2)		
	Prop 1 –adjusted basis \$30	P3 has the adjusted basis of Prop 1 of \$30	§ 732(a)(2)	P3 has the adjusted basis of Prop 1 of \$40	§ 732(b)
3	cash \$120	P3 makes capital gains \$20	§ 731(a)(1)	P1 makes capital gains \$20	the same
		P3 outside basis reduced to nil	§ 733(1)		
		PRS may make adjusted basis adjustment	§ 734(b)	the same	§ 734(b)(1)
4	Prop 2 – adjusted basis \$120	P3's outside basis is reduced to \$ nil	§ 733(1) & (2)		
		Prop 2 has adjusted basis of \$100 in the hand of P3	§ 732(a)(2)	the same	§ 732(b)
		PRS may make distribution basis adjustment	§ 734(b)	the same	§ 734(b)
5	Cash \$110	P3 make capital gains \$10	§ 731(a)(1)	the same	§ 731(a)(1)
	Prop 1	P3's outside basis is reduced to \$ nil	§ 733(1) & (2)		
		Prop 1 will have nil value	§ 732(a)(2)	the same	§ 732(b)
		PRS may make adjusted basis adjustment	§ 734(b)	the same	§ 734(b)(1)

distribution, P3's Outside Basis no longer exists. The tax implications of a liquidation distribution in Scenarios 1 and 2 are as follows (see the "Liquidation" column in Table 4.1 for an arithmetic illustration):

1. if only property (ie Prop 1) is distributed, the property will adopt the Outside Basis of P3;
2. if only money is distributed, it will result in the realisation of a loss equal to the difference between P3's Outside Basis and the amount of money received; and
3. if money is distributed together with property, the money will reduce the Outside Basis, and then the distributed property will adopt the reduced Outside Basis.

Thus, in a liquidation distribution, since the amount of cash and/or 'adjusted basis' distributed is less than the Outside Basis, which is eliminated by the liquidation, arithmetically, the Basis Equilibrium cannot be maintained. However, the Basis Equilibrium can be notionally restored under §743, as discussed below.

At this stage of the discussion, it is worth noting that, according to Bittker and Lokken,<sup>5</sup> money is not considered property for the purposes of §1001(a). This view should also be adopted as correct in the context of partnership distributions. This means that cash distributed from a partnership cannot adopt the Outside Basis of the distributee partner. Therefore, when a partner

receives a cash amount larger than their Outside Basis (after the reduction in the 'adjusted basis' of other property distributed, if applicable) in a non-liquidation distribution, or when a partner only receives cash in a liquidated distribution, gains and losses must be recognised. This has the obvious consequence of disturbing the Basis Equilibrium. The preceding discussion in this paragraph is illustrated in Scenario 1 (liquidation distribution) and Scenario 3 (as discussed immediately below).

In Scenario 3, the amount of cash distribution exceeds P3's Outside Basis. In this situation, P3 must recognise gains. This is because cash cannot take on the Outside Basis, thereby disrupting the Basis Equilibrium. Additionally, in a non-liquidated distribution, P3's Outside Basis is reduced to zero, and in a liquidated distribution, it disappears (see Table 4.1 for an arithmetic illustration). Once again, the disrupted Basis Equilibrium can be restored under §743, as discussed below.

In Scenario 4, the 'adjusted basis' of the distributed property (ie Prop 2) exceeds the Outside Basis of P3. In this case, one might expect to recognise the excess of the distributed property's 'adjusted basis' over the Outside Basis as a gain. However, the provision of roll-over relief appears to be a more significant legislative objective. Consequently, the tax implication is that no gain is recognised, and the distributed property assumes the amount of P3's Outside Basis, reducing P3's

Outside Basis to zero in a non-liquidation distribution and resulting in its disappearing in a liquidated distribution (see Table 4.1, Scenario 4 for an arithmetic illustration). This, of course, disrupts the Basis Equilibrium. The Basis Equilibrium can be restored under §734(b), as discussed below.

Scenario 5 is a more complicated scenario, extending from Scenario 2. In this scenario, there is a cash distribution greater than the outside basis of P3 and another property, namely Prop 1. The cash distribution reduces the basis to zero, resulting in gains, and Prop 1 adopts a reduced Outside Basis of zero in both non-liquidated and liquidated distributions. The Outside Basis becomes zero in a non-liquidated distribution and disappears in a liquidated distribution. There are both gains recognition and a reduction in the 'adjusted basis' of Prop 1, which obviously disrupts the Basis Equilibrium. However, the Basis Equilibrium can be restored under s 734(b), as discussed below.

Where only cash, 'unrealised receivables' (as defined in §751(c)), and 'inventory items' (as defined in §751(d)) are distributed in a liquidated distribution, capital losses are recognised to the extent that the Outside Basis is greater than their 'adjusted bases' (§731(a)(2)). This rule, as discussed in detail below, is intended to ensure that the adjusted bases of unrealised receivables and/or inventory items are not uplifted, thereby reducing the 'ordinary income'<sup>6</sup> that would have been realised by the partnership if liquidation had not occurred.

## Section 2: Endogenous basis adjustment

Endogenous basis adjustment refers to adjustments made to the Outside Basis of a partner as a consequence of operational outcomes of the partnership. During the operational period of a partnership, Basis Equilibrium is generally preserved by the adjustments set forth in §705(a) IRC, in which various events that increase or decrease the aggregate 'adjusted bases' of partnership property usually trigger equivalent increases or decreases in the partners' Outside Bases. Under §705:

1. The Outside Basis of a partner is increased by the sum of her 'distributive share' for the taxable year and prior taxable years of:
  - a. taxable income of the partnership as determined under §703(a); and
  - b. income of the partnership exempt from tax.
2. The Outside Basis of a partner is decreased (but not below zero) by the sum of his 'distributive share' for the taxable year and prior taxable years of:
  - a. losses of the partnership; and
  - b. expenditures of the partnership that are neither deductible in computing its taxable income nor properly chargeable to the capital account, such as bribes.

## Example 4.3. Outside basis adjustments as consequences of operational outcomes

1. P1 and P2 formed a partnership (PRS), and they share all Tax Items (as defined in Part II) equally. Each contributed \$100, which PRS used to purchase \$200 worth of inventory items.
2. In Scenario 1, the inventory is sold for \$320, resulting in \$120 in taxable income for PRS. The tax implications are as follows:
  - a. each of P1 and P2 will be allocated \$60 in taxable income;
  - b. each of them will have an upward Outside Basis adjustment of \$60, bringing it up to \$160;
  - c. if either P1 or P2 sells their partnership interest for \$160, the gains will be nil, thus avoiding double taxation of the taxable income distributed to them; and
  - d. the Basis Equilibrium is preserved, as the sum of the Outside Basis of P1 and P2 equals the cash (\$320).
3. In Scenario 2, the inventory is sold for \$120:
  - a. each of P1 and P2 will be allocated a loss of \$40;
  - b. each of them will have a downward Outside Basis adjustment of \$40, bringing it down to \$60;
  - c. if either P1 or P2 sells their partnership interest for \$60, there will be no gains or losses, thus avoiding double dipping of the tax loss distributed to them; and
  - d. the Basis Equilibrium is preserved, as the sum of the Outside Basis of P1 and P2 equals the cash (\$120).

## Section 3: Gross-up of liabilities

By treating the partners as contributing cash in an amount equal to their shares of partnership liabilities (eg the borrowings), §752 preserves Basis Equilibrium and avoids distortions. Without the inclusion of liabilities, the Outside Basis would be lower than the Inside Basis by the amount of liability. If that were the case, a partner would have a smaller amount of Outside Basis to absorb the loss or deduction distributed from the partnership to avoid the potential capital gains under §731(a)(1).

## Example 4.4. Distortion if liability is disregarded

1. P1 and P2 contributed \$50 each, while P3 contributed \$100 to form a partnership (PRS). They shared all Tax Items 25%, 25% and 50%. PRS borrowed an additional \$60, in addition to the \$100 contributions, to purchase a property at its fair market value (FMV) for \$160. P1, P2 and P3 were liable for the borrowing at ratios of 25%, 25% and 50%, respectively.
2. In a subsequent year, when the property's FMV had not changed, PRS distributed the property to P3, and P3 assumed the liability. After the transaction, PRS had \$100 remaining, with P1 and P2 as equal partners.
3. Without considering the liability, P3 would have received the property with an 'adjusted basis' of \$100 under §732(b). P3 would have realised a \$60 gain if the property were immediately sold, effectively taxing the borrowing amount.

§752(a) treats an increase in a partner's share of partnership liabilities (to the extent that the partner is personally obligated to pay the liability, as defined in Treas. Reg. §1.752-1(d)(1)(i)) as if the partner had made a contribution of money to the partnership, in accordance with §752(a) IRC and Treas. Reg. §1.752-1(b). This constructive contribution, much like an actual cash contribution, is added to the partner's Outside Basis (§722).

Conversely, §752(b) treats a decrease in a partner's share of partnership liabilities as a distribution of money from the partnership to the partner (§752(b) IRC and Treas. Reg. §1.752-1(c)). The partner's Outside Basis is reduced by the amount of this constructive distribution. If the deemed distribution amount exceeds the partner's Outside Basis, the partner must recognise gain equal to the excess distribution, as specified in §731(a)(1).

By including partnership liabilities in the partners' Outside Bases, the Basis Equilibrium is maintained and the uncontroversial notion that a borrowing transaction does not generate taxable income is protected.

If a partner's share of partnership liabilities, or the partner's personal liabilities in respect of partnership property, both increase and decrease as a result of a single or multiple transactions, only the net increase or decrease is taken into account in applying the foregoing rules §1.752-1(f).

#### Example 4.5. Illustration of liability gross-up rules

1. The same facts as Example 4.4. When the borrowing occurred, P3 was treated as contributing \$30, as P3 is liable for 50% of the borrowing, which increases P1's Outside Basis to \$130 (initial \$100 plus the \$30). P1 and P2 were treated as making cash contributions of \$15 each, since each of them was liable for 25% of the borrowing, increasing their Outside Basis to \$65.
2. When the property was distributed to P1, P3's Outside Basis was further increased to \$160, as P3 assumed 100% of the borrowing, thereby making an extra cash contribution of \$30, while P1 and P2's Outside bases were reduced to the \$50, since their share of the borrowing had been reduced to nil, which was treated as a cash distribution.
3. After the distribution, P3 had the 'adjusted basis' in the property of \$160. P3 would not make gains or losses if the property were sold for \$160.

## Section 4: Transactional basis adjustment

Maintenance of Basis Equilibrium requires consistent application of the aggregate theory. As long as the partnership functions as an aggregate of its partners, the partnership's tax consequences will flow through and be reflected in the partners' Outside Bases. However, like a corporation, the 'adjusted basis' of property of the partnership (ie Inside Basis) does not change because of distribution of partnership property (§734(a)) or transfer of a partner's interest (§743(a)), which of course reflect entity theory. Consequently, such a distribution and transfer

may displace the Basis Equilibrium, thereby causing the distortion, as illustrated below.

#### Example 4.6. Displacement of basis equilibrium

1. P1 contributed \$100 cash, while P2 and P3 contributed \$50 each for a 50%:25%:25% interest in a partnership (PRS). They share all Tax Items at 50%:25%:25%. PRS purchased a property for \$100, which has increased its FMV to \$140.
2. Scenario 1: where P3 sells its interest to P4 for \$60 and realises gains of \$10. The \$10 reflects P3's share of the increase in FMV of the property. At that point, the Basis Equilibrium is displaced because the Inside Basis of PRS remains \$200, while the sum of the Outside Bases of P1, P2 and P4 is \$210. If the property is sold, the partnership will realise \$40 in gains. These \$40 gains include \$10, which has already been taxed in the hands of P3. This double-taxed \$10 represents distortion because the Basis Equilibrium has been displaced.
3. Scenario 2: PRS makes a distribution of \$60 cash to liquidate P3's 25% interest in PRS, who recognises \$10 in capital gains. The \$10 reflects P3's share of the increase in the FMV of the property. At that point, the Basis Equilibrium is displaced. The property's 'adjusted basis' is \$100 plus \$40 in cash, totalling \$140 (ie the Inside Bases), while the sum of the Outside Bases of P1 and P2 is \$150. If the property is sold, the gains would be \$40, including \$10 in double-taxed gains, which duplicates the \$10 gains P3 made on the distribution. This is the distortion caused by the displacement of Basis Equilibrium.
4. In theory, the distortion caused by the displacement of Basis Equilibrium is temporary and will be cured upon liquidation. Thus, in Scenario 1, if the property is sold immediately, the \$40 in gains would be allocated as follows: \$20 to P1, increasing P1's Outside Basis to \$120; \$10 to P2, increasing her Outside Basis to \$60; and \$10 to P4, increasing her Outside Basis to \$70. If PRS is liquidated, \$240 cash is available for distribution. P1 and P2 would receive \$120 and \$60, respectively, with no gains or losses. However, P4 would incur a \$10 loss, which offsets the \$10 gain from the sale of the property.

Sections 743(b)<sup>7</sup> and 734(b) provide specific rules for a partnership to restore Basis Equilibrium where a partner's interest in a partnership is transferred (as in Scenario 1 of Example 4.6) or distribution is made to a partner (as in Scenario 2 of Example 4.6).

#### Subsection 1: Basis adjustment on transfer of a partner's interest in partnership

Where a partner's interest is transferred, the 'adjusted basis' of partnership property may be adjusted if the election provided by §754 is in effect or the partnership has a substantial built-in loss immediately after such transfer.

The basis adjustment of partnership property under §743(b)<sup>8</sup> (Sale Basis Adjustment) has limited purposes; it is personal to the transferee partner (Treas. Reg. §1.743-1(j)(1)). This Sale Basis Adjustment, which can be either positive or negative, has no effect on the partnership's computation of any item under §703 (Treas. Reg. §1.743-1(j)(1)), nor does it impact the transferee's capital account (§1.743-1(j)(2)).

The Sale Basis Adjustments are equal to the positive or negative difference between:

1. the transferee partner's Outside Basis; and
2. his 'proportionate share' of the basis of partnership property (§1.743-1(d)) (Shared Property Basis).

The transferee partner's Outside Basis is determined under the generally applicable basis rules, as established in §742 IRC and Treas. Reg. §1.742-1 (also refer to §752 and §1.752-1 to §1.752-5). The determination of the second factor, the transferee's Shared Property Basis, is more complex.

A transferee's Shared Property Basis equals the sum of (Treas. Reg. §1.743-1(d)(1)):

1. the transferee's interest in a 'partnership's previously taxed capital'; and
2. the transferee's share of liabilities.

A transferee partner's interest in 'partnership's previously taxed capital' (Treas. Reg. §1.743-1(d)(1)) is equal to the amount of cash the partner would receive in a 'hypothetical transaction', increased by the amount of tax loss and decreased by the amount of tax gain (including any 'remedial allocations' under §1.704-3(d)) that would be allocated to the transferee partner from the 'hypothetical transaction' (to the extent attributable to the acquired partnership interest).

A 'hypothetical transaction' means the disposition by the partnership of all of the partnership's property, immediately after the transfer of the partnership interest, in a fully taxable transaction for cash equal to the FMV of the property (Treas. Reg. §1.743-1(d)(2)).

It is worth interpolating to note that, given the partnership's considerable flexibility to distribute Tax Items (eg income, deductions, credits, and gains), in the author's view, the only feasible way to ascertain a partner's interest in a particular partnership property is to deploy methodologies based on a notional liquidation of the partnership, similar to the method used to ascertain 'partnership's previously taxed capital'. This has implications for Australian rules that operate based on the partners' interests in partnership property, such as s 106-5 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) (as discussed in Part V of this article), and s 830-35 ITAA97 (as discussed in Part VI).

The 'hypothetical transaction' is designed to capture the idiosyncratic character of a partner's interest in partnership property. A notable example is that fragmental allocations of gains from the notional sale of property, valid under §704(b), take into account fully operational §704(c) allocations in respect of built-in gains (ie pre-contribution gains) of the property under Treas. Reg. §1.743-1(d).

#### Example 4.7. Illustration of sale basis adjustment

1. P1 and P2 formed a partnership (PRS) and agreed to share all Tax Items equally. P2 contributed \$100 in cash, while P1 contributed a property with an FMV of \$120 and an 'adjusted basis' of \$50 (ie built-in gains of \$70), along with a loan of \$20.
2. In a subsequent year, the property's FMV increased by \$60 to \$180. P2 sold her interest to P3 for \$130, and PRS had a §754 election in place at that time. Under §742, P3's Outside Basis is \$140, which includes the cash paid for P2's interest (\$130) plus \$10, representing P3's share of partnership liabilities.
3. P3's interest in the 'partnership's previously taxed capital' is \$30. This is calculated as \$130 (the amount of cash P3 would receive if PRS liquidated immediately after the 'hypothetical transaction'), decreased by \$100 (the amount of tax gain allocated to P3 from the 'hypothetical transaction', including built-in gains of \$70 under §704(c) and \$30 in post-contribution gains). P3's Shared Property Basis is \$40, consisting of a \$30 share of 'partnership's previously taxed capital' and a \$10 share of the partnership's liabilities.
4. The Sale Basis Adjustment, which represents the amount of basis adjustment under §743(b) to partnership property, was \$100. This adjustment is determined by the difference between \$140 (P3's Outside Basis) and \$40 (P3's Shared Property Basis).
5. If the property was later sold for \$220, the post-contribution gains of \$100 would be distributed, with \$50 going to P1 and \$50 to P3. Additionally, P3 would be allocated \$70 in built-in gains, bringing her total gains to \$120. However, P3's gains would be reduced by \$100, corresponding to her Sale Basis Adjustments, resulting in a net gain of \$20, which represents her shares of gains accrued after her admission to PRS.

Obviously, the Sale Basis Adjustment needs to be allocated to individual property so that it can be taken into consideration when that property is sold. §755 IRC, and the Treasury Regulations promulgated under it, endeavour to prioritise the allocation of the Sale Basis Adjustments to 'ordinary income property' according to their FMV and the balance, including any underpayment or overpayment, of the sale price to 'capital gain property'. 'Capital gain property', as defined in Treas. Reg. §1.755-1(a)(1), consists of 'capital assets' (§1221 IRC) and '§1231(b) property',<sup>9</sup> while other properties not falling under the category of 'capital gain property' are classified as 'ordinary income property' (§1.755-1(a)(1)).

Sale Basis Adjustments are allocated through a three-step process (Basis Adjustments Allocation Process):

1. determine the value of each item of property;
2. allocate the adjustment between two classes of property: 'ordinary income property' and 'capital gains property'; and
3. the portion of the basis adjustment allocated to each class is further allocated among the items within the class.

At step (1) of the Basis Adjustments Allocation Process, *prima facie*, the value of property is its FMV. However, where property of the partnership constitutes a trade or business under §1060(c)(1) IRC, which is the assumed case for the purpose of this article, §1.755-1(a)(2) sets out an additional process to ascertain the value of intangible property as defined in §197 IRC (§197 Intangible) under the residual method, which is described as follows:

1. Ascertain the 'gross value', which, generally, is equal to the amount that, if assigned to all partnership property, would result in a liquidating distribution to the partner equal to the transferee's Outside Basis in the transferred partnership immediately following the relevant transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities) (Gross Value Ascertaining Process; §1.755-1(a)(4)(i)).
2. Allocating the 'gross value'—first to tangible property, second to intangible, which come within the extended definition of 'unrealised receivable' as defined in §751(c) IRC, then to intangible other than the goodwill and going concern, and last to goodwill and going concern.

#### Example 4.8. Assigning value of intangibles under the residual method

1. P1 and P2 each contributed \$100 to establish a partnership (PRS). They agreed to share all Tax Items equally. After several years of successful operation, PRS owns tangible property, which is a building with an FMV of \$400, and three §197 intangibles, collectively valued at \$580. These intangibles include a trademark with an FMV of \$80, which is classified as an 'unrealised receivable', a patent with an FMV of \$60, and goodwill with an FMV of \$40, which are not considered 'unrealised receivables'. At this point, P3 purchases P2's interest in PRS.
2. If P3's purchase price exceeds \$270, for example, \$320 (an overpayment scenario), the gross value to be assigned to all of PRS's property is \$640. This amount ensures that P3 receives \$320 according to the Gross Value Ascertaining Process. In other words, in a hypothetical liquidation immediately after P3's purchase, if all of PRS's property were sold for \$640, P3 would receive a distribution of \$320. In this case, the gross value of \$640 is allocated in the following order: the building (\$400), the trademark (\$80, considered an 'unrealised receivable'), the patent (\$60) and the remaining balance (\$100) is allocated to goodwill.
3. If P3's purchase price falls between \$240 and \$270, the allocation is as follows: \$400 to the building, \$80 to the trademark and the remaining value (amount between \$0 to \$60) to the patent. Goodwill is not allocated any value.
4. If P3's purchase price is between \$200 and \$240, the allocation is as follows: \$400 to the building, an amount between \$0 and \$80 to the trademark and no value allocated to the patent or goodwill.
5. If the purchase price is less than \$200 (eg \$190), the allocation is as follows: \$380 to the building, and no value is allocated to any of the intangibles.

In the allocation scheme described above, using the residual method, it becomes apparent that the distribution of the 'gross value' is skewed in favour of tangible property. Price fluctuations are reflected in the values assigned to §197 intangibles, with goodwill and going concern value being the most susceptible, followed by other §197 intangibles that are not classified as 'unrealised receivables,' and finally, the §197 intangibles considered 'unrealised receivables'.

Step (2) of the Basis Adjustments Allocation Process involves the allocation of Sale Basis Adjustments as follows:

1. Sale Basis Adjustment to 'ordinary income property' equals the total amount of income, gain or loss (including any remedial allocations under Treas. Reg. §1.704-3(d)) that would be allocated to the transferee partner, to the extent attributable to the acquired partnership interest in question, from the sale of all 'ordinary income property' in the 'hypothetical transaction', as defined in §1.755-1(b)(1)(ii). This definition is essentially the same as that in §1.743-1(d)(2), as discussed above.
2. The remaining Sale Basis Adjustment pertains to 'capital gain property', which captures the overpayment or underpayment of the sale price of a partner's interest. However, if a decrease in Sale Basis Adjustments exceeds the 'adjusted basis' of the partnership in the 'capital gain property', resulting in a notional negative 'adjusted basis', this excess is reallocated to the 'ordinary income' property (Excess Reallocation). Excessive Reallocation is likely to occur in cases of underpayment of the sale price.

#### Example 4.9. Illustration allocation of sale basis adjustment between two class of property

1. P1 and P2 are equal partners in a partnership (PRS) and have agreed to share all Tax Items equally. PRS possesses an inventory item with an FMV of \$100 and an 'adjusted basis' of \$80, as well as land (a 'capital gains property') with an FMV of \$100 and an 'adjusted basis' of \$20. Therefore, the total property FMV of PRS is \$200, with an 'adjusted basis' of \$100.
2. In the event that P3 acquires P2, the 'previous taxed capital' stands at \$50. This is calculated as the cash received (\$100) by P3 from the notional liquidation immediately after the sale of all property in the hypothetical transaction, minus the gains allocated to P3 (\$50). Since there is no liability, Shared Property Basis is the same as 'previous taxed capital'.
3. When the sale price is \$120 (indicating an overpayment scenario), the Sale Basis Adjustment amounts to \$70. This is determined by subtracting the Shared Property Basis (\$50) from P3's 'adjusted basis' (\$120). In this scenario, \$10 of the Sale Basis Adjustment is allocated to 'ordinary income property,' which represents 50% of the gains from the sale of the inventory item (\$100-\$80) in the hypothetical transaction. The remaining Sale Basis Adjustment of \$60 is allocated to the land, signifying that the overpayment is assigned to the 'capital gain property'.

**Example 4.9. Continued**

4. If P3 makes a payment of \$85 (an underpayment case), the Sale Basis Adjustment is \$35. This adjustment would be allocated as follows: \$10 to the inventory, which is consistent with the overpayment case, and \$25 to the land. This allocation demonstrates that the underpayment is attributed to the 'capital gain property'.

Once the Sale Basis Adjustment has been allocated between the class of 'ordinary income property' and the class of 'capital gain property,' the next step (Step (3)) of the Basis Adjustments Allocation Process is to further allocate the adjustment to individual properties as follows (§1.755-1(b)(3)):

1. The amount of Sale Basis Adjustment allocated to each item of property within the class of 'ordinary income property' is equal to the amount of income, gain or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest in question) from the hypothetical sale of that *specific item* (the Amount of Notional Item Sale), reduced by the products of Excess Reallocation multiplied a fraction, the numerator of which is the FMV of that item, and the denominator of which is the total FMV of all of the partnership's items of 'ordinary income property'.
2. The amount of the Sale Basis Adjustment to allocated to each item of property within the class of 'capital gain property' is equal to:
  - a. the Amount of Notional Item Sale in respect of an item of "capital gain property"; minus
  - b. the product of:
    - i. The total amount of gain or loss (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all items of 'capital gain property' (Amount of Total Notional Sale):
      - minus the amount of the positive basis adjustment to all items of capital gain property (ie where the Amount of Total Notional Sale is greater than the Sale Basis Adjustment allocated to 'capital gain property'); or
      - plus the amount of the negative basis adjustment to capital gain property (ie where the Amount of Total Notional Sale less than the Sale Basis Adjustment allocated to 'capital gain property');
 multiplied by:
    - ii. a fraction, the numerator of which is the FMV of the particular item of property to the partnership, and the denominator of which is the FMV of all of the partnership's items of capital gain property.

Thus, the Sale Basis Adjustment is prioritised to be allocated to individual items within 'ordinary income property' class as closer to its FMV as possible, and then to the items within 'capital gains property class' with

adjustment to overpayment and underpayment, according to their FMV.

Mechanically, the Treasury Regulations provide that the transferee's Sale Basis Adjustment with respect to each partnership property is segregated from the partnership's common basis in the property (§1.743-1(j)). The transferee's gain or loss from the sale or exchange of a partnership property is thus equal to the transferee's share of the partnership's gain or loss, including remedial allocations, minus the amount of any positive adjustment (which can convert a shared partnership gain to a loss for the individual partner) or plus the amount of any negative adjustment (which can convert a shared partnership loss to gain for the partner; §1.743-1(j)(3)). Further, the Sale Basis Adjustment is also taken into consideration when calculating Tax Items at the partner's level, such as depreciation and depletion, which involve complex computations (§1.743-1(j)(4)). This topic is not discussed in this article. The process of allocating the Sale Basis Adjustment to individual properties is illustrated in Example 4.10 on the next page.

**Subsection 2: Basis adjustment on distribution of partnership property**

Where a distribution of partnership property is made, whether or not in liquidation of the partner's entire interest in the partnership, the 'adjusted basis' of the remaining partnership property shall be (Treas. Reg. §1.734-1(b)):

- (a) increased by the amount of any gain or decreased by the loss recognised under §731(a)(1) IRC to the distributee partner (Gain/Loss Adjustment); or
  - (b) increased by the negative difference or decreased by the positive difference between the 'adjusted basis' of distributed property in the hand of the distributee partner and in the hand of the partnership immediately before the distribution (including adjustments under §743(b) or §732(d) when applied) (Basis Difference Adjustment)
- (collectively referred to as Distribution Basis Adjustment).

Section 734(b) applies to the common basis of partnership property, and thus inured to the benefit or detriment of all continuing partners. Accordingly, following a §734(b) adjustment, it is not necessary to maintain separate special adjustment accounts for individual partners.

Where there is multiple property involved, obviously a methodology is needed to allocate the Distribution Basis Adjustment to individual items of property so that the tax implication can be ascertained when a transaction occurs to it. This allocation has a similar three-step process (ie Basis Adjustments Allocation Process) in respect of the Sale Basis Adjustment, as described above under Treas. Reg. §1.755-1(a)(1).

At step (1) of the Basis Adjustments Allocation Process, the value of property other than §197 Intangibles is its FMV. Where §197 Intangibles are involved, their values are assigned under the residual method (§1.755-1(a)(2)), which has similar process to that described above in respect of the Sale Basis Adjustment, saving for ascertaining 'gross value'. In the case of the Distribution Basis Adjustment,

**Example 4.10. Allocation of sale basis adjustment to individual properties<sup>10</sup>**

1. P1 and P2 formed equal partnership (PRS) and agreed share all Tax Items equally. P1 contributed \$1,000. P2 contributed \$500 and a property (Prop1), a non-depreciable 'capital gain property' with an FMV of \$500 and an adjusted tax basis of \$250. PRS used the cash to purchase property 2 (Prop2), property 3 (Prop3) and property 4 (Prop4). The following table (left side) provides a snapshot of PRS' property.

Property Summary			Hypothetical Transaction		
Assets	Adjusted basis	Fair market value	Built-in Gain/ (Loss)	Gain/(Loss) Post contribution	
				100 per cent	P3 share
<b>Capital Gain Property:</b>					
Prop 1	250	750	250	250	375
Prop 2	1,000	1,175		175	87.5
<b>Sub Total</b>				425	462.5
<b>Ordinary Income Property:</b>					
Prop 3	400	450		50	25.0
Prop 4	100	25		(75)	(37.5)
<b>Sub Total</b>				(25)	(12.5)
<b>Total</b>	<b>1,750</b>	<b>2,400</b>		<b>400</b>	<b>450.00</b>

2. At that point, P2 sells her interest in PRS to P3 for \$1,100, which is an underpayment by \$100. At the time of the transfer, P3's Share Property Basis is \$750 (ie \$2,400 \* 50% - \$450, representing the gains allocated to P3 in a 'hypothetical transaction', as shown in the table above (on the right), including \$250 built-in gain from Prop 1 allocated under §704(c)). Thus, the Sale Basis Adjustment is \$350 (\$1,100 - \$750).
3. The allocation of the Sale Basis Adjustment (\$350) between classes of property is as follows:
- 'ordinary income property': (\$12.5) (as shown in the table above, on the right)
  - 'capital gain property': \$350 - (\$12.5) = \$362.5.
4. The allocation of the Sale Basis Adjustment to individual items of 'ordinary income property' (as shown in the table above, on the right):
- Prop 3: \$25
  - Prop 4: (\$37.5).
5. The allocation of Sale Basis Adjustment to individual items of 'capital gain property' is summarised in the following table:

	Prop 1	Prop 2	Total
As per Hypothetical Transaction allocation	375.0	87.5	<b>462.5</b>
Less			
(1) Underpayment	100.0	100.0	
(2) FMV of Prop 1 or Prop 2 / (FMV of Prop 1 + FMV of Prop 2)	38.96%	61.04%	
Product (1) * (2)	38.96	61.04	<b>100.0</b>
<b>Sale Basis Adjustment allocated to items</b>	<b>336.04</b>	<b>26.46</b>	<b>362.50</b>

the partnership ‘gross value’ equals the value of the entire partnership as a going concern immediately following the distribution, increased by the amount of partnership liabilities immediately following the distribution (Treas. Reg. §1.755-1(a)(4)(iii) and §1.755-1(a)(6), example 5).

At step (2) of the Basis Adjustments Allocation Process, §1.755-1(c)(1) makes a distinction between Basis Difference Adjustments and Gain/Loss Adjustments when allocating Distribution Basis Adjustments among different classes of property.

When it comes to the Basis Difference Adjustment, §1.755-1(c)(1)(i) focuses on countering Character Streaming (as defined in Part II of this article) by requiring that the adjustment must be allocated to the remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose. Thus, as a general rule:

1. if the Distribution Basis Adjustment arises from the distribution of ‘capital gain property’, Basis Difference Adjustment is allocated to the remaining ‘capital gains property’ of the distributing partnership; and
2. if the Distribution Basis Adjustment arises from the distribution of ‘ordinary income property’ the Basis Difference Adjustment is allocated to ‘ordinary income’ property’ of the partnership.

In respect of Gain/Loss Adjustment, the adjustment is allocated to ‘capital gains property’ (§1.775-1(c)(1)(ii)).

As for the allocation of Distribution Basis Adjustment within the class at step (3) of the Basis Adjustments Allocation Process, the allocation rules under §1.775-1(c)(2) are as follows:

1. Where there is an increase in Distribution Basis Adjustment, the increase must be allocated first to properties with unrealised appreciation (which is the amount of FMVs exceeding adjusted bases) in proportion to their respective unrealised appreciation before such an increase (but only to the extent of each property’s unrealised appreciation). Any remaining increase must be allocated among the properties within the class in proportion to their FMVs.
2. If there is a decrease in Distribution Basis Adjustment, the decrease must be allocated first to properties with ‘unrealised depreciation’ (which is the amount of adjusted bases exceeding FMVs) in proportion to their respective amounts of unrealised depreciation (but only to the extent of each property’s unrealised depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to their adjusted bases (as adjusted under the preceding sentence).

The ‘adjusted basis’ of the property is set to zero when a decrease adjustment results in a negative basis (§1.775-1(c)(2)). Further, any unallocated Distribution Basis Adjustment (owing to a lack of like character or when the basis of all property of a like character has been reduced to zero) will be carried forward until the partnership subsequently acquires property of a similar character to which an adjustment can be made.

#### Example 4.11. Allocation of distribution basis adjustment<sup>11</sup>

1. P1, P2 and P3 formed an equal partnership (PRS). P1 and P2 each contributed \$1,000, while P3 contributed \$500 and Property 1 (Prop 1), a non-depreciable ‘capital gain property’ with an FMV of \$500 and an adjusted tax basis of \$250. PRS used the cash to purchase Property 2 (Prop 2) and Property 3 (Prop 3), both of which were non-depreciable ‘capital gain property’. Additionally, they acquired Property 4 (Prop 4) and Property 5 (Prop 5), which were inventory items that had not substantially appreciated in value within the meaning of §751(b)(3). Prop 4 and Prop 5 were the only properties held by PRS subject to §751. PRS had an election in effect under §754. After seven years, the ‘adjusted basis’ and FMV of PRS’s properties were as follows:

	Adjusted basis	Fair market value
<b>Capital Gain Property:</b>		
Prop 1	250	750
Prop 2	1,000	1,175
Prop 3	500	600
<b>Ordinary Income Property:</b>		
Prop 4	500	475
Prop 5	500	600
<b>Total</b>	<b>2,750</b>	<b>3,600</b>

2. Allocation between classes: PRS distributed Prop 3 and Prop 5 to P3 in complete liquidation of P3’s interest in PRS. P3’s Outside Basis was \$750. PRS’s basis in Prop 3 and Prop 5 was \$500 each. P3’s Outside Basis of \$750 was allocated between Prop 3 and Prop 5 under §732(b) and (c) IRC. Therefore, P3 had an ‘adjusted basis’ of \$250 in Prop 3 (considered ‘capital gain property’) and an ‘adjusted basis’ of \$500 in Prop 5 (considered ‘ordinary income property’). According to Treas. Reg. §1.755-1(c), since the Basis Difference Adjustment arose from Prop 3, which is ‘capital gains property’, the upward Distribution Basis Adjustment of \$250 is allocated to Prop 1 and Prop 2, which are the remaining properties having the same character as Prop 3, with no change in the ‘adjusted basis’ of ‘ordinary income property’ (ie Prop 4).
3. Allocation within class: The upward Distribution Basis Adjustment of \$250 must be allocated among the remaining ‘capital gain properties’ (ie Prop 1 and Prop 2) in proportion to their unrealised appreciation (§1.755-1(c)(2)(i)). The unrealised appreciation (ie excess of the FMV over ‘adjusted basis’) of Prop 1 was \$500, and Prop 2 had \$175. Therefore, the basis of Prop 1 would increase by \$185.19 (\$250 multiplied by \$500, divided by \$675), and the ‘adjusted basis’ of Prop 2 would increase by \$64.81 (\$250 multiplied by \$175, divided by \$675).

The primary purpose of transactional basis adjustments, whether triggered by a transfer partner's interest or the distribution of property from the partnership, is to restore the Basis Equilibrium. Additionally, the allocation rules of basis adjustments between and within classes of property aim to counter the Character Conversion, which is a form of Partnership Tax Arbitrage (as defined in Part II of this article). This is done to prevent the achievement of desirable property character outcomes either in the hands of partners or within the partnership through such transfers or distributions.

### Section 5: Anti-capital gains conversion through realising partner's interest

Section 741 provides that the gain or loss resulting from a partner's sale or exchange of a partnership interest is generally treated as capital gain or loss. When considered on its own, this capital gain treatment allows a partner to convert potential 'ordinary income' into capital gain by selling their interest in the partnership when the partnership holds 'ordinary income property' such as 'inventory items' (§751(d)) and 'unrealised receivables' (§751(c)).

Colloquially called "hot asset" rules are contained in §751 to combat such types of Character Conversion—a form of Partnership Tax Arbitrage. It operates where there is either a disposal of a partner's interest in a partnership, with 'unrealised receivables' and 'inventory items' (§751(a)), or a distribution of such property to a partner (§751(b)).

As an ordinary concept, 'unrealised receivables' are rights to payment for goods and services provided by the partnership to the extent such payments have not previously been included in income under the partnership's method of accounting. 'Inventory items', conversely, are property held for sale to customers in the ordinary course of a partnership's trade or business. However, the definitions of 'unrealised receivables' (§751(c)) and 'inventory items' (§751(d)(1)) have been expanded over the years to include numerous items that bear little resemblance to the ordinary concept of these terms, saving that the realisation of them produces 'ordinary income' rather than capital gain. 'Unrealised receivables' and 'inventory items' are collectively referred to as "§751 Property".

#### Subsection 1: Computation of ordinary gains and losses on sale of a partner's interest

It is provided in §751(a) IRC that the amount realised from the sale or exchange of a partner's interest is treated as an amount realised from the disposition of property, other than a 'capital asset', to the extent that such amount is attributable to the partner's interest in the partnership's 'unrealised receivables' or 'inventory items'. This provision effectively characterises the portion of otherwise capital gains or losses under §741 as ordinary gains and losses.

The Treasury Regulations operationalise required computations under §751(a) by adopting a notional sale approach, similar to the 'hypothetical transaction' utilised in Treas. Reg. §1.743-1(d)(2) and §1.755-1(b)(1)(ii), as discussed above. Under that approach, the selling partner's gains or

losses subject to §751(a) equals her distributive share of any 'ordinary income' or loss that would have been recognised by the partnership had it sold all of its §751 Property for the FMV in a fully taxable transaction immediately before the sale of the partnership interest, taking into consideration §704(c) principles, including remedial allocations, as well as any §743(b) basis adjustments (ie Sale Basis Adjustments) to which the selling partner is entitled (§1.751-1(a)(2); Hypothetical Sale Approach).

Once the selling partner's 'ordinary income' or loss is computed, the amount of capital gain or loss that the selling partners recognises on the sale is the difference between (§1.751-1(a)(2):

1. the total amount of gain or loss that she would have recognised on the sale of her partnership interest in the absence of §751(a); and
2. the amount of 'ordinary income' or loss recognised under §751(a).

#### Example 4.12. Income and loss arising from sale of an interest in partnership with an 'Unrealised Receivable'

1. P1 contributed \$100, in the form of a 'capital asset' with an FMV and 'adjusted basis' of \$100, while P2 contributed an 'unrealised receivable' with an 'adjusted basis' of \$nil and an FMV of \$100 to form a partnership (PRS). They agreed to share all Tax Items equally.
2. After one year of operation, PRS broke even. However, the value of the 'capital asset' decreased to \$20, while the value of the 'unrealised receivable' remained the same. P2 sold its interest for \$60.
3. P2 made capital gains of \$60 under §741, in the absence of §751(a). However, under the hypothetical sale approach, P2 would have been allocated \$100 'ordinary income', related to gains accrued on 'unrealised receivables' before the formation of PRS, under §704(c). Consequently, P2's tax implications on the sale of her interest in PRS are as follows:
  - a. \$100 'ordinary income'; and
  - b. \$40 capital loss (ie \$60 - \$100 (§1.751-1(a)(2))).<sup>12</sup>

Example 4.12 illustrates that the computations required under §751(a) may fragment the overall gain or loss recognised by the selling partner in various ways—an overall gain may be split into ordinary gain and capital gain, a combination of ordinary gain and capital loss, or a combination of capital gain and ordinary loss. The same is true of an overall loss.

#### Subsection 2: Computation of ordinary income and losses on partnership distribution

Disproportionate distributions that alter the partners' interest in 'unrealised receivables' or 'inventory items' are dealt with in §751(b). The scope of §751(b) is smaller than that of §751(a), since it only applies to the substantially

appreciated 'inventory items', defined as where their FMV exceeds 120% of the Inside Base of such items (§751(b)(3)).

Although they serve different functions, §751(b) appears to complement §751(a). §751(a) is an anti-Character Conversion rule, while §751(b) addresses Character Streaming (as defined in Part II of this article). For example, in the absence of §751(b), a partnership could distribute 'inventory items' disproportionately to a low-rate partner with significant built-in profits while retaining 'capital asset' with built-in gains or 'inventory items' with built-in losses, with the intention of distributing these capital gains or

ordinary losses to a partner with a higher tax rate upon realisation.

In determining whether a partner receives a disproportionate distribution of §751 Property from a partnership, current Treasury Regulations focuses on the FMV of the partnership's assets (Treas. Reg. §1.751-1(b)(1)(ii) and §1.751-1(g)). The operation §751(b) is extraordinarily complicated under the current Treasury Regulation, the essence of which can be illustrated by the following example.

#### Example 4.13. Illustration of §751(b) operation<sup>13</sup>

1. P1, P2 and P3 are partners of a partnership (PRS), who agree to share all Tax Items equally. PRS owns the property as shown in the following table:

	Adjusted basis	Fair market value
Cash	120	120
Inventory Item 1	15	30
Inventory Item 2	15	30
	<b>150</b>	<b>180</b>
	<b>Capital account balance</b>	
P1	50	60
P2	50	60
P3	50	60
	<b>150</b>	<b>180</b>

2. P3 is to receive Inventory item 1 (Inv1) and reduce her interest by 50% in remaining property in PRS accordingly. This transaction reduces the FMV of PRS's property from \$180 to \$150 and the FMV of the P3 partner's interest in PRS from \$60 to \$30. After the distribution, P's interest in PRS is 20% (\$30/\$150).
3. Before the distribution, P3 has 30% interest in the 'inventory items', which is \$18 out of the total FMV \$60; after the distribution, P3 has 20% in the inventory item, which is \$6 out of the total \$30. That means P3 is to receive a normal distribution (ie not deemed as sale of 'inventory items') of \$14 (\$18-\$6) and the balance \$16 (ie \$30-\$14) is subject to §751(b). The above process can be summarised in the following table:

	PRS			P3		
	Cash	Inventory	Total	Cash	Inventory	Total
After distribution	120	30	150	24	6	30
Distribution received				0	30	30
P3 total interest in property				24	36	60
Before distribution	120	60	180	40	20	60
Deemed sale portion				(16)	16	

4. The comparison between the sum of the P3 interest in the PRS's property after the distribution and the property received by P3 from the distribution and P3 interest in the PRS's property before distribution reveals that P3 gives up \$16 cash in exchange for \$16 'inventory items'. Thus, P1 is deemed to have received \$16 cash and then used it to purchase \$16 inventory. The tax implications of the deemed sale under §751(b) are as follows:

- a. P3's Outside Basis is reduced by \$16 cash;

- b. P3 has an adjusted basis of \$16 in that portion of inventory items, deemed to be purchased by a notional cash distribution of \$16;
  - c. PRS makes ordinary income of \$8, calculated as:
    - \$16 (cash deemed received); minus
    - \$8 proportionated basis of \$16 'inventory item' ( $\$15 \times 16 / 30$ );
  - d. the \$8 ordinary income made by PRS is to distributed to P1 and P2; and
  - e. P1 and P2 increase their Outside Bases by \$4 each (ie \$54).
5. In respect of the \$14 'inventory item', which is regarded as a distribution in accordance with P3's entitlement, the tax implications are as follows:
    - a. P3's Outside Basis is reduced proportionated by \$7 ( $\$18 \times 14 / 30$ ), after a reduction of \$16 deemed cash distribution; and
    - b. P3 has \$7 'adjusted basis' in that portion of 'inventory item';
  6. Consequently, P3's 'adjusted basis' in the inventory is \$23:
    - a. \$16 for portion of 'inventory item' under operation §751(b); and
    - b. \$7 for portion of inventory distributed in accordance with P3's entitlement.
  7. P1's Outside Basis is \$27 (ie \$50 reduced by \$16 cash distribution and \$7 = \$27).
  8. At the completion of the process, the Basis Equilibrium is maintained, which is shown in the following table:

	Adjusted basis	Fair market value
Cash	120	120
Inventory Item 2	15	30
	<b>135</b>	<b>150</b>
	<b>Capital account balance</b>	
P1	54	60
P2	54	60
P3	27	30
	<b>135</b>	<b>150</b>

The opposite situation, where a partner receives non-§751 Property and the distribution reduces her share of the partnership's §751 Property, the transaction is also recast as a taxable disposition under §751(b). The partner is treated as exchanging all or a portion of her interest in the partnership's §751 Property for the partnership's non-§751 Property. Once again, this deemed asset exchange involves several constructive steps, which is not to be illustrated further.

The Treasury Regulations seem to proceed on the basis that the distributing partner has the proportionate interest in partnership profits, losses and capital, and in each class of partnership property. It is not clear as how to determine a partner's interest in a partnership property where partners have different ratio of sharing of profits, losses and capital, and particular items of partnership profit or loss can be allocated among the partners in different percentages.<sup>14</sup>

Another issue with the current Treasury Regulations is that they focus on the market value of a partnership's

properties rather than the unrealised gain or loss attributable to such properties. Thus, if a partnership has two items of §751 Property, both of equal FMV but with different amounts of unrealised gains, the partnership could distribute the high-basis item to its high-bracket partner with impunity, provided only that she get correspondingly less of the partnership's low-basis item.

Treasury subsequently published proposed regulations in 2014, the proposed regulations adopt a hypothetical sale approach. Under this approach, the proposed regulations compare the consequences of a hypothetical sale of the partnership's §751 Property immediately before and immediately after the distribution, while also taking into account any §751 Property received by a partner in the distribution. If the amount of 'ordinary income' or loss recognised by any partner on these two hypothetical sales changes, the distribution is considered disproportionate and §751(b) thus applies. As the proposed regulation has

yet to become operational, it will not be subject to further discussion.<sup>15</sup>

### Section 6: Anti-character conversion through partner contributions

Section 724 IRC is aiming to counter the Character Conversion planning strategies through contributing property to partnership and disposing of that property by partnership, with a character that is different from that in the hands of contributing partner. For example, a partner may contribute an ‘inventory item’ to a partnership, which sells that item as a capital gains asset. Section 724 operates to freeze the pre-contribution character of contributed property in three specific categories:

1. ‘unrealised receivables’;
2. ‘inventory items’; and
3. capital loss property.

Where a partner contributes ‘unrealised receivables’ to a partnership, any future income or gain on the partnership’s collection or other disposition of the property is treated as ‘ordinary income’ (§724(a)). The term ‘unrealised receivables’<sup>16</sup> has been discussed above. A classic example of an unrealised receivable is a cash method taxpayer’s accounts receivable for services performed.

Where a partner contributes ‘inventory item’, any gain or loss recognised on the partnership’s disposition of such property within the five-year period beginning after contribution is treated as ‘ordinary income’ or loss (§724(b)). This category of ‘inventory items’<sup>17</sup> is not restricted to inventory in any literal sense; indeed, its scope is much broader, including any property that is not a ‘capital asset’ or quasi-capital asset described in §1231(b).<sup>18</sup> In addition, inventory items include any property that would be treated as an ‘inventory item’, on the hypothesis that it was held by the contributed partner; that is, §724(b) applies where a property was not inventory at the time of contribution but later becomes an inventory item, on the hypothesis that the contributing partner continuously held the property.

Where a partner contributes a capital loss property<sup>19</sup> and eventually the property is disposed of at loss during the five-year period following contribution, the portion of loss to the extent of the built-in loss (ie the property’s ‘adjusted basis’ exceeds its FMV at contribution time) is quarantined as capital loss (§724(c)); the character of the balance of loss, if any, is determined at the partnership level based on the partnership’s use of the property and the nature of the transaction in which the loss is recognised.

### Section 7: Preservation of ordinary gains on liquidation of the partner’s interest

When a partnership makes a distribution to liquidate a partner’s interest in the partnership, the partner’s Outside Basis is extinguished. Thus, the property distributed normally carries that Outside Basis (reduced by any money distributed, but not below zero; §732(b)), which defers the recognition of gains or losses accrued by the partner upon liquidating her interest until the property is realised.

As foreshadowed above, where the partnership distributes only “Ordinary Gain Property” (ie property producing ‘ordinary income’ on its realisation), such as the ‘unrealised receivables’ and ‘inventory items’, which carries a smaller Inside Basis than Outside Basis of a partner, a liquidated distribution would increase the ‘adjusted basis’ of the ‘ordinary income property’ under the normal operation of §732(b).

An increase in the ‘adjusted basis’ of Ordinary Gain Property would create opportunities for Partnership Tax Arbitrage. Section 731(a)(2) IRC provides that in liquidation of a partner’s interest in a partnership where no property other than money, ‘inventory items’ and ‘unrealised receivables’ are distributed to such partner, loss shall be recognised to the extent of the excess of Outside Basis over the sum of:

1. any money distributed; and
2. the basis to the distributee, as determined under §732, of any ‘unrealised receivable’ (as defined in §751(c)) and ‘inventory item’ (as defined in §751(d)).

#### Example 4.14. Illustration of anti-partnership tax arbitrage rule on liquidating a partner’s interest

1. P1 has an Outside Basis of \$100 in a partnership (PRS) with an FMV of \$85, and receives the following property in liquidation of her interest:
  - a. cash of \$15; and
  - b. ‘inventory item’ with an FMV \$70 and an ‘adjusted basis’ in the hands of PRS of \$30.
2. Assuming §751(b) does not apply, P1 realises a \$55 capital loss upon the distribution under §731(a)(2)—that is, the excess of P1’s Outside Basis (ie \$100) over the sum of the amount of cash received (\$15) and the adjusted basis of the inventory item in the hands of the partnership (\$30), instead of having an adjusted basis in the inventory item of \$85 (ie the Outside Basis minus the cash).
3. The basis limitation of §732(c)(1) prevents the allocation of more than \$30 of basis to the ‘inventory item’. Upon the partner’s subsequent sale of the ‘inventory item’ for \$70, P1 will recognise \$40 of ‘ordinary income’. In aggregate, P1 will thus have a \$55 capital loss and \$40 of ‘ordinary income’ as a result of the distribution and eventual sale of the distributed inventory.
4. Thus, in the present example, the operation of §731(a)(2) and §732(c)(1) negates the Character Conversion—that is, the Conversion of a \$55 capital loss and \$40 of ‘ordinary income’ into an ordinary loss of \$15 (\$70–\$85).

The above rules do not apply when there is a distribution of other property to a partner along with money, ‘inventory items’ and/or ‘unrealised receivables’. In such cases, the excess of the Outside Basis over money and the ‘adjusted basis’ of the property distributed can be allocated to that other property, while the ‘inventory items’ and

'unrealised receivables' retain their basis in the hands of the partnership.<sup>20</sup> For illustration, in Example 4.14, if there was also a distribution of a non-depreciable 'capital asset' with an 'adjusted basis' and an FMV of \$1, the inventory item would retain its 'adjusted basis' of \$30 under §732(c)(1), and the basis of the non-depreciable capital asset would be increased to \$55.<sup>21</sup> In other words, the 'adjusted basis' of the non-depreciable capital asset would be uplifted, not the 'inventory item', thus negating the possibility of Character Conversion.

### Section 8: Rules displace the roll-over principle to counter gain/loss shifting

As discussed earlier, the roll-over is an integral part of Basis Equilibrium, since it serves the function of initially establishing Basis Equilibrium and continuously maintaining it throughout the life of a partnership. One consequence of the roll-over is the ineluctable variance between the FMV and 'adjusted basis' of the property. This is because the 'adjusted basis' of a property transfers to a transferee when the property either moves into or out of a partnership, despite the fact the beneficial interests in property have changed.

Thus, roll-over in the partnership context (both in the US and Australia) is susceptible to being exploited as a device for Gain/Loss Shifting (as defined in Part II of this article). As discussed above, §704(c)(1)(A) counters this type of device by quarantining the built-in gain and loss of contributed property to be distributed only to the contributing partner.

Congress<sup>22</sup> was concerned that partnerships may use distributions of contributed property to circumvent the allocation rules outlined in §704(c)(1)(A). This could lead to an improper shifting of built-in gains and losses from contributing partners to non-contributing partners, in violation of the foundational principles animating §704(c), which is to allocate built-in gains/losses to contributing partners.

#### Example 4.15. Gain/loss shifting through sale

1. P1 and P2 each contributed \$50 to form a partnership (PRS). PRS desires to acquire a 'capital property' (Prop 1) co-owned by P3 and P4, which has an FMV of \$100 but an 'adjusted basis' of \$20. P3 and P4 also desire to own a 'capital property' (Prop 2), with an FMV of \$100, in substitution for Prop 1. If P3 and P4 sell Prop 1 to PRS and then buy Prop 2, they would realise a gain of \$80.
2. Plan 1: P3 and P4 contribute Prop 1 in exchange for their interest in PRS. After the contribution, PRS owns Prop 1 with an 'adjusted basis' of \$20, and the Outside Basis of P3 and P4 is \$10 each. PRS then purchases Prop 2 and distributes Prop 1 to P1 and P2 in a liquidation distribution. Ultimately, P1 and P2 own Prop 1 with a combined 'adjusted basis' of \$100 (§732(b)). PRS, with partners P3 and P4, owns Prop 2 with an 'adjusted basis' of \$100. It should be noted that PRS is not planning to make a §754 election. If it were to do so, the 'adjusted basis' of Prop 2 would be adjusted downward to \$20 under §734(a).

3. Plan 2: P3 and P4 contribute Prop 1 in exchange for their interest in PRS. After the contribution, PRS owns Prop 1 with an 'adjusted basis' of \$20, and P3 and P4 have an Outside Basis of \$10, respectively. PRS then acquires Prop 2 and distributes it to P3 and P4 in a liquidation distribution. Ultimately, P3 and P4 own Prop 2 with an 'adjusted basis' of \$20. PRS adjusts the 'adjusted basis' of Prop 1 up to \$100 under §734(b) by making an election under §754.

Section 704(c)(1)(B) and §737, complementing §704(c)(1)(A), aim to counter Gain/Loss Shifting through a disguised sale of contributed property, through devices such as Plan 1 and Plan 2 in Example 4.15.

Section 704(c)(1)(B) aims at a Plan 1 (as in Example 4.15) type of device, where a property contributed to a partnership is distributed to non-contributing partner within seven years of contribution. Under the operation of §704(c)(1)(B):

1. the contributing partner must recognise any built-in gain or loss that would have been recognised on a notional sale of the contributed property at its FMV at the time of the distribution (§704(c)(1)(B)(i); Treas. Reg. §1.704-4(a)(1));
2. any gain or loss recognised by the partner has the same character as the gain or loss that the partnership would have recognised on the said national sale of the contributed property to the distributee partner (§704(c)(1)(B)(ii));
3. the Outside Basis of the contributing partner is increased by any gain or decreased by any loss, as the case may be, recognised by the contributing partner (§704(c)(1)(B)(iii); Treas. Reg. §1.704-4(e)(1)) immediately before the distribution of the contributed property and, therefore, are taken into account in determining the tax consequences of the distribution; and
4. the 'adjusted basis' of the partnerships in the contributed property is increased by any gain or decreased by any loss, as the case may be, recognised by the contributing partner (§704(c)(1)(B)(iii); Treas. Reg. §1.704-4(e)(2)), immediately before the distribution of the contributed property and, therefore, are taken into account in determining the tax consequences of the distribution.

Similarly, §737 IRC, complementing §704(c)(1)(B), attacks Plan 2 (as in Example 4.15) where remaining partners keep property contributed with built-in gains by distributing another property to contributing partner.

Under §737, where a partnership distributes property to a partner who contributed another property with built-in gains to the partnership during the seven-year period preceding the distribution, the partner may recognise gain on the distribution. The property distributed does not include money (which includes marketable securities under §737(e)), since money reduces the partner's Outside Basis and may trigger gain recognition (§731(a)(1)). In contrast, the distribution of other property would not give rise to gain recognition, since roll-over provisions are available, as discussed above.

The gain recognised under §737 is determined as the lesser of two amounts:

1. The ‘excess distribution’, if any, which is defined in Treas. Reg. §1.737-1(b) as the excess of:
  - a. the FMV of property (other than money) received in the distribution; over
  - b. the Outside Basis of such partner’s interest in the partnership immediately before the distribution, reduced (but not below zero) by the amount of money received in the distribution.
2. A partner’s ‘net pre-contribution gain’, which is the net amount of gain that the partner would recognise under §704(c)(1)(B) if all of the property she contributed to the partnership during the seven-year period preceding the distribution—and which the partnership still holds—were distributed to another partner immediately before the distribution (§737(b)). If property contributed by a partner is distributed to another partner as part of the same transaction, the partner’s net pre-contribution gain is reduced by any gain that she recognises under §704(c)(1)(B) (Treas. Reg. §1.737-1(c)(2)(iv); §1.737-1(e), Ex. 3).

The Outside Basis of the contributing partner is increased by the amount of any gain recognised immediately before the distribution (§737(c)(1)). Similarly, the ‘adjusted basis’ of the partnership in the contributed property is also increased by the recognised gain (§737(c)(1); §1.737-3(c)).

#### Example 4.16. Operation of §704(c)(1)(B) and §737

1. The same facts as in Example 4.15.
2. §704(c)(1)(B) is applicable to Plan 1:
  - a. Prop1 would be deemed to be sold at \$100, with gains of \$80 distributed equally to P3 and P4;
  - b. the Outside Basis of P3 and P4 is increased by \$40 to \$50 each immediately before the distribution;
  - c. the ‘adjusted basis’ of Prop1 would be increased to \$100 immediately before the distribution.
3. §737 is applicable to Plan 2:
  - a. “excess distribution” is \$40 each for P3 and P4; that is, it is 50% of the FMV of Prop 2 minus P3 and P4’s respective Outside Basis;
  - b. the net pre-contribution gain, as calculated under §737(b)(1), is also \$40 each; that is, it represents 50% of the difference between the FMV of Prop 1 (\$100) and its adjusted tax basis at the time of the distribution (\$20);
  - c. thus, P3 and P4 recognise gains of \$40 each;
  - d. the Outside Basis of P3 and P4 is increased by \$40 each to \$50 immediately before the distribution—meaning the ‘adjusted basis’ of Prop 2 will be \$50 in the hands of each of P3 and P4 (§732(b)); and
  - e. Prop 1’s ‘adjusted basis’ is increased by \$80 to \$100.

Section 737 does not attack a contributed property with a built-in loss, which means the Outside Basis of the contributing partner is higher than the FMV of the contributed property at the time of contribution. Thus, a liquidated distribution of another property to the contributing partner is likely to trigger the downward adjustment in the ‘adjusted basis’ of the contributed property (thereby reducing the built-in loss) under §734(b) (2), where either there is a ‘substantial basis reduction’ under §734(d) or a §754 election in place, because the distributed property adopts the Outside Basis of the contributing partner (§732(b)).

However, the rationale mentioned above does not apply to non-liquidated distributions, since the distributed property may simply inherit the ‘adjusted basis’ of the property in the hands of the partnership (§732(b)), instead of adopting the Outside Basis of the contributing partner, as in the case of liquidation distributions. Therefore, it seems that §737 is poorly conceived.<sup>23</sup>

## Part V: Partner-level transactions (Australia)

The partnership taxation rules in the US are centralised in Subchapter K of Chapter 1 of the IRC. In comparison, the organisation of Australian partnership taxation rules is somewhat haphazard. Besides Div 5 of Pt III of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (as discussed in Part II of this article), there are four other major provisions scattered throughout ITAA97:

1. s 70-100, which deals with trading stock;
2. s 40-295, s 40-300 and s 40-340, which deal with depreciating assets;
3. s 106-5, and s 108-5(2)(c) and (d), which contain capital gains tax (CGT) rules in respect of partnership assets; and
4. s 15-50 and s 25-95, which address works in progress amounts.

Generally speaking, these rules operate on partner-level transactions, and as the above brief descriptions show, they deal with a particular set of transactions. It is difficult to see whether there is a uniform principle underpinning them. This raises the question of what the tax consequences are for transactions falling outside those specific provisions. A notable example is the tax consequence of the sale of a partner’s interest in a partnership that holds a revenue asset or when a revenue asset is distributed to a partner to reduce or liquidate their interest in the said partnership.

In the following paragraphs of this part, this article first discusses the four statutory rules, as set out above, in chronological order of their introduction, and then the revenue asset rules.

### Section 1: Trading stock rules

In general terms, s 70-100 ITAA97 sets out the specific trading stock taxation rules where there is a change in composition of a partnership.<sup>24</sup> Section 70-100 is successor

of former s 36A ITAA36, which was introduced, together with former s 59AA ITAA36 to overcome<sup>25</sup> the High Court decision in *Rose v FCT*<sup>26</sup> (*Rose*). The successors of former s 59AA, namely ss 40-295(2), 40-300(2) and 40-340(3)–(7) ITAA97, concerning taxation of depreciating assets (Depreciating Asset Provisions) where there is a change in the composition of a partnership, are discussed in the next section.

Where a partnership sells trading stock, the partnership will calculate the profits or loss of the said sale, which form part of ‘net income’ and ‘partnership loss’ to be allocated to the partners, according to their ‘individual interest’. However, where a partnership composition changes, two main issues will arise in respect of the trading stock of the relevant partnership:

1. Should the partnership, or alternatively, the relevant partner, be taxed on the transaction?
2. How should the value of trading stock be determined in the hands of a newly formed partnership, considering that a change in composition triggers the dissolution of the old partnership and the formation of a new one?<sup>27</sup>

In *Rose*, where a father gifted two-thirds of his business as a pastoralist to form an equal partnership, the High Court rejected the Commissioner’s assessment based on the former s 36 ITAA36, which deemed items of trading stock disposed at market value, if they were disposed outside of ordinary course of business.

The High Court decided that “unless the partnership can for the purposes of s 36 be considered as a *distinct entity* to which the assets were transferred” (emphasis added), former s 36 didn’t apply, since “it is directed at the disposal of the entirety of ownership in the assets and not the conversion of single ownership into collective ownership” (*Rose Principle*).

Unfortunately, the High Court omitted to discuss what value of trading stock should be recorded in the hands of the newly formed partnership. This hiatus in partnership taxation rules was never addressed in subsequent cases and leaves considerable uncertainty for the tax implications of partnership assets where there is a change in composition of partnership, except for trading stocks and depreciating assets, which are subject to specific statutory rules.

It is clear that the High Court reached the decision in *Rose* because at general law, a partnership is not a legal person. As mentioned in Part III of this article, currently, s 960-100(1)(d) ITAA97 deems a partnership as an entity. However, this definition is an empty concept; without being reified by further provisions, deeming it as owning asset, owing liability, deriving income or incurring expenses, it will not have meaningful operation. Therefore in the author’s view, the mere inclusion of partnership as an entity in s 960-100(1)(d) has no impact on the *Rose Principle*.

Subsequently, the *Rose Principle* was considered by the High Court in *FCT v Westraders Pty Ltd (Westraders)*<sup>28</sup> where Mason J (as agreed by Aickin J and Wilson J) provided:<sup>29</sup>

1. the then main operative trading stock provisions—former s 28 ITAA36 (the predecessor of s 70-35 ITAA97) and former s 31 ITAA36 (the predecessor of ss 70-45 and 70-50 ITAA97) did not apply to undivided fractional interests in property forming part of trading stock; and
2. it is also problematic for the application of former s 25 ITAA36 (the predecessor of s 6-5 ITAA97) to the proceeds of sale of an undivided fractional interest in property hitherto forming part of the vendor’s trading stock.

In the author’s view, Mason J’s decision in *Westraders* was a notable development of the *Rose Principle*, which stands for the proposition that, without specific statutory intervention, there should be no income tax implication arising from disposal of fractional interest in an asset.<sup>30</sup>

To overcome the decision in *Rose*, former s 36A ITAA36 was introduced, which was rewritten into ITAA97 as s 70-100 by the *Tax Law Improvement Act 1997* (Cth). Section 70-100 is clearly intended to apply to a change in the composition of partnership. The operation of s 70-100 is rather obscure, and its operation is discussed through the following example.

#### Example 5.1. Change in composition of a partnership holding trading stock

1. P1, P2 and P3 formed an equal partnership (PRS1) with \$100 cash contribution each. PRS used the \$300 to purchase an item of trading stock, which increased its value to \$450.
2. P3 sold her 1/3 interest in the partnership to P4; a new partnership (PRS2) came into existence.

Both a partner and a partnership are defined by s 960-100(1)(d) as an ‘entity’. It is reasonably clear that the ‘entity’, which is repeated eight times through s 70-100, means a partner (ie P1, P2 and P3 in the present example), rather than a partnership (ie PRS1 or PRS2 in the present example).

Thus, the section is triggered when an item of trading stock is no longer on hand of a partner. A partner can be interpreted as partners.<sup>31</sup> According to IT 2670, the test determining the stock on hand is whether an entity has the power to dispose of the stock. In a partnership context, this dispositive power seems to be owned by partners collectively. Thus, an item of stock stops being on hand when its dispositive power shifts from a group of partners (ie P1, P2 and P3) to another group of partners (ie P2, P3 and P4). The first group (ie P1, P2 and P3) is the transferor and the second is the transferee (ie P2, P3 and P4).

It follows that the section does not apply to partners who merely vary their interest between them, but the partners remain the same (eg P3 reduces her interest through a non-liquidation distribution or by selling portion of her interest to P2).

Generally speaking, since it is impossible for a *selling* partner (ie P3) to be a sole owner of an item of trading stock after the sale,<sup>32</sup> s 70-100(1)(a) reinforces the above

conclusion that the transferor means partners (not the partnership) include non-selling partners (ie P2 and P3). The requirement “the transferor is not the item’s sole owner” in s 70-100(1)(a) necessarily means that that s 70-100 does not apply where a partnership converts to a sole trader (eg P2 and P3 sell their interests to P1, which is curious, since this is the reverse situation to that of *Rose*).

Section 70-100(1)(b) effectively requires that at least some of the partners within a partnership selling trading stock must “still have an interest” in the specific item of trading stock after the sale (ie in the current example, P1 and/or P2 are required to retain their interest in the trading stock item after P3 has transferred her interest to P4). As explained in more detail below, it is now clear that a partner does not possess a fractional interest in a partnership asset unless the partnership agreement explicitly specifies such interests. Therefore the requirement of s 70-100(1)(b) can only be met if partners are considered to have a *collective* interest in an item of trade stock, although a partner, *individually*, is not regarded as having interest in that item.

This item was deemed to be disposed of at market value (\$450) by the transferor (ie P1, P2 and P3), and the transferee (ie P1, P2 and P4) is deemed to have received this item at market value under s 70-100(2) and (3). Thus, these sections reinforce that the transferor includes both selling and non-selling partners, and that the transferee includes both purchasing and non-selling partners. It follows that the profits on the sale (\$150) should be reported by PRS1, since it was a transfer collectively made by all partners.<sup>33</sup>

The operation of s 70-100(2) may seem counterintuitive because it requires not only the selling partner to report their share of profits, but also the non-selling partners, whose interest in the partnership has not changed. This can lead to dramatic outcomes, where the entire profits and losses of all items of trading stock can be crystallised by a fractional change in the partnership composition.

To mitigate the impact, s 70-100(4)–(9) provides, through election, a roll-over relief option where partners (eg P1 and/or P2) from the previous partnership (ie PRS1) have interests in an item whose total value is at least 25% of the market value of the item. As discussed below, generally speaking, a partner does not have a fractional interest in an asset. It is uncertain how this criterion can be met.

It is perspicuous that the election provides planning opportunity where P3, at high tax rate, can shift her share profit (\$50) by selling her interest to a low tax rate entity such as P4, which is a loss entity, thereby reducing their collective tax liability.

Section 70-100(10) counters the above planning strategy by rendering the election ineffective where:<sup>34</sup>

1. the item stops being trading stock in the hand of the transferor outside the course of ordinary family or commercial dealing; and

2. the consideration receivable by the transferor substantially exceeds the value of the item in the hand of the transferor as determined under s 70-100(4).

However, s 70-100(10) does not address the other side of the coin, which is loss shifting. For example, if the value of the trading stock item drops to \$10, P3, who has a carried-forward loss, may sell the item to P4, who has a high tax rate. Through election, there will be no tax on the sale of P3’s interest. Yet, the built-in loss of the trading stock is transferred from P3 to P4, who is in a better position to utilise the loss.

It can be observed that the roll-over election provides an opportunity to engage in built-in Gain/Loss Shifting, which is one form of Partnership Tax Arbitrage (as defined in Part II of this article). This type of activity is regulated by §704(c) IRC and its corresponding Treasury Regulations (as discussed in Part II of this article), under which:

1. the contributing partner is taxed on the pre-contribution gains and losses of the contributed property to a partnership; and
2. original partners are taxed on the gains and losses of a partnership accrued in a period before a new partner is admitted.<sup>35</sup>

In the author’s view, the roll-over relief in trading stock provisions as contained in s 70-100(4) (the similar roll-over relief provision [s 40-340(3)] in respect of depreciating assets) should have similar safeguard measures to §704(c) IRC in the US. Further, the operation of s 70-100 is overreaching and counterintuitive, since non-selling partners can either be subject to tax or reap extra tax loss on the disposal of a selling partner’s interest in a partnership, while their economic entitlements in respect of the relevant partnership have not changed. It seems desirable that s 70-100 should be amended to confine its operation to only selling partners.

## Section 2: Depreciating assets rules

As mentioned above, in parallel with former s 36A, former s 59AA ITAA36 was introduced to overcome the decision in *Rose*. In that case, the High Court ruled that there was no disposal in respect of a depreciating asset when there was only a change in fractional interest in the said asset.

The successors of the former s 59 ITAA36 are contained in Subdiv 40-D ITAA97. A notable difference with trading stock provisions (ie s 70-100) discussed above is that item 7 of s 40-40 ITAA 1997 specifies that a partnership, rather than any particular partner, ‘holds’ a depreciating asset that is a partnership asset. Therefore, for the purposes of the Depreciating Asset Provisions (ie Div 40 ITAA97), the relevant entity is the partnership itself, not the individual partner.

These provisions come into play when there is a change in the composition of a partnership, triggering the ‘balancing adjustment event’, as defined in s 40-295(2), for a depreciating asset of the partnership. The ‘termination value’, as defined in s 40-300, of the depreciating asset is considered its market value (s 40-300(2), item 5) at the

occurrence of that event. The effect of these provisions is to crystallise a gain or loss, which is the difference between the market value and its 'adjustable value' (s 40-85) for the relevant depreciating asset in the hands of that partnership (s 40-285). The new partnership that comes into existence after the change in composition is treated as having acquired the depreciating assets at market value (s 40-180(2), item 5).

Similar to the trading stock provisions, roll-over relief is provided by s 40-295(2) and s 40-340(3)-(7) ITAA97. In other words, the new partnership that comes into existence after the change in composition will step into the shoes of the old partnership and continue to depreciate the asset at the same rate as the old partnership (s 40-345).

The provisions concerning depreciating assets differ from the trading stock provisions in several aspects:

1. a 'balance adjustment event' can occur where there is a variance of interest between the partners, even if the partners remain the same, whereas 70-100(1) is only triggered when there is at least one partner who has changed;
2. roll-over relief seems to apply when the partnership converts into a sole trader because there is no sole owner requirement as contained in s 70-100(1)(a);
3. roll-over relief appears to be available even if the former partner only has a minimal interest in the recomposed partnership, since there is no equivalent 25% restriction under s 70-100(6)(b); and
4. there is also no similar constraint as contained in s 70-100(10), so roll-over relief is available even if the selling partner reaps substantial profits, reflecting the excess of the market value of a depreciating asset over its adjustable value.

As mentioned above, a pitfall inherent in any roll-over relief is that it offers the opportunity to engage in Gain/Loss Shifting (as defined in Part II of this article) by exploiting the difference between its market value and its tax cost (ie adjustable value in the case of depreciating assets).

In the author's view, the flexibility of roll-over relief in the case of a 'balancing adjustment event' arising from a change in the composition of a partnership offers considerable scope for Gain/Loss Shifting. Given the myriad concessions related to depreciating assets introduced by the government,<sup>36</sup> including significant immediate write-offs, during the pandemic period, the perceived opportunities for shifting built-in gains should attract the attention of policymakers.

It is worth noting that depreciating assets and items of trading stock are considered 'CGT assets', as defined in s 108-5 ITAA97. However, the capital gains or losses resulting from transactions involving depreciating assets and trading stock, triggered by a change in the composition of a partnership, are exempted by s 118-24 and s 118-25 ITAA97. These exemptions help avoid many complications arising from the concurrent operation of depreciating asset/trading stock rules as contained in Divs 40 and 70, and the capital

gains tax rules (CGT Rules) as found in Pt 3-1 and Pt 3-3 ITAA97.

### Section 3: Capital gains tax

It is generally recognised that the current CGT regime concerning partnerships (Partnership CGT Rules), including s 106-5, and s 108-5(2)(c) and (d) ITAA97, operates on the basis that "each partner has an undivided fractional interest in each and every partnership asset"<sup>37</sup> (referred to as the "Fractional Interest Approach").

However, in the author's view, Australian Partnership CGT Rules, in fact, adopt a dual-assets model. This is because s 108-5(2) recognises two types of assets in respect of a partnership: an interest in an asset of a partnership (ie the fractional interest) under s 108-5(2)(c) and an interest in a partnership that is not covered by the Fractional Interest Approach (Partner Residual Interest) under s 108-5(2)(d).

The Supplementary Explanatory Memorandum (SEM) of the Taxation Laws Amendment Bill 1991<sup>38</sup> provided the reason for introducing the former s 160A(e) ITAA36, which is the predecessor of s 108-5(2)(d). As explained in the SEM, this was because it was recognised that a partner had an interest (being a chose in action) in the partnership, and that interest itself was a 'CGT asset', which relates in whole or in part to interests in underlying partnership assets (which themselves are to be treated as separate assets). To avoid "double taxation" on the same effective gains, a partner's interest in the partnership was to be treated as a separate asset for CGT purposes only to the extent that its *value* did not relate to a partner's interests in individual partnership assets, which themselves are treated as separate assets for CGT purposes.

Consequently, it seems that the Partner Residual Interest is intended to capture something valuable within a partnership but not a 'CGT asset' as defined in s 108-5, which can be termed as an "Economic Asset".

Such types of Economic Assets are numerous and ubiquitous. The most prominent example is information<sup>39</sup> such as mining information, know-how, trade secrets, email accounts<sup>40</sup> and digital records.<sup>41</sup> It does not seem controversial that information can be considered partnership assets as a matter of partnership law.<sup>42</sup> Another example of such an Economic Asset is a character of a partner, such as skill, connection, command of the confidence and respect of other partners<sup>43</sup>, which other people want to access through becoming a member of that partnership. Besides the Economic Assets, it seems the Partner Residual Interest extends to the overprice captured by a selling partner of her interest in a partnership.

It is worth noting that in the US, some items of Economic Assets have long been recognised as intangible property,<sup>44</sup> such as going concern value, workforce in place, customer-based intangibles<sup>45</sup> and supplier-based intangibles,<sup>46</sup> among others. In Australia, the High Court recognised that the value of going concern value<sup>47</sup> is different from the value of goodwill and further adumbrated that going concern value can be regarded as property in Australia.<sup>48</sup>

Many items recognised in the US as intangible property have not been considered by the Commissioner and the court as to whether they are ‘CGT assets’ in Australia, as far as the author is aware. Given the fact that an Australian partner may sell an interest in a US foreign hybrid within the meaning of s 830-5 ITAA97, it is palpable that issues, even disputes, can arise when there is an advantage in classifying a transaction as selling a Partner Residual Interest instead of a fractional interest in the assets of a US foreign hybrid, or vice versa.

If it was accurately described in the SEM, this Partner Residual Interest appears to be elusive—it emerges when a partner’s interest has a value unassociated with her fractional interest in the partnership asset and vanishes with the disappearance of that value. Thus, for example, it seems that the Partner Residual Interest springs into the hand of a selling partner, where a purchaser is prepared to pay an overprice for her interest in the partnership. It also seems that the Partner Residual Interest would disappear where the source of its value evaporates (eg a trade secret has been made public). Given this coming and going nature, determining how the CGT Rules should apply to the Partner Residual Interest seems elusive (as discussed below and pursued further in Part VI of this article).

In the author’s view, the significance of Partner Residual Interest, as discussed above, has been ignored in Australian CGT practice in relation to partnerships, leading to an undue emphasis on the Fractional Interest Approach.

However, as discussed below, a series of cases in Australia deny that partners have a fractional interest in the assets of a partnership, except, perhaps, when such fractional interests are provided by the partnership agreement.<sup>49</sup> Further, in the author’s view, the Fractional Interest Approach is theoretically flawed because it is based on a conceptual confusion between capital gains and the asset or interest in an asset. On closer examination, it becomes evident that the current Partnership CGT Rules operate quite differently from what the legislation originally seemed to intend. Therefore, reforming the current Partnership CGT Rules appears necessary.

### Subsection 1: The development of case law in respect of fractional interest

At the introduction of the CGT in the mid-1980s, there was heated debate over whether capital gains should be accounted for by partnerships using the so-called “separate entity approach” or by partners using the Fractional Interest Approach.<sup>50</sup> Eventually, legislation was enacted in 1992 that endorsed the Fractional Interest Approach by introducing former s 160A(d) and (e) ITAA36—the predecessors of s 108-5(2)(c) and (d) ITAA97, and s 160C(3) ITAA36.<sup>51</sup> Former s 160C(3) explicitly excluded partnerships from the operation of former Pt IIIA ITAA36, then CGT provisions, by stating that partnerships were not considered taxpayers for the purpose of those provisions.

Currently, s 106-5(1) specifies that it is the partners who make a capital gain or loss from a CGT event, not the

partnership itself. Example 2 of s 106-5(1) illustrates how the Fractional Interest Approach is intended to operate. The Partnership CGT Rules were drafted on the foundation that, under general partnership laws, the partner has a fractional interest in the assets of the partnership,<sup>52</sup> which was a misconceived notion.

A series of cases in Australia have denied that a partner has a fractional interest in a partnership’s assets, according to partnership laws. These cases include two High Court decisions: *Commissioner of State Taxation (SA) v Cyril Henschke Pty Ltd*<sup>53</sup> and *Commissioner of State Revenue v Rojoda Pty Ltd (Rojoda)*,<sup>54</sup> as well as a Court of Appeal (Vic) decision, *Danvest Pty Ltd v Commissioner of State Revenue (Danvest)*.<sup>55</sup> The conclusion of those cases was captured by the High Court in *Rojoda* in the following passage:<sup>56</sup>

“unlike a beneficiary of a fixed trust, it was well established that a partner’s interest was not an interest in, or in relation to, any specific asset other than an entitlement to the partner’s share of the net proceeds from the sale of each asset at the completion of winding up. In other words, the only right that the partners have, both before and after dissolution, in relation to each asset is a right to the account and distribution after sale of the proceeds of that asset – ‘not to an individual proportion of a specific article, but to an account: the property to be made the most of, and divided’. Hence, a partner’s equitable interest is not accurately expressed as a ‘beneficial interest’, at least in the sense of being a right to any proportion of, or for the personal use of, or for the benefit from, any particular asset.” (footnotes omitted)

Thus, although each partner has a proprietary interest in each and every asset, they have no entitlement to any specific asset.<sup>57</sup> In *Hedges v FCT (Hedges)*,<sup>58</sup> the Full Federal Court noted the incongruence between the general partnership law position and Partnership CGT Rules. However, unfortunately, it did not provide any further guidance and proceeded on the basis that the parties had agreed<sup>59</sup> what the taxpayer proportionate interest was in the goodwill of the business carried on by the partnership.<sup>60</sup> The Full Federal Court seems to assume that a partner can have a fractional interest in the asset of partnership if the partnership agreement provides so.<sup>61</sup>

It conceivable that members in some foreign limited liability companies (LLCs) and limited liability partnerships (LLPs), which are subject to Australian Partnership CGT Rules through application of the ‘foreign hybrid’ rules within Div 832 ITAA97, may not have fractional interest in the asset of those structures. This will add difficulty for CGT Partnership Rules to operate based on Fractional Interest Approach. For example, the Court of Appeal in *Her Majesty’s Revenue and Customs v Anson* noted that, as found by The First-tier Tribunal, members did not own assets of an LLC incorporated in Delaware.<sup>62</sup>

The Partnership CGT Rules are deeming provisions. There is no reason why the ITAA97 cannot continue to deem partners to hold fractional interests in partnership assets for CGT purposes, despite the fact that such fractional

interest does not exist as a matter of general partnership law or foreign law. However, it is worth emphasising that this was not the original intent of the legislation when the Partnership CGT Rules were initially drafted,<sup>63</sup> and they were drafted on the basis that partners already hold such an interest under general partnership law. More importantly, in the absence of such a fractional interest, there is no mechanism to quantify a partner's interest in a partnership, which is essential for the Partnership CGT Rules to operate.<sup>64</sup> Thus, the non-existence of a partner's interest in a partnership under general partnership law in Australia and under foreign laws<sup>65</sup> raises serious doubts about the feasibility of adopting the Fractional Interest Approach as the theoretical foundation underpinning the operation of Partnership CGT Rules

To overcome *Danvest*, which denied that a partner has a fractional interest in the assets of the partnership for Victorian duty purposes, the *State Taxation Acts Amendment Act 2018* (Vic) introduced s 3H into the *Duties Act 2000* (Vic). Section 3H imposes transfer and landholder duty as if the partners collectively had a beneficial ownership of each item of partnership property, with their ownership shares proportionate to their 'partner's partnership interests' (s 3H(1)). The term 'partner's partnership interest' refers to the proportion of any surplus that the partner would be entitled to regarding capital if the partnership were to dissolve (s 3H(5)).

As discussed above (in Part IV), similar to s 3H(5), the US also utilises the concept of hypothetical liquidation in some instances to determine the partner interests in the assets of the partnership. For example, as previously discussed, the 'hypothetical transaction' under Treas. Reg. §1.743-1(d)(2) employs a hypothetical liquidation as the basis for determining a basis adjustment of an asset of the partnership, which is specific to a particular partner, after she has purchased a partner's interest in the partnership (§743(b) IRC).

Consequently, it is difficult to see how the Partnership CGT Rules can operate without similar hypothetical liquidation mechanisms, except probably where the partnership agreement provides that a partner has a specific interest in the assets of the partnership. Indeed, as discussed below, a hypothetical liquidation mechanism has been employed by the ITAA97 itself in s 803-35 to ascertain a partner's interest in the assets of a foreign hybrid company, which is treated as a partnership in Australia. Obviously, a member may not have an interest in an asset of such a company as a matter of foreign laws.

### **Subsection 2: Partnership CGT rules based on the fractional interest approach is flawed by design**

Even if there was hypothetical liquidation mechanism in the Partnership CGT Rules, the Fractional Interest Approach is nevertheless flawed, since it is based on conceptual confusion between a gain, and an asset or interest in asset. This misconception arises from the importation of the general partnership law principle that partnership assets are owned by partners individually into the tax context, and then extrapolating it into the wrong notion that partners

must also account for gains and losses made from the disposal of those assets.

Generally speaking, as recognised by Lord Lindley<sup>66</sup> more than a century ago, partnership is a venture where a partners contribute various resources, including capital, skill, connection, command of the confidence and respect of others. The ultimate object of a partnership will be the realisation and division of profits,<sup>67</sup> not dividing assets. This necessarily means that partners can agree to divide profits generated from an asset, without any necessary reference to their interest in that asset. That is, there is no correlation between the division of profits from an asset and an interest in that asset,<sup>68</sup> even if such an interest was ascertainable.

At general law, as far as it goes back to 1875 in *Robinson v Ashton*,<sup>69</sup> the court determined that the capital profits arising from sale of a capital asset (ie a cotton mill) should be divisible between the partners according to ratio of the division of business profits. In reaching that conclusion, the court did not inquire into the fractional interest of the partner in the said asset.

Capital profits or losses represent the amount by which the value (or net sale proceeds) of the partnership assets exceeds or falls short of their book value.<sup>70</sup> In the author's view, although capital gains for tax purposes and capital profits under partnership law may not be conceptually equivalent, capital profits should be the starting point for calculating capital gains. It is conceivable in many instances that the capital profits from dealing with partnership assets would be the same as capital gains.

It is worth interpolating that, for both Partnership Accounting (as defined in Part III of this article) and tax purposes, profits/losses from the disposal of trading stocks and depreciating assets by a partnership have always been accounted for by the partnership and distributed to partners according to their agreement or by operation of the law, without the need to inquire about each partner's fractional interest in them.

The author readily agrees that a partner's fractional interest in a partnership asset can be ascertained based on the dissenting judgment of Gageler J (as his Honour then was) in *Rojoda*. In his Honour's view, a partner's fractional interest in each partnership asset is equivalent to the proportionate share of the surplus to which each partner would be entitled under the partnership agreement in an immediate hypothetical liquidation of the said partnership (Surplus Proportionate Approach).<sup>71</sup> However, from a tax policy perspective, the issue with the Fractional Interest Approach is that it can lead to a tax outcome that is inconsistent with the economic arrangement between the partners. As may be recalled from the discussion in Part II of this article, in the US, §704(b) IRC and the Treasury Regulations promulgated thereunder prescribe elaborative distribution rules, aiming to achieve their ultimate goal: ensuring that the allocation of the Tax Items (as defined in Part II of this article) of a partnership among partners accurately reflects the economic arrangement of the partners.

### Example 5.2. The conceptual confusion underlying the fractional interest approach

1. P1, an investor, and P2, an entrepreneur, formed a partnership (PRS), with P1 contributing \$150 and P2 contributing \$50. P1 and P2 agreed to share the profits equally, including capital profits. PRS purchased a Capital Asset for \$200. A “Capital Asset”, as referred to in this Part, means that an asset that is only subject to CGT Rules as contained in Pt 3-1 and Pt 3-3 ITAA97.
2. PRS operated successfully for the next 10 years, during which P1 and P2 withdrew all the operating profits distributed to them. In year 11, the property was sold for \$500, which produced \$300 capital profits and capital gains.

Based on Example 5.2, the position under general partnership rules should be as follows:

1. At the formation of PRS, P1 contributed \$150, and P2 contributed \$50 as the initial capital.<sup>72</sup>
2. P1’s capital account was credited with \$150, and P2’s with \$50. Once the value of assets is credited in the capital account of PRS’s books, the property belongs to PRS as partnership assets.<sup>73</sup> The capital cannot be altered without the consent of all partners.<sup>74</sup> Therefore, capital and partnership assets are fundamentally different concepts,<sup>75</sup> since the value of assets fluctuates, while the capital remains constant.<sup>76</sup>
3. Profits generated by the business are divisible between partners according to their agreement. In the absence of an agreement, the default split is 50%:50%, as per s 24(1) of the *Partnership Act 1890* (UK).<sup>77</sup> These divided profits are credited to the partners’ current accounts.<sup>78</sup>
4. The capital profits (\$300) arising from the sale of the property are also divisible according to the agreement. In the absence of an agreement, they are divided in the proportions in which the profits of the business were divisible at the time of the sale.<sup>79</sup> These divided capital profits are also credited to the partners’ current accounts, from which a partner is entitled to withdraw, unless the partnership agreement imposes restrictions.<sup>80</sup>

From Example 5.2, it is discernible that there are three associated, but discrete, concepts:

1. sale proceeds, which were \$500;
2. capital profits, which amount to \$300. These capital profits were divided equally and credited into the current account, with each of P1 and P2 receiving \$150. Thus, in the present case, P1 and P2 each had \$150 of undrawn profits; and
3. capital—P1’s capital was \$150, and P2’s capital was \$50, remaining unchanged.

After the sale of the Capital Asset,<sup>81</sup> the surplus available for distribution to the partners was \$500, with P1 entitled to \$300 and P2 to \$200. It appears that if the Partnership CGT

Rules had a hypothetical liquidation mechanism in place, P1 and P2 would have had a fractional interest of 60% to 40% under the Surplus Proportionate Approach, determinative of their tax burden on the capital gains. This fractional interest of 60% to 40% is inconsistent with P1 and P2’s economic arrangement, which was a 50%:50% share of the capital profits.

The distortion mentioned above can be exacerbated when debts are involved. For instance, consider the same facts as in Example 5.2, with the exception that the partnership had to take out a loan to cover its operating loss of \$300 in year 10. This loss was distributed equally to P1 and P2, and debited into their respective current accounts. On the sale of the asset, the surplus amounted to \$200, which is the \$500 capital proceeds reduced by the loan. P1 and P2’s current accounts were at zero. In such a scenario, the capital gains are divided in a 75%:25% ratio between P1 and P2, based on the Surplus Proportionate Approach.

Further, it is not clear how the fractional interest in an asset should be determined under the Surplus Proportionate Approach when the hypothetical liquidation produces a deficiency rather than a surplus. For instance, in Example 5.2, PRS took out a \$600 loan to cover its operating loss of \$600 in year 10; thus, the market value of its assets fell below the loan.

There are situations where the fractional interest is simply impossible to discern. For example, when partners agree to share capital profits on an asset that belongs to one of the partners.<sup>82</sup> Yet another example is when the assets are funded by a non-recourse loan that exceeds the market value of the asset. In such a scenario, economically, it is the lender, not the partner, who has an interest in the assets. This scenario animates Treas. Reg. §1.704-2, which is designed to allocate deductions and gains arising from property funded by a non-recourse loan in the US (as discussed in Part II of this article).

It can be seen that the Fractional Interest Approach, as described above, has a proclivity to distort the quantitative relationship between capital profits for partnership law purposes and capital gains for tax purposes. This distortion creates inconsistency between the tax outcome and the economic arrangement of a partnership, which is undesirable from a tax policy perspective.

### Subsection 3: A view on current operation of CGT rules in respect of partnership

In the author’s view, without legislative intervention or guidance from the judiciary, the Partnership CGT Rules, underpinned by the Fractional Interest Approach, are neither theoretically sound nor practically workable. As demonstrated above, the Fractional Interest Approach is fundamentally flawed. Capital gains from an asset should not be allocated based on a partner’s interest in the asset itself, but rather on the partner’s share of the profits arising from dealings with the asset. This approach is consistent with the operation of Div 5A ITAA36 in Australia and Subchapter K of Chapter 1 IRC in the US—neither of them concerns itself with a partner’s fractional interest in assets

for the purpose of allocating profits/gains. The Partnership CGT Rules need to be reformed.

Therefore, in the author's view, it is probably useful to examine the current operation of the CGT Rules concerning partnerships, disregarding the Fractional Interest Approach as prescribed by s 106-5. This will provide a backdrop for reforming the Partnership CGT Rules.

It should be noted that, unlike former Pt IIIA ITAA36, which excluded partnerships from CGT Rules,<sup>83</sup> the current CGT Rules do not contain such an exclusion and therefore can, theoretically, apply to a partnership, being an entity recognised by s 960-100(1)(d) ITAA97.

In the past, although a partnership was deemed an entity for tax purposes, it was not a legal entity and, as such, did not own assets, owe liabilities or derive income.<sup>84</sup> Consequently, it was an empty concept without content, making it challenging to see how the partnership could have capital gains or capital losses.

However, in the author's view, there is a significant development in *Rojoda* where, after extensive discussion,<sup>85</sup> the High Court accepted that a partner's legal title to partnership property is held on trust for all the partners (Partnership Trust). The nature of the partners' rights under that trust is unique, and they differ significantly from the rights under a fixed trust. The rights of a partner under the trust are determined by partnership agreement.

The High Court further spelled out the nature of a partner's interest in the Partnership Trust—it is an equitable interest, with peculiar nature of the fluctuating, unascertained, non-specific in relation to partnership assets, which can be assigned<sup>86</sup> (Non-Specific Interest).

In the author's view, such a *sui generis* trust can be considered an entity within the meaning of s 960-100 ITAA97.<sup>87</sup> It follows that when the capital gains or losses are realised, it is the Partnership Trust that is, *prima facie*, responsible for the capital gains/losses (Partnership Trust Approach).

### Example 5.3. Capital asset purchased and sold by a partnership

1. P1 and P2 formed an equal partnership (PRS). The PRS purchased a Capital Asset for \$80, which is held on trust for P1 and P2 (ie the Partnership Trust), and sold it for \$120, resulting in a capital profit of \$40, which was *prima facie* made by the said trust.
2. They shared this capital profit equally, in a 50%:50% ratio, which is the same as their business profits ratio. The amount of the capital profits is equal to the capital gains.

The capital profit is distributed to the partners according to their business profits ratio, with each partner receiving \$20 credited to their current account. In this scenario, provided that the capital gains have been properly recorded according to their character (s 115-228(1)(c) ITAA97), it appears that P1 and P2 are specifically entitled

to the amount of capital gains under s 115-228. Each of them has received, or can reasonably expect to receive, their respective shares of net financial benefits (s 115-228(1)), which, in the present case, are the capital gains. The capital gains will be attributed to them based on their share of net financial benefits divided by the total net financial benefits.

The CGT Rules proceeding on the basis of the Partnership Trust Approach work reasonably well in respect of Partnership-Level Transactions, as demonstrated in Example 5.3. However, they produce many anomalies in respect of Partner-Level Transactions, and it could probably be broadly stated that all Australian tax rules in respect of Partner-Level Transaction produce considerable anomalies, which are subject to extensive discussion in this Part.

As discussed above, s 108-5(2) ITAA97 recognises, *inter alia*, two types of 'CGT assets' in relation to partnerships, namely the fractional interest in an asset of a partnership (s 108-5(2)(c)) and the Partner Residual Interest (s 108-5(2)(d)). As discussed above, as a matter of partnership law, a partner does not have a fractional interest in an asset of a partnership unless such an interest is specifically provided by a partnership agreement. That means that s 108-5(2)(c) does not operate, nor does the proviso "that is not covered by paragraph (c)" in s 108-5(2)(d) in most cases. Thus, it seems that this Non-Specific Interest falls squarely within s 108-5(2)(d), without said proviso.<sup>88</sup>

### Example 5.4. Formation of partnership

P1 and P2 formed an equal partnership (PRS), with P1 contributing \$100 cash and P2 contributing a Capital Asset with a market value of \$100 and cost base of \$60.

On formation of PRS, P1 and P2 seem to acquire an asset; that is, Non-Specific Interest with a cost base of \$100 under s 110-25 ITAA97. It seems that P2 will make capital gains on the whole asset contributed (\$40), most likely under E1 and alternatively under A1, since P1 did not retained any beneficial interest, as discussed above.<sup>89</sup>

In respect of PRS, it does seem that CGT event D1 occurs as the Partnership Trust creates an enforceable right in P1 and P2, which is similar to the right created by a company when allotting shares or a unit trust when issuing units. However, the issuance of shares and units is specifically excluded from CGT event D1 by s 104-35(5), which does not apply in the present case. The capital gains amount to \$200, less the incidental cost. These gains appear to be taxed in the hands of the Partnership Trust under s 99A ITAA36. The cost base of the asset in the hands of the Partnership Trust is the market value of the Non-Specific Interest issued to P1, presumably \$100, based on the rationale of TR 2008/5,<sup>90</sup> which provides that the cost base of assets acquired by a company by issuing its own shares is the market value of the issued share. According to TD 2002/25, the \$100 cash received is not considered a 'CGT asset'.

As a result, P2 is taxed on the gains of the entire asset (\$40) instead of \$20, as purportedly intended by the operation of s 106-5, which does not tax the interest in the asset retained by P2 under the Fractional Interest Approach. The capital gains arising under CGT event D1, as the Partnership Trust creates enforceable rights in both P1 and P2, are illusory. This is because, from an economic substance perspective, akin to the subscription of company shares or unit trust units, the subscription of interest in a partnership cannot be regarded as a taxable event.

#### Example 5.5. Change in the composition of partnership

1. P1 and P2 were equal partners in a partnership, PRS1, which held two assets: \$100 in cash and a Capital Asset with a market value of \$100 and a cost base of \$100. Both P1 and P2 had a Non-Specific Interest with a cost base of \$100.
2. The partnership agreement included a continuation clause.
3. In a subsequent year, when the market value of the Capital Asset increased to \$180, P3 purchased P2's Non-Specific Interest for \$140.
4. On the purchase of P2's Non-Specific Interest, PRS1 was dissolved, and P1 and P3 constituted a new partnership, PRS2.

P2 appeared to realise capital gains of \$40, since P2's Non-Specific Interest in RSP1 was either lost or destroyed under s 104-20,<sup>91</sup> triggering CGT event C1, or ended under s 104-25, triggering CGT event C2. P3 seemed to have paid \$140 to acquire P2's Non-Specific Interest in RSP2. However, it is important to note that the Non-Specific Interest in RSP2 did not come from P2 but somehow directly vested in P3.<sup>92</sup>

Counterintuitively, P1 also had tax implications to deal with from the transaction involving P3 purchasing P2's interest in PRS1, even though she was not a party to the transaction and may have had minimal involvement as a passive partner. P1's Non-Specific Interest in RSP1 disappeared; simultaneously, a non-specific interest in RSP2 sprang into P1's hand.

Similar to P2's Non-Specific Interest in RSP1, either a CGT event C1 or C2 happened to P1's Non-Specific Interest, since it was either lost or destroyed, or ended. It is arguable that the proceeds were the market value of P1's newly acquired Non-Specific Interest in RSP2. Thus, P1 also realised the capital gains of \$40. This seems like a surprising outcome, but theoretically, it has always been the case under the Partnership CGT Rules. This tax outcome is ignored in practice because it is seemingly generally accepted that Partner Residual Interest has no value.<sup>93</sup> As discussed above, the author does not agree with this view, especially when the relevant partnership has valuable Economic Assets other than CGT assets.

Intuitively, the cost base of P1's Non-Specific Interest in RSP2 should be \$140. The first element of the cost base is either the money paid or the market value of any other

property that P1 gave, or was required to give, in respect of acquiring the non-specific interest in RSP2 (worked out at the time of the acquisition) under s 110-25(2). Obviously, P1 did not make any monetary payment. It is not clear whether P1's Non-Specific Interest in RSP1 can be regarded as having been *given* in respect of acquiring P1's Non-Specific Interest in RSP2, since P1's Non-Specific Interest in RSP1 simply disappeared. The Commissioner seems to think that the property was given, within the meaning of s 110-25(2), to the vendor if it moves the transaction (TR 2008/5, para 81).

Alternatively, it seems that P1 may obtain the cost base of the Non-Specific Interest in RSP2 through the market value substitution rule under s 112-30. This is because P1 did not incur expenditure to acquire it, and the Non-specific Interest in RSP2 was not acquired under a CGT event D1 (s 112-30(3)(b)). CGT event D1, arguably, did not happen because P1's Non-Specific Interest in RSP2 was not different from P1's Non-specific Interest in RSP1, both of which are governed by the same agreement containing the continuance clause. Thus, the Non-Specific Interest in RSP2 is not a newly created right in the hands of P1. It is admitted that both paths to render the perceived market value to the cost base of Non-Specific Interest in RSP2 are murky. However, once again, it should be pointed out that this has always been the case under current practice of Partnership CGT Rules if the Residual Partners Interest is not ignored in practice.

Superficially, the asset seemed to have passed from RSP1 to RSP2. However, from a Partnership Trust perspective, under the Partnership Trust Approach, given the existence of a continuation clause, the Partnership Trust continuously held the asset for the partners. In this scenario, since the partnership agreement continuously governed the relationship between the current partners (P1 and P3), capital gains should not arise concerning the said Capital Asset.<sup>94</sup> However, if the current partners had entered into a new partnership agreement, there could be capital gains arising in respect of the asset in the hand of Partnership Trust. As a sidenote, *Rojoda* seems to portend the possibility that even a change in partnership agreement between the *same* partners might trigger the capital gains.

Further, it is arguable that the Partnership Trust did not undergo a CGT event D1, as at the formation. From the Partnership Trust perspective, P1 had the same right against the Partnership Trust under the same agreement (which has the continuance clause), although from P1's perspective, P1's Non-Specific Interest in RSP1 substituted with a Non-Specific Interest in RSP2. In the same vein, P3 had the same right as P2 before the transaction, as against the Partnership Trust, and there was no new Non-Specific Interest created from the Partnership Trust perspective.

Based on the above discussion, it is author's view that the Partnership Trust Approach can operate under current legislation but with unintended consequences. Therefore, it can be concluded that CGT Rules in respect of partnership

cannot work sensibly under either the Fractional Interest Approach or the Partnership Trust Approach.

In reforming the CGT Rules concerning partnerships (a topic clearly beyond the intended scope of this article), it seems to the author that capital gains should be allocated according to the distribution of capital profits arising from dealing with a capital asset, in line with the economic arrangement agreed on by the partners. The recognition of a Partnership Trust under general law removes the obstacle for a partnership to be regarded as a full-fledged entity for tax purposes. In general, legislation should be introduced to eliminate capital gains on formation and on technical dissolution by providing roll-over reliefs. Further, rules should be introduced to allow capital losses to flow to partners.

Given the considerable uncertainties associated with the Partnership CGT Rules, it would be an arduous pursuit to have a meaningful discussion about the interaction between the Partnership CGT Rules and other taxing rules concerning partnerships in Australia, as well as taxing rules in respect of partnerships in the US (through foreign hybrid rules contained in Div 830 ITAA97). Fortunately, in the *Hedges*, the Full Federal Court encountered a similar challenging situation and extricated itself by assuming that the relevant partner had a fractional interest in the partnership asset under the agreement.<sup>95</sup> Thus, the author proposes to take this lead and will proceed with further discussion hereinafter in respect to the Partnership CGT Rules on the basis that the partner has a fractional interest in the partnership asset because the partnership agreement provides for it.

### Section 4: Works in progress

Antithetically, s 15-50 ITAA97 includes assessable income of the recipient, whereas s 25-95 provides a deduction for a “work in progress (WIP) amount”. This amount is defined by s 25-95(3) as “the amount in respect of partially performed (but not goods), yet to be matured into recoverable debt on its completion”.

According to the explanatory memorandum to the Taxation Laws Amendment Bill (No. 5) 2002, s 15-50 and s 25-90 (WIP Provisions) were introduced to overcome the double taxation of amounts paid or received in respect of the WIP amount, as a result of series of court decisions.<sup>96</sup>

It should be noted that the Administrative Appeals Tribunal, in the first instance of *Crommelin v DCT*,<sup>97</sup> ruled that WIP was considered an asset for capital gains purposes. On the contrary, the Commissioner considers that WIP is not a CGT asset within the meaning of s 108-5 but nevertheless an asset.<sup>98</sup> If WIP is indeed considered an asset, it is arguable that the WIP amount should not be assessable when only partial disposals are involved, following the *Rose* Principle. Just as partial disposals of trading stocks and depreciating assets are not assessable, in the absence of specific statutory provisions to the contrary. Of course, this issue becomes academic after the enactment of the WIP Provisions.

### Example 5.6. Illustration of the operation of WIP provisions

1. P1, P2, and P3 are equal partners in an accountancy practice partnership (PRS1). P3 decided to leave the practice, which led to the dissolution of PRS1 and the creation of a new partnership (PRS2). P3 was paid \$100, with \$40 allocated as P3's share (1/3) of the WIP amount and \$60 for goodwill (with a cost base of nil), as specified in the agreement.
2. The \$40 is assessable to P2 under s 15-50. It appears that when the job has been completed, the entire fee would be included in the process of calculating the ‘net income’ of PRS2 and distributed to P1 and P2. P1 and P2, personally, can claim a deduction of \$20 each under s 25-95 for the payment of \$40 to P3.
3. There was a capital gain of \$60 on the sale of P3's interest in the goodwill. P1 and P2 each acquired 1/6 of the goodwill for \$30.

It is reasonably clear that the WIP amount is assessable and deductible in the hands of partners, thereby bypassing the operation of Div 5 ITAA36. Consequently, the statutory methodology for calculating the taxable amount in respect of the WIP amount differs from the methodology employed in the partial disposal of trading stock (s 70-100 ITAA97) and depreciating assets under the Depreciating Asset Provisions. In the author's view, WIP, trading stock, depreciating assets and goodwill, among others, are assets of the partnership from an economic perspective, and they should be treated in a consistent manner to achieve tax neutrality.

Generally speaking, receipts in respect of WIP seem inherently on a revenue account and therefore should be assessable as such. This is the policy underlying the “hot asset” rules contained in §751 IRC (as discussed in Part IV of this article).

As it turns out, the WIP Provisions operate in a manner similar to the “hot asset rules” in the US and achieve their intended policy objective. They ensure that the WIP amount is isolated from other assets (eg the goodwill in Example 5.6) and taxable in the hands of the exiting or selling partner (ie P3) as revenue, to the extent of her interest in the WIP. Simultaneously, tax neutrality is achieved by providing a deduction to the remaining or purchasing partners. This avoids the anomalies that arise from the deemed disposal of the entire WIP, which was employed in relation to the partial disposal of trading stock and depreciating assets.

### Section 5: Revenue asset rules

Gains made from an asset in an isolated transaction can be nevertheless assessed as ordinary income under s 6-5 (Revenue Gain), in accordance with the principle in *FCT v Myer Emporium Ltd*<sup>99</sup> (*Myer Emporium* Principle) where:<sup>100</sup>

1. the intention or purpose of the taxpayer in entering into the transaction was to make a profit or gain; and

- the transaction was entered into, and the profit or loss was made, in the course of carrying on a business or in carrying out a business operation or commercial transaction.

This type of asset is now termed the 'revenue asset' under s 977-50 ITAA97. Examples of such assets include:

- investments held by an investment partnership for the purpose of producing income;<sup>101</sup> or
- one-off land development project undertaken by a syndicate.<sup>102</sup>

According to *Tikva Investments Pty Ltd v FCT (Tikva)*,<sup>103</sup> if the 'revenue assets' are sold by the partnership, the gains constitute the 'net income' of the partnership. However, the tax implications of changing a partner's interest have not been fully addressed by the court or the Commissioner. In both *Tikva* and *Sarich v FCT (Sarich)*,<sup>104</sup> there was a disposal of a partner's interest, but the cases were silent on the implications on them, since they were not the issues agitated therein.

The following discussion proceeds on the basis that *Myer Emporium* Principle does not apply to a change in the composition of partners in a partnership itself, such as the sale of a partner's interest or distribution made to a partner in liquidating her interest.

#### Example 5.7. Disposal of a partner interest in a partnership with revenue assets

- P1, P2 and P3 formed a partnership (PRS1), with each contributing \$30 in cash for the purpose of acquiring and developing two pieces of property for sale at a profit.
- In a subsequent year, PRS1 spent \$30 to acquire and develop Property 1 (Prop1), which had a market value of \$90 upon completion, and \$60 to acquire and develop Property 2 (Prop2), which had a market value of \$180 upon completion. Therefore, Prop1 had built-in profits of \$60, and Prop2 had built-in profits of \$120 for the purposes of calculating both Revenue Gains and capital gains.
- P3 encountered financial difficulties and sold P3's interest to P4 for \$115, with P4 overpaying by \$25. Consequently, RSP2 came into existence with P1, P2 and P4 as partners.

It is uncontroversial that if PRS1 were to sell either or both of the properties, the resulting profits would be classified as Revenue Gains. Since this is a partial sale, it does not appear that the profits would be assessable. This is because, according to the *Rose Principle*, vesting rights in P4 do not constitute a disposal of an asset. There appears to be a tacit acceptance of the *Rose Principle* in *Tikva, Sarich and Watson v FCT (Cth)*.<sup>105</sup> In all of these cases, there were changes in the composition of partnerships engaged in a profit-making scheme concerning land, but they all seemed to proceed on the basis that there were no tax implications arising from such changes.

Consequently, this transaction only triggers CGT consequences. Owing to the considerable uncertainty associated with the operation of current Partnership CGT Rules, for the sake of further discussion, it is proposed that the approach taken in *Hedges* is adopted. This involves assuming that the partnership has an agreement specifying that each partner has a 1/3 interest in the Prop1 and Prop2, which is a happenstance in practice.

For CGT purposes, the cost base for each partner is summarised in Table 5.1.

Thus, from a CGT perspective, P3 realised gains of \$20 on Prop 1 and \$40 on Prop 2. Although Prop 1 and Prop 2 are 'revenue assets', interestingly, it seems that P3 can access CGT concessions such as the discount capital gains under Subdiv 115-A ITAA97 and small business concessions under Div 152 ITAA97 small business relief, provided other conditions in those provisions are met.

In addition, there was \$25 from the disposal of her Partner Residual Interest (s 108-5(2)(d)), which equalled the \$25 overpaid price paid by P4. As discussed above, it is not clear when P3's Partner Residual Interest came into existence. Perhaps it came into existence at the time when the P4 and P3 sales contract was entered into because only at that time could it be established that this Partner Residual Interest was not covered by P3's fractional interest in the assets of PRS within the meaning of s 108-5(2)(d). If this is the case, this Partner Residual Interest has different characteristics from P3's fractional interest in Prop1 and Prop2. One consequence is that capital gains arising from the disposal of Partner Residual Interest cannot access the discount capital gains under Subdiv 115-A ITAA97, since it was owned by P3 for less than a year.

After the transaction, the cost base of each partner are as follows in Table 5.2.

**Table 5.1. Cost bases of properties prior to the sale of P3's interest**

	Prop 1				Prop 2			
	Total	P1	P2	P3	Total	P1	P2	P3
Market value	90.00	30.00	30.00	30.00	180.00	60.00	60.00	60.00
Cost base	30.00	10.00	10.00	10.00	60.00	20.00	20.00	20.00
Built-in gains	60.00	20.00	20.00	20.00	120.00	40.00	40.00	40.00

**Table 5.2. Cost bases of properties after the sale of P3's interest**

	Prop 1				Prop 2			
	Total	P1	P2	P4	Total	P1	P2	P4
Market value	90.00	30.00	30.00	30.00	180.00	60.00	60.00	60.00
Cost base	50.00	10.00	10.00	30.00	100.00	20.00	20.00	60.00
Built-in gains	40.00	20.00	20.00	-	80.00	40.00	40.00	-

It appears curious that immediately after P4 purchased P3's interest, she did not have a Partner Residual Interest, since it could not be established that P4 had an interest in PRS 2 that was not covered by her fractional interest in Prop 1 and Prop 2. In other words, P3's Partner Residual Interest, arising from overpayment by P4, disappeared after the transaction. The author is aware that, in practice, the overpaid price by P4 for P3's interest is often simply translated into an increase in the cost bases of Prop1 and Prop2, or becomes part of the cost base of goodwill.<sup>106</sup> However, the author is not convinced that the \$25, characterised as proceeds from the disposal of P3's Partner Residual Interest, could be simply transformed into the cost bases of Prop1 and Prop2, or goodwill.

On the sale of Prop1 and Prop2 by PRS 2, it seems that there were gains on the revenue account as per *Tikva* and *Sarich*, but the quantum of those gains were uncertain, given the fact that the Prop1 and Prop 2 were passed from RSP1 to RSP 2. As alluded to above, the High Court did not rule what should be costs of trading stock and a depreciating asset of the partnership formed after the father gifted his 2/3 interest in those assets to his two sons in *Rose*. In *Tikva* and *Sarich*, it seems to be assumed that the cost of transferee partnership was the original cost of property in the hand of transferor partnership (Original Cost Method); that is, the cost of Prop1 and Prop2 in the hand of PRS2 should be the original cost in the hand of PRS1.

In *Tikva*, Mr Krasnostein, a partner in a partnership that intended to speculate on a piece of land located in Mullaloo, near Perth, gifted a share in the partnership to Tikva, a company controlled by him. Stephen J<sup>107</sup> held that Tikva should include its individual interest in the 'net income' of the partnership in its assessable income. This 'net income' was profit made from selling the Mullaloo land, calculating by deducting from the sale proceeds only its initial cost to the syndicate plus sequent expenditure on it.<sup>108</sup>

It seems that when Tikva was admitted into the partnership, the Mullaloo land was not revalued to market value, because his Honour specifically left this question open regarding how the profits should be calculated when a new firm takes up the market value in a reconstituted set of accounts.<sup>109</sup>

Surely, in the author's view, how the partnership accounts are prepared should not control the tax outcome. Therefore, *Tikva* represents a missed opportunity to provide judicial guidance on what tax cost a new partnership (ie PRS2) should take up in respect of the assets of the old

partnership (ie PRS1) dissolved because of a change in the composition of that partnership, which is regrettable.

Again, in *Watson v FCT*,<sup>110</sup> the Original Cost Method was used to calculate the profit of selling land on revenue account under former s 26(a) ITAA36 by a new partnership formed because of the death of a partner in the old partnership, and a portion of that profit was included in the assessable income of the deceased estate of that partner.<sup>111</sup>

Similarly, in *Sarich*, the court provided that:

1. the profits from the sale of revenue assets by a partnership were ascertained on the basis of the Original Cost Method. These assets had been owned by two previous partnerships, which had been dissolved because changes occurred in their composition; and
2. the payments made by other partners to acquire the interest of two exiting partners were not deductible to the paying partners on the basis that what they purchased was an equitable interest in the partnership assets, so it constituted outgoings of a capital nature. Importantly, it did not address the issue of whether the payment could be considered an additional cost to ascertain, thereby reducing the profits made by the partnership.

Returning to the example, under the Original Cost Method, PRS2 would realise profits on revenue of \$60 from Prop1 and \$120 from Prop2 on the sale of them. These profits would be distributed to P1, P2 and P4, and each of them would be assessed on \$60. Simultaneously, P1 and P2 would realise capital gains of \$60, which would be reduced to nil under s 118-20. In contrast, P4 would make no capital gain. The outcomes of the sale of Prop1 and Prop2 by PRS2 are summarised in Table 5.3.

**Table 5.3. Outcomes of property sales by the succeeding partnership**

	Sale of revenue property			
	Total	P1	P2	P4
Revenue gains	180.00	60.00	60.00	60.00
Concurrent capital gains	120.00	60.00	60.00	-

The Revenue Gain of \$60 distributed to P4 is double taxed, since she made no economic gain. The double taxation issue is exacerbated by the overpayment of \$25 (see the above comment on her Partnership Residual Interest).

**Example 5.8. Distribution of a revenue asset to a partner**

- The facts are the same as those in the previous example, except that PRS 2 decided to distribute Prop1 to liquidate P2's interest in PRS 2, after P3 sold her interest to P4 for \$90.
- The essence of the distribution to P2 is that P2 exchanged her 1/3 interest in Prop2 for 2/3 interest in Prop 1, whereas P1 and P4 gave up their 1/3 interest in Prop2 to increase their interest in Prop 2 by 1/6. The CGT consequences are as follows:

Capital gains summary on distribution	Prop 1		Prop 2
	P1	P4	P2
Proceeds (market value)	30.00	30.00	60.00
Cost base	10.00	30.00	20.00
Built-in gains	<b>20.00</b>	-	<b>40.00</b>

- Thus, from her perspective, P2:
  - made capital gains of \$40 on the disposal of her 1/3 interest in Prop2;
  - kept her 1/3 interest in Prop1 with an original cost base of \$10; and
  - acquired a 2/3 interest in Prop1 with a cost base of \$60.
- From P1's perspective, she:
  - made capital gains of \$20 on the disposal of her 1/3 interest in Prop1;
  - kept her 1/3 interest in Prop2 with an original cost base of \$20; and
  - acquired a 1/6 interest in Prop2 with a cost base of \$30.
- From P4's perspective, she:
  - made capital gains of \$0 on the disposal of her 1/3 interest in Prop1;
  - kept her 1/3 interest in Prop2 acquired from P3 with a cost base of \$60; and
  - acquired a 1/6 interest in Prop2 with a cost base of \$30 from the current distribution.
- The cost bases of Prop1 and Prop2 after the distribution are summarised in the following table:

Cost base summary after distribution	Prop 1		Prop 2
	P2	P1	P4
Cost base (before the distribution)	10.00	20.00	60.00
Cost base acquired from distribution	60.00	30.00	30.00
Total	<b>70.00</b>	<b>50.00</b>	<b>90.00</b>

If the new partnership (PRS3), comprising P1 and P4, sold Prop2 for \$180, under the Original Cost Method, the Revenue Gains would be \$120, which would be distributed equally to P1 and P4. However, from a CGT perspective, P1 would make capital gains of \$40, which would be reduced to nil under s 118-20, and P4 would have made no capital gains. Again, P4 is subject to double taxation.

The operation of Australian taxation rules in respect of 'revenue assets' held by a partnership is odd. In essence, when a partner sells her interest in the partnership or when a 'revenue asset' is distributed to a partner, only CGT implications occur for the partners. Revenue Gains and Losses only arise when the 'revenue asset' is sold by a successive partnership, which flow to the partners of that successive partnership. It seems that these Revenue Gains and Losses should be calculated based on costs, such as acquisition costs and construction costs, incurred by one or more predecessor partnerships under the Original Cost Method, which can lead to either double taxation or loss duplications. It is conceivable that other methods, such as those based on market value taken up by the successive partnership for its accounting purposes, can be equally problematic.

In the author's view, the issues associated with a partnership holding 'revenue assets', as discussed above, arise because there is no mechanism to adjust the cost of the 'revenue asset' when there is either a sale of a partner's interest or a liquidated distribution made to a partner. These issues are subject to §734(b), §743(b) and §755 IRC (as discussed in Part IV of this article). The US practice in this regard demonstrates that these issues do not easily lend themselves to a solution, which might only be attainable through the introduction of convoluted rules similar to those found in Treasury Regulations promulgated under §734(b), §743(b) and §755 IRC.

Finally, it is worth emphasising that, as canvassed in this Part, the current Partnership CGT Rules adopt a dual assets model, which is often ignored in Australian partnership CGT practice. However, the concept of Residual Partnership Interest is always lurking nearby and comes into operation whenever there is a change in the composition of a partnership where:

- the partnership agreement does not specify that the partners have specific interest in the partnership asset;
- there is overpayment for the purchase of an interest in a partnership, as have been touched on in Example 5.7; and/or
- the partnership has Economic Assets, which will be revisited in the Part VI where foreign hybrid rules are discussed in the US context.

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**References**

- Treas. Reg §1.705-2(a).
- Congress has acknowledged the fundamental equality between the aggregate bases of partnership assets and the aggregate bases of partners for their partnership interests in the "alternative rule" of §705(b), which provides for the determination of a partner's basis in his interest by reference to his proportionate share of the basis of partnership assets.

- 3 *US v Basye*, 410 US 441, 448 n. 8 (1973).
- 4 A gain may be recognised by the contributor under §721(b) in connection with contributions to investment partnerships, which is not discussed in this article.
- 5 B Bittker and L Lokken (n.d.), *Federal tax of income, estates and gifts*, Warren, Gorham & Lamont, para 40.8.7. Available at <https://1.next.westlaw.com> (accessed 10 September 2023).
- 6 ‘Ordinary income’ is defined in §64 IRC. Ordinary loss, as used in this article, has the opposite meaning.
- 7 The operation of §743(b) is extended by §732, which applies where the election provided in §754 is not in effect, partnership property is distributed to a transferee within two years of the date he acquires his interest, the transferee may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in §743(b) were in effect with respect to the partnership property.
- 8 §743(b) also applies to transfer upon the death of a partner, which is not discussed herein.
- 9 Under §1231, real or depreciable property used in a trade or business and held for more than one year. It includes buildings, equipment, land, timber, natural resources, crops, livestock and leaseholds. A gain from the sale of §1231 property is taxed at the lower capital gains rate, while a loss is deductible as ordinary income.
- 10 This example is based on Treas. Reg. 1.755-1(b)(2)(ii) example 1 and 1.755-1(b)(2)(iv) example 2.
- 11 This example is based on Treas. Reg. 1.755-1(c)(6).
- 12 This example adopts the example (with modification) at B Bittker and L Lokken (n.d.), *Federal tax of income, estates and gifts* [online], Warren, Gorham & Lamont, para 88.5.3.
- 13 Based on example 88-1 in B Bittker and L Lokken (n.d.), *Federal tax of income, estates and gifts*, Warren, Gorham & Lamont, para 88.2. Available at <https://1.next.westlaw.com> (accessed 10 September 2023).
- 14 W McKee, W Nelson and R Whitmire, R (n.d.), *Federal taxation of partnerships and partners*, Thomson Reuters, para 21.03. Available at <https://1.next.westlaw.com> (accessed 10 January 2024).
- 15 B Bittker and L Lokken (n.d.), *Federal tax of income, estates and gifts*, Warren, Gorham & Lamont, para 88.2.3. Available at <https://1.next.westlaw.com> (accessed 10 September 2023).
- 16 Defined in §724(d)(1), which is further defined by reference to §751(c).
- 17 Defined in §724(d)(2), which is further defined by reference to §751(d).
- 18 §724(d)(2). In very general terms, §1231(b) quasi-capital assets include assets on revenue account, which are used in a taxpayer’s trade or business
- 19 Capital loss property is used in §724 but is not defined in §724, and no Treasury regulations have been promulgated.
- 20 Treas. Reg. §1.731-1(a)(2)(ii); W McKee, W Nelson and R Whitmire, R (n.d.), *Federal taxation of partnerships and partners*, Thomson Reuters, para 19.05.
- 21 Treas Reg §1.731-1(a), example 2.
- 22 HR Rep. No. 247, 101st Cong., 1st Sess. 1356 (1989).
- 23 W McKee, W Nelson and R Whitmire, R (n.d.), *Federal taxation of partnerships and partners*, Thomson Reuters, para 19.08 [1]. Available at <https://1.next.westlaw.com> (accessed 10 January 2024).
- 24 A change in composition is used in broad sense—to include not only the admission of new partners and retirement a partner, but also the formation of a partnership or cessation of partnership because of the retirement of partners, such as two partners retiring from a three-partner partnership.
- 25 *Glenfield Estates Pty Ltd v FCT* (1988) 19 ATR 1426 at 1443.
- 26 *Rose v FCT* (1951) 84 CLR 118.
- 27 R Banks (2022), *Lindley & Banks on partnership* (21st ed.), Sweet & Maxwell, para 24-03; *James L.J., in Smith v. Anderson* (1880) 15 Ch. D 247, at p. 274.
- 28 *FCT v Westraders Pty Ltd* (1980) 11 ATR 24 (*Westraders*).
- 29 *Westraders* at [36]–[37].
- 30 It appears that GT Pagone took a similar view in his article “Capital gains tax and partnerships”, (1988) 17 *Australian Tax Review* 76 at 84 .
- 31 This is demonstrated by s 70-100(10)(b), which contains the sentence in brackets “or by any of the entities constituting the transferor”.
- 32 Unless through such unusual means, such as granting an option over land (in which case, there is no change in interests in the land—*Glenfield Estates Pty Limited v FCT* 88 ATC 4548).
- 33 See private rulings: 1012595772097, 1051351626886 and 1051338195433.
- 34 For examples of the application of s 70-100(10), refer to private rulings: 1012595772097, 1051351626886 and 1051338195433.
- 35 §1.704-1(b)(2)(iv)(f).
- 36 Such as Subdiv 40-BA and 40-BB of the *Income Tax (Transitional Provisions) Act 1997*.
- 37 T Russell and C Evans (n.d.), *Australian CGT handbook*, Thomson Reuters Australia, para 21 010. Available at <https://www.checkpointau.com.au> (accessed 17 September 2023).
- 38 Notes on clause 44.
- 39 *FCT v United Aircraft Corporation* (1943) 68 CLR 525 at 531. Law Commission (UK) (2022), *Digital assets consultation paper*, ch 3. Available at <https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2022/07/Digital-Assets-Consultation-Paper-Law-Commission-1.pdf>.
- 40 Law Commission (UK) (2022), *Digital assets consultation paper*, ch 7.
- 41 Law Commission (UK) (2022), *Digital assets consultation paper*, ch 6.
- 42 R Banks (2022), *Lindley & Banks on partnership* (21st ed.), Sweet & Maxwell, para 18-38.
- 43 R Banks (2022), *Lindley & Banks on partnership* (21st ed.), Sweet & Maxwell, para 19-34.
- 44 §197(d)(1) IRC.
- 45 As defined in §197(d)(2) IRC as meaning (i) composition of market, (ii) market share and (iii) any other value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers.
- 46 As defined in §197(3) IRC as meaning any value resulting from future acquisitions of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer.
- 47 *Commissioner of State Revenue (WA) v Placer Dome Inc.* [2018] HCA 59 at [97].
- 48 *Commissioner of State Revenue (WA) v Placer Dome Inc.* [2018] HCA 59 at [98].
- 49 *FCT v Everett* 78 ATC 4595, Dean J at [4603].
- 50 C Evans, A Kayis-Kumar and T Russell, *Australian CGT handbook* [online], Thomson Reuters, para 21 010.
- 51 Taxation Laws Amendment Bill 1991.
- 52 D Breznik (2023), *The application of capital gains tax to partnership assets: challenges and reform*, (winner of the Law Council’s Forsyth/Pose Scholarship 2023 for a paper in the field of taxation), p. 22.
- 53 (2010) 242 CLR 508.
- 54 *Commissioner of State Revenue v Rojoda Pty Ltd* [2020] HCA 7 (*Rojoda*).
- 55 [2017] VSCA 382.
- 56 *Rojoda* at [33].
- 57 *Popat v Shonchhatra* [1997] 3 All ER 800 at 805 (Nourse J).
- 58 *Hedges v FCT* [2022] FCA 1389 (*Hedges*).
- 59 *Hedges* at [17]–[27].
- 60 In fact, what was agreed is not completely clear. The parties agreed that the appellant’s proportionate interest in the *Partnership* was 13.435%, which seems to be taken as proportionate interest in *each asset* of the partnership.
- 61 *Popat v Shonchhatra* [1997] 3 All ER 800 at 805 (Nourse J); R Banks (2022), *Lindley & Banks on partnership* (21st ed.), Sweet & Maxwell, para 19-16.
- 62 [2013] STC 557 at [25].
- 63 D Breznik (2023), *The application of capital gains tax to partnership assets: challenges and reform*, (winner of the Law Council’s Forsyth/Pose Scholarship 2023 for a paper in the field of taxation), p. 24.
- 64 *Ibid*, p. 22.
- 65 The absence of fractional interest provisions in foreign laws appears to animate the introduction of s 830-35(2) ITAA97 (to be discussed in Part VI of this article). This provision is applicable exclusively to a foreign hybrid company, as defined in s 830-10.
- 66 R Banks (2022), *Lindley & Banks on partnership* (21st ed.), Sweet & Maxwell, para 19-34.
- 67 *Ibid*, para 21-01.
- 68 Cf. *BCM Cayman LP v HMRC* [2023] EWCA Civ 1179, para 83-86.
- 69 (1875) LR 20 Eq 25.
- 70 R Banks (2022), *Lindley & Banks on partnership* (21st ed.), Sweet & Maxwell, para 17-06.
- 71 [2020] HCA 7 at [86].

- 72 R Banks (2022), *Lindley & Banks on partnership* (21st ed.), Sweet & Maxwell, para 17-01.
- 73 *Ibid*, para 17-03.
- 74 *McClelland v Hyde* [1942] NI 1 at 6; R Banks (2022), *Lindley & Banks on partnership* (21st ed.), Sweet & Maxwell, para 17-17.
- 75 R Banks (2022), *Lindley & Banks on partnership* (21st ed.), Sweet & Maxwell, para 17-02.
- 76 *McClelland v Hyde* [1942] NI 1 at 7. Also, Nourse LJ in *Reed (Inspector of Taxes) v Young* [1984] STC 38 at 57, approved by the House of Lords [1986] STC 285 at 289.
- 77 Or equivalent legislations of Australian states.
- 78 R Banks (2022), *Lindley & Banks on partnership* (21st ed.), Sweet & Maxwell, para 24-04.
- 79 *Robinson v Ashton* (1875) LR 20 Eq 25, cited by Murphy LJ in *McClelland v Hyde* [1942] NI 1 at 18
- 80 R Banks (2022), *Lindley & Banks on partnership* (21st ed.), Sweet & Maxwell, para 10-172.
- 81 Based on the example, the division of surplus would remain the same if all the assets of PRS had been sold at market value, and then a liquidation were assumed to occur immediately before the sale of that capital asset.
- 82 R Banks (2022), *Lindley & Banks on partnership* (21st ed.), Sweet & Maxwell, para 18-07.
- 83 Former s 160C(3) ITAA 36.
- 84 *Rowe (B & HG) v FCT* 82 ATC 4243 at [4244].
- 85 *Rojoda* at [3] and [30]–[38].
- 86 *Rojoda* at [39] and [41].
- 87 It is immaterial for the present purposes, whether it is classified as a partnership under (d) or alternatively as trust under (f) of s 960-100(1) ITAA97.
- 88 It should be noted that interest covered by the whole s 108-5(2)(d) is referred to as Partnership Residual Interest, in contrast with Non-Specific Interest.
- 89 *Taras Nominees Pty Ltd as Trustee for the Burnley Street Trust v FCT* [2015] FCAFC 4.
- 90 Paras 77 to 90 of TR 2008/5.
- 91 GT Pagone (1988), “Capital gains tax and partnerships”, (1988) 17 *Australian Tax Review* 76 at 87.
- 92 G Muir (1985), *The termination of partnerships and the assessability of consequent receipts* (1985) 14(2) *Australian Tax Review* 94 at 111.
- 93 GT Pagone (1988), “Capital gains tax and partnerships”, (1988) 17 *Australian Tax Review* 76 at 87.
- 94 *FCT v David Clark; FCT v Helen Clark* [2011] FCAFC 5; TD 2012/21.
- 95 *Hedges* at [25].
- 96 *Crommelin v DCT* (1998) 39 ATR 377; *Jamieson v IRC (NZ)* (1974) 4 ATR 327; *Stapleton v FCT* (1989) 20 ATR 996, *Coughlan v FCT* 91 ATC 4505.
- 97 Case 11,020; Case No. QT 94/233, AAT, 18 June 1996, at para 59.
- 98 Para 3 of TD 2004/D85.
- 99 [1987] HCA 18.
- 100 As noted by the Commissioner in his Decision Impact Statement on *Greig v FCT* [2020] FCAFC 25.
- 101 *London Australia Investment Co. Ltd. v FCT* (1977) 138 CLR 106.
- 102 *Whitfords Beach Pty Ltd v FCT* 10 ATR 549.
- 103 *Tikva Investments Pty Ltd v FCT* (1972) 128 CLR 158 (*Tikva*) at 169.
- 104 *Sarich v FCT* (1978) 9 ATR 294 .
- 105 (1982) 13 ATR 202.
- 106 As a matter of fact, given in this example, there was no goodwill.
- 107 *Tikva* at 169.
- 108 *Tikva* at 166.
- 109 *Tikva* at 169.
- 110 *Watson v FCT* (1982) 13 ATR 202 (*Watson*).
- 111 *Watson* at 211.



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