

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

By Buck Xiao, CTA, Director Tax,  
Hall Chadwick Melbourne

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 first of three instalments of the article. The remaining instalments will be published in the next two issues of *The Tax Specialist*.

## Part I: Introduction

At first glance, the US and Australian rules regarding the taxation of partnerships appear to share the same two-tier architectural features. That is, the partnership acts as a conduit through which taxable income and loss flow to the partners, who are then responsible for paying the tax. However, when delving into the details, the rules that implement these principles are markedly different.

This article intends to critically examine Australia's partnership taxation rules in juxtaposition with those of the US. This will form the foundation for further analysis of their

interactions through the foreign hybrid rules, with the aim of providing practical guidance to Australian enterprises conducting business in the US via a partnership structure.

Transactions involving partnerships can be broadly categorised into:

- transactions carried out by the partnership itself (referred to as "Partnership-Level Transactions"); and
- transactions entered into between a partner and the partnership, or between partners themselves (referred to "Partner-Level Transactions").

Consequently, the discussion hereinafter will proceed under the following headings:

- Part II: Partnership-level transactions (US);
- Part III: Partnership-level transactions (Australia);
- Part IV: Partner-level transactions (US);
- Part V: Partner-level transactions (Australia);
- Part VI: Interaction through foreign hybrid; and
- Part VII: Conclusion.

The current issue comprises Parts I–III, with the remaining parts to be published in the next two issues.

In this article, certain terms are defined for specific parts, rather than for the entire article, and are capitalised. This is because terms applicable to Australian partnership taxation rules may not be appropriate in the US context, and vice versa. However, some defined terms may be used across different parts. In such cases, they will be noted on first appearance in any part outside the one in which they were originally defined. Terms defined by legislation and regulations in Australia and the US are indicated with single quotation marks.

There are four sets of legislation and regulations that will be referred to throughout this article. They are set out below with their abbreviations:

- *Income Tax Assessment Act 1997* (Cth) (ITAA97): "s" will be used as the provision prefix;
- *Income Tax Assessment Act 1936* (Cth) (ITAA36): "s" will be also used as the provision prefix;
- *Internal Revenue Code of 1986* (US) (IRC): "§" will be used as the provision prefix; and
- Treasury Regulations promulgated under the IRC (Treas. Reg.): "§" will be also used as the provision prefix.

A reference to legislations and regulations applies only to the initially mentioned section and does not extend to subsequent sections referred to under the same legislations or regulations, unless ambiguities can arise in a particular context. It is worth noting that sections in the Treasury Regulations start with the prefix "1"; for example, Treasury Regulations promulgated under §701 of the IRC start with §1.701.<sup>1</sup>

Given the purpose of this article is to discuss the taxation rules in respect of partnerships in Australia and the US in the business context, it proceeds on the premise that

a partnership carries on a business and where a business is carried on in the US, it is at or through a permanent establishment.

## Part II: Partnership-level transactions (US)

In the US, the taxation rules in respect of a partnership are contained in Subchapter K of Chapter 1 of the IRC (Subchapter K). From a tax perspective, a partnership in the US is fiscally transparent. This implies a three-stage taxation process:

1. taxable income is, in the first instance, computed by the partnership (§703 IRC);
2. the taxable income so computed is distributed to the partners according to their interest in the partnership (§704); and
3. the “distributive shares” are to be taken into account by partners to compute their income tax (§702).

At the partnership level, the taxing rules mainly focus on the allocation of taxable income from the partnership to the partners. In this aspect, the discussion of US tax rules can proceed and divide into the following four aspects:

1. the distribution process of partnership taxable income;
2. general rules concerning the distribution of partnership taxable income to partners (General distribution rules);
3. specific rules dealing with distribution in respect of property contributed by partners (Contributed property rules); and
4. limitations on the allowance of losses.

## Section 1: The distribution process of partnership taxable income

In Australia, a partner takes into account a portion of ‘net income’ or ‘partner loss’<sup>2</sup> distributed to them from a partnership for the purpose of computing their taxable income. This portion, as discussed below, is a single amount and cannot be broken down into components. In contrast, in the US, items of income,<sup>3</sup> gain, loss, deduction or credit (Tax Items) can be fragmented into different components and separately distributed to the partners (§703), which will be incorporated into the process of calculating the partners’ taxable income.

Example 2.1 provides a glimpse into how Tax Items of a partnership are allocated to its partners in the US.

Assuming that taxable income in the US is equal to the ‘net income’ in Australia, in the author’s view, for Australian tax purposes, the PRS may only allocate a portion of the net income, \$1,000, to the partners (ie P1 \$100, P2 \$250, P3 \$400 and P4 \$250), with the character of Tax Items flowing through proportionately. This will be discussed in more detail below in Part III. However, in the US, taxable income can be distributed to partners with distinct characters in a disproportionate manner. To achieve fragmented distribution as illustrated in Example 2.1, the partnership agreement often contains complex waterfall clause provisions (ie multiple tiers of allocation) that regulate how the Tax Items should be allocated among the partners.

Initially, a partnership’s taxable income is computed in the same manner as an individual’s taxable income (§703). Once the taxable income is determined, under §702(a), the partnership is required to segregate various Tax Items. These Tax Items are then allocated to the partners and taken into account to determine their individual tax

### Example 2.1. Flexibility of the US partnership distribution scheme

A partnership (PRS) has four partners: P1, P2, P3 and P4. In the current year, it derives \$1,000 taxable income. The following table illustrates how the allocation of Tax Items can be accomplished in the US:

Gross Income	PRS	P1	P2	P3	P4
US sales	400.00	100.00	100.00	100.00	100.00
Long-term capital gain	500.00			300.00	200.00
Dividends (non-portfolio)	200.00	60.00	140.00		
Income from Australian business	150.00	40.00	35.00	25.00	50.00
Income from UK business	100.00		30.00	70.00	
<b>Deduction</b>					
Charitable contributions	(100.00)	(25.00)	(30.00)	(30.00)	(15.00)
Depreciable Machine A	(150.00)			(65.00)	(85.00)
Depreciable Machine B	(100.00)	(75.00)	(25.00)		
<b>Taxable income (US)</b>	<b>\$ 1,000.00</b>	<b>100.00</b>	<b>250.00</b>	<b>400.00</b>	<b>250.00</b>

liabilities, based on their ‘distributive shares’ of each segregated item.

Under §702(b), Tax Items that are separately accounted for have the same character as if they were “realized directly from the source from which they were realized by the partnership, or incurred in the same manner as incurred by the partnership”. In other words, the character of the partnership’s Tax Items will be carried over to the partners. In contrast, as discussed in Part III, it seems that each item of ‘net income’ or ‘partnership loss’ will flow through to the partners proportionately in Australia.

There are six statutory Tax Items contained in §702(a)(1) through §702(a)(6) that are required to be segregated. These items were further expanded on extensively by Treasury Regulations promulgated under the authority granted by §702(a)(7). Additionally, the Treasury Regulations also mandate the segregation of any item that would otherwise fall within the §702(a)(8) residue<sup>4</sup> when:

1. any Tax Item subject to a special allocation under the partnership agreement (Special Allocation) that differs from the allocation of partnership taxable income or loss generally; and
2. any Tax Item that affects partners differently. For example, rental income is normally not required to be separately stated if all partners are ‘United States Persons’.<sup>5</sup> However, where a partner is a US ‘controlled foreign corporation’,<sup>6</sup> rental income should be segregated from other income such as sales income, which is not ‘foreign base company sales income’,<sup>7</sup> as rental income is ‘foreign personal holding company income’<sup>8</sup> and should be included in gross income of the US shareholder of that partner.<sup>9</sup>

Any item that is subject to a Special Allocation may also be broken down for further allocation purposes.<sup>10</sup> For example:

1. depreciation, gain or loss with respect to a particular partnership property can be allocated to one partner, while similar items with respect to another property may be allocated to another partner;
2. alternatively, depreciation attributable to a single property may be fractured or allocated in tiers; and

3. similarly, income from a particular source, such as a foreign country, may be specially allocated in a manner different from the allocation of income generally.

Tax Items that are not subject to specific allocation rules, as described above, are grouped together in an undifferentiated residual hotchpotch that constitutes the partnership’s “bottom-line” taxable income or loss under §702(a)(8).

Therefore, in the US, what is allocated to partners can consist of fragments of the partnership’s taxable income, while in Australia, what is allocated to partners is a single portion of the partnership’s net income.

The extensive segregation of items required by §702(a) means that a partnership has incredible flexibility and latitude to devise a distribution plan to minimise its partners’ taxable income and, therefore, the tax payable.

Owing to the tax circumstances of the partners, none of the items of gross income, in Example 2.2, will be taxable in the partners’ hands in the US for the following reasons:

1. US sales income was exempt for P1 as it was an exempt organisation.
2. Long-term capital gains were offset by long-term capital losses in P2’s hands.
3. The Australian source business income was not taxable for P3 because it was considered a foreign company from a US perspective.

In the author’s view, the two-tier taxation system for partnerships (ie taxable income determined at the partnership level and tax liabilities determined at the partner level) inevitably creates opportunities for tax arbitrage, referred to as “Partnership Tax Arbitrage” in this article, which encompasses the following three aspects:

1. “Character Streaming” refers to a situation where the partnership distributes tax items that match the partners’ circumstances for tax purposes—example 2.2 illustrates this concept.
2. “Character Conversion” describes a situation where the partnership or partners undertake transactions to convert a Tax Item into another Tax Item with a more desirable character in the hands of a partner; for instance, assuming the absence of §751, partners could realise capital gains by selling their interests in the

### Example 2.2. Allocation to minimise partners’ taxes

1. A partnership (PRS) has four partners: P1 is a tax-exempt organisation, P2 is a US individual with long-term capital loss and P3 is an Australian company.
2. PRS derived the following items of income, which was distributed to a partner as shown in the following table:

Gross Income	PRS	P1	P2	P3
US sales	100.00	100%		
Long-term capital gains	100.00		100%	
Income from Australian business	100.00			100%

partnership instead of selling partnership inventories to avoid realising ordinary income, which will be discussed in Part IV (to be published in a later issue); Character Streaming and Character Conversion are collectively referred to as “Character Arbitrage”).

3. “Gain & Loss Shifting” refers to a situation where a partnership shifts built-in gains/losses (ie unrealised gains/losses) from one partner to another or among other partners.

Therefore, it is probably not surprising that successive rules have been introduced to curtail the use of partnerships as a structure for tax planning, including §704(b) and §704(c), which will be discussed in subsequent paragraphs of this part.

## Section 2: General distribution rules

The goal of §704(b) is to ensure that the allocation of Tax Items of the partnership among partners accurately reflects the economic arrangement the partners. Treas. Reg. §1-704(b)(1) provides that an allocation contained in a partnership agreement is valid if it satisfies the requirements of one of three tests:

1. it is in accordance with the partners’ interests in the partnership, as determined by reference to all the facts and circumstances (Default Rules);
2. it has ‘substantial economic effect’ (Safe Harbour Rule); and
3. it is *deemed* to be in accordance with the partners’ interests in the partnership (Deeming Rule).

In respect of the Default Rules, there is often considerable difficulty to ascertain partners’ interests in a particular Tax Item of a partnership, because it is not always perspicuous what the economic arrangement between partners is. Treas. Reg. §1.704(b)(3) requires a determination of partners’ interest based on four factors put forward therein. It is not surprising that reasonable minds may differ, in many instances, considerably, in outcome of such determination.

The Deeming Rules apply where the Safe Harbour Rules are inapplicable to a particular Tax Item (eg allocations attributable to nonrecourse loan—see discussion below). Under the Deeming Rules, items are to be allocated either under the Default Rules or their own safe harbour rules, which are discussed briefly below.

In the author’s view, although very complicated, Safe Harbour Rules are sensible and pragmatic, and they work reasonably well to allocate Tax Items to partnerships in a way consistent with the economic entitlements of the partners. As McKee et al.<sup>11</sup> pointed out, “Taxpayers who stray from the safe harbor do so at their peril, as the IRS and the courts may not arrive at the correct result if left to deduce the appropriate allocation scheme from the economics of the transaction”.

Consequently, this article will focus on explaining the Safe Harbour Rules, with a brief discussion of Deeming Rules.

In all instances, §704(b) aims to allocate Tax Items of a partnership consistently with the economic arrangement agreed on by the partners so that a partner who receives

the distributive share of an item of economic benefits (Economic Item) must bear its tax burden, and a partner who suffers the economic detriment (also Economic Item) may enjoy the tax benefits associated with it. The Safe Harbour Rules carry out this goal by requiring the following:

1. an allocation must have economic effect (Economic Effect). That is, the allocation of Tax Items must be arithmetically consistent with the allocation of Economic Items; and
2. the allocation’s Economic Effect must be substantial (Substantiality Test), which requires that the tax effect of the allocation should not be undermined or nullified by Character Streaming, thereby minimising the overall tax of partners, as illustrated in Example 2.2.

### Subsection 1: An allocation must have economic effect

The key to implementing this Economic Effect requirement is the “Capital Account Rule”, under which each partner has only a single capital account that reflects all such interests, regardless of the class of interests, owned by the partner (Treas. Reg. §1.704-1(b)(iv)(b)(7)). A Capital Account Rule has three interrelated components:

1. capital accounts must be maintained for the partners in accordance with a very precise set of rules set out in the Treasury Regulations (Maintenance Rules);
2. upon liquidation of the partnership, liquidating distributions must be made to partners in accordance with their positive capital account balances (Distribution Rules); and
3. upon liquidation, partners with deficit capital accounts must restore the amounts of their deficits to the partnership (Deficit Makeup Rules).

The Maintenance Rules essentially involve book-keeping, with the purpose of providing a snapshot of a partner’s entitlement at a particular time. The Distribution Rules and the Deficit Makeup Rules ensure that the Maintenance Rules are not undermined or circumvented so that, for example, if a partner receives \$100 deduction in the capital account, that partner will eventually receive \$100 less in term of economic entitlement where she had a positive capital account, or be called on to make the good of \$100 loss, if she has capital account deficit.

Thus, the function of the capital account is to regulate partners’ economic entitlement in the partnership. Through the allocations made to the capital account, a partner’s economic entitlement either increases or decreases, which provides an impetus for partners to allocate Tax Items consistent with their economic arrangement. For example, when P1 and P2 find themselves in similar circumstances for tax purposes, a Special Allocation of \$100 depreciation may not be attractive to them if the \$100 reduction in their capital accounts, and hence economic entitlement, outweighs the tax benefits associated with the deduction.

Under the Maintenance Rules, the capital account must be maintained under specific rules under §1.704-1(b)(2)(iv), as summarised in Table 1.

**Table 1. Capital account maintenance rules summary**

Capital account	Increased by	Decreased by
Entry 1	the amount of money contributed	the amount of money distributed
Entry 2	the fair market value of property contributed (net of liabilities that the partner is to assume)	the fair market value of property distributed (net of liabilities that the partner is to assume)
Entry 3	allocations of partnership tax income and gain (or items thereof) and income and gain exempt from tax	allocations of partnership tax loss and deduction (or item thereof) and non-deductible, noncapital expenditures (as described in §705(a)(2)(B) of IRC)
Entry 4	non-tax income and gain specifically required to be allocated.	non-tax loss and deduction specifically required to be allocated.

Referring to Table 1, first, the capital account is initially established and subsequently increased through contributions, as seen in Entry 1 (cash), and Entry 2 (fair market value (FMV) of property); conversely, it is reduced or liquidated through distributions of the same items. Notably, cash and the FMV of property are considered Economic Items. Second, during the operation of the partnership, the capital account is subject to increases and decreases by Tax Items<sup>12</sup> at Entry 3, such as income, gain, deduction and loss for tax purposes (either taxable or tax exempt). Third, specific non-tax items must be recognised in the capital account at Entry 4.

Entries 1, 2 and 3 in Table 1 represent the basic rules outlined in §1.704-1(b)(iv)(b). However, there are situations that require special adjustments to be made to the capital accounts to ensure that they accurately reflect the economic entitlements of the partners. Entry 4 encompasses those special items, such as depreciation deductions related to contributed property<sup>13</sup> (§1.704-1(b)(iv)(d)(3)) and unrealised gains (§1.704-1(b)(iv)(f)) after revaluation, and so on – see Example 2.3.

Another noteworthy special adjustment required at Entry 4 is an item captured by Treas. Reg. §1.704-1(b)(2)(iv)(q). This regulation provides that if the Treasury Regulations fail to cover the proper treatment of an item, the partners' capital accounts must be adjusted in a manner that:

1. maintains equality between the aggregate governing capital accounts of the partners and the amount of partnership capital reflected on the partnership's balance sheet, as computed for book purposes;
2. is consistent with the underlying economic arrangement of the partners; and
3. wherever practicable, is based on federal tax accounting principles.

Treas. Reg. §1.704-1(b)(2)(iv)(q) is a backstop provision, which prevents items falling outside the scope of the Capital Account Rules, thereby debilitating its effectiveness as a measurement of partners' economic entitlements. A notable example is a fictional taxable amount. In the author's view, a deeming taxable amount would not be included in the capital account as per §1.704-1(b)(2)(iv)(q), even though it is otherwise mandated at Entry 3 of the Table 1.

### Example 2.3. Recognition of unrealised tax items

1. P1 and P2 are equal partners in a partnership (PRS) who share all Tax Items equally. Each of them has a capital account balance of \$50 and PRS has a property with basis of \$100, which has a market value of \$400. P3 contributes \$400 cash to acquire 50% interest in PRS so that the P3 initial capital account balance is \$400.
2. Without any adjustment, the sum of the capital account balance of P1, P2 and P3 is \$500. According to the capital account, P1 and P2 only have 1/10 interest in PRS, which does not reflect their 25% interest in PRS.
3. Thus, under §1.704-1(b)(2)(iv)(f), PRS can revalue the property to \$400 and allocate revaluation gains of \$300 to P1 and P2, thereby increasing their capital account balance of \$200 each, at Entry 4 of Table 1, to reflect their economic entitlements.
4. On the sale (assuming the sale price is \$500), for tax purposes, the \$300 realised capital must be allocated to P1 and P2 equally under §1.704-1(b)(2)(iv)(f) and §1.704-1(b)(4), the balance of \$100, \$25 to P1 and P2 each, and \$50 to P3.
5. For capital account Maintenance Rules purposes, under §1.704-1(b)(4)(i), the \$300 gain is ignored for the rules at Entry 3 of Table 1, as it duplicates the previous allocation of unrealised revaluation gains at Entry 4.

This way, the Treasury Regulation upholds the integrity of the capital account.

Consequently, the items entering into capital account can be eclectic, comprising Economic Items, Tax Items and specific items, which are neither Economic Items nor Tax Items. It may not be theoretically perfect, but nevertheless, in the author's view, the capital account Maintenance Rule provides tangible guidance to ascertain a partner's economic entitlement, which can be followed in practice.

The Distribution Rules and Deficit Makeup Rules pertaining to capital accounts appear to be easily comprehensible; therefore, they will not be further elaborated on here. However, it is worth noting that there is an alternative way

to satisfy the Deficit Makeup Rule under §1.704-1(b)(2)(ii)(d). Under the Deficit Makeup Rules, the amount required to make up a capital account deficit is unlimited, and this rule should be in place throughout the term of the partnership (§1.701-1(b)(5)—Example 1(ii)). This presents a challenge for limited liability partnerships, including limited liability companies treated as partnerships. Since all or some partners of these entities have limited liabilities by design, such partnerships generally cannot satisfy the Deficit Makeup Rules.

Pragmatically, the Treasury Regulation devised the ‘alternate test for economic effect’ (as per §1.704-1(b)(2)(ii)(d)). The name of this test is somewhat misleading, since it operates on the premise of fulfilling both the Maintenance Rules and Distribution Rules, yet it substitutes the rules as described below to the Deficit Makeup Rules. Hence, it effectively functions as an alternative test for the Deficit Makeup Rules.

The ‘alternate test for economic effect’ is a snapshot test at each end of the income year (§1.704-1(b)(2)(ii)(d)), which requires:

1. the allocation must not cause or increase a deficit balance in the capital account or in excess of any limited dollar amount of such deficit balance that a partner is obligated to restore under partnership agreement of the partner receiving the allocation, on the basis that this capital account had been reduced by distributions that, as of the end of the year, are reasonably expected to be made to the partner;<sup>14</sup> and
2. the partnership agreement contains a ‘qualified income offset’ provision: “if, and only if, it provides that a partner who *unexpectedly* receives an adjustment, allocation, or distribution will be allocated items of income and gain ... in an amount and manner sufficient to eliminate such deficit balance as quickly as possible.”

#### Example 2.4. Illustration of ‘alternate test for economic effect’

1. P1 and P2 are from a limited liability partnership (PRS). P1 is the general partner with unlimited liability, while P2 has limited liability.
2. P2 agrees to restore up to \$100 of a deficit balance in her capital account upon the liquidation of her partnership interest. The PRS would not meet the Deficit Makeup requirement, but it would meet the ‘alternative test for economic effect’, as long as the allocation does not result in a deficit balance exceeding \$100 in P2’s capital account.
3. Even if the allocation results in a deficit balance exceeding \$100, only the amount that increases the partner’s deficit capital account balance above \$100 fails to meet the Economic Effect test.<sup>15</sup> In that case, the partnership must reallocate this “excess” portion among its other partners based on their respective interests.

#### Subsection 2: The allocation’s economic effect must be substantial

If partnership could undertake Character Streaming distribution by allocating Tax Items tailoring to the tax circumstances of a partner, the partner can be worse off before the tax but nevertheless better off after tax.

#### Example 2.5. Character Streaming distribution

1. In an equal partnership (PRS), P1 is at a tax rate of 40%, and P2 is an exempt entity. It is highly likely that the PRS will derive \$100 taxable income and \$100 exempt income for the next 10 years.
2. Without Special Allocation, in a particular income year, the tax payable by P1 is \$20, and P2 owes nothing in taxes. Thus, P1 has \$80 on hand after paying taxes and P2 has \$100.
3. However, if the partnership distributes 90% exempt income (ie \$90) to P1 and the balance to P2; on an after-tax basis, P1 has \$90, making P1 \$10 better off. Additionally, P2 is also \$10 better off since P2 receives \$110.

Example 2.5 shows that Character Streaming distribution can undermine or nullify the Economic Effect test. Thus, mere mechanical compliance with the Economic Effect requirement may not effectively safeguard against tax-motivated allocation.

There are two aspects of the Substantiality Test, as follows (§704-1(b)(2)(iii)(a)):

1. “Pre-Tax Test”, which is met, if, only if, “there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences”; and
2. “After-Tax Test”, which is satisfied where the after-tax economic consequences of at least one partner may, in present value terms, be enhanced, there is a strong likelihood that the after-tax economic consequences of at least one partner will, in present value terms, be substantially diminished if the allocation (or allocations) were not contained in the partnership agreement.

#### Example 2.6. Illustration of failing the Pre-Tax Test

1. A partnership (PRS) comprises P1 and P2, who share all Tax Items equally. Since its formation, PRS has always made profits of about \$100, which have historically been allocated 50:50.
2. In the current year, P1 has carried forward a loss of \$100, which is set to expire in that year. P1 and P2 agree to allocate the entire \$100 to P1 and \$100 to P2 in the next year.
3. This rearrangement does not affect the pre-tax amount (ie the \$100) received by the partners. Thus, it fails the Pre-Tax Test.

3. The Pre-Tax Test would have been met if, under the rearrangement, P1 were to receive \$80, and P2 were to receive \$20 in the current year. P2 would receive \$100 in the next year.
4. However, to satisfy the substantiality requirement, PRS also has to meet the After-Tax Test.

The After-Tax Test is obviously difficult to apply in practice. The test is prospective—it involves predicting future outcomes with respect to particular allocations, which are, of course, unknown at the time of applying the test. The Treasury Regulation formulates a ‘strongly likely’ standard, which, in the author’s view, is incorporated into the following three steps to carry out this After-Tax Test:

1. ascertain Tax Items (eg income, gains, deductions, losses) that are ‘strongly likely’ to arise in respect of an allocation (or allocations) in question;
2. allocate the above Tax Items and ascertain the tax outcome, taking into consideration the ‘strongly likely’ tax circumstances of each partner; and
3. calculate the net present value of each partner’s tax outcome by applying the ‘strongly likely’ applicable discount rate.

In contrast with the mechanical test for determining whether an allocation has Economic Effect, the Substantiality Test is far more complicated and subjective. In an effort to provide clearer guidance on the Substantiality Test, the Treasury Regulation describes two common situations where the allocation will fail the Substantiality Test:

1. shifting allocations: the economic effect of allocation is largely offset by the partnership’s allocation of another Tax Item in the same taxable year (Shifting Allocations); and
2. transitory allocations: the transitory test for substantiality focuses on situations where a partnership allocates offsetting items over the years among the partners, thereby achieving a reduction in the total tax liabilities of the partnership without substantially affecting their capital accounts (Transitory Allocations).

Example 2.5 provides a glimpse of Transitory Allocation. The Shifting Allocations can be illustrated in the following example.

#### Example 2.7. Illustration of shifting allocations<sup>16</sup>

1. P1 and P2 form an equal partnership (PRS) who share all Tax Items equally to operate a travel agency in the US and Australia. P1 is an Australian resident, while P2 is a US resident. The partnership agreement provides that P1 will be allocated all such items derived from operations within Australia up to the amount of P1’s equal share.
2. Although the allocation has Economic Effect, it is not substantial because:

- a. the partners’ capital account balances at the end of the taxable income period would be the same with such allocation as they would be in the absence of such allocation; and
- b. the allocation reduces the total tax liability of the partners.

There are two significant carve-outs of the Substantiality Test:<sup>17</sup>

1. the Treasury Regulation presumes the allocation is not insubstantial, where there is a strong likelihood that the offsetting allocation(s) will not, in large part, be made within five years after the original allocation(s) is made<sup>18</sup> (5 Years Presumption); and
2. the Treasury Regulation presumes a partnership’s ‘adjusted basis’<sup>19</sup> in its property is equal to the property’s FMV, and adjustments to the property’s basis are presumed to be matched by corresponding changes to its FMV<sup>20</sup> (*Value Equals Basis Presumption*)

Where the Value Equals Basis Presumption applies, there would be no gains or losses on disposal, ensuring that the allocation of gains and losses associated with depreciating property does not violate the substantiality requirement. This presumption applies even if the presumed facts contrast starkly with the actual facts.<sup>21</sup>

#### Example 2.8. Illustration of transitory allocations and carve-outs

1. A partnership (PRS) owns depreciable equipment that can be fully depreciated over the next 3 years. The resulting deduction of \$100 each year for the next 3 years will be allocated to P1, who is subject to the highest marginal tax rate in years 1–3.
2. P1 plans to retire in year 9, which will significantly reduce her marginal tax rate. The PRS is confident that it will make a profit of at least \$300 on the disposal of this depreciable equipment in year 9. This profit will also be allocated to P1.
3. The Special Allocations of depreciation deductions and profits from the equipment’s subsequent disposition to P1 may appear to be offsetting Transitory Allocations. This is because, when the partners agree to these Special Allocations, there a strong likelihood that the depreciation deduction will be offset by the profits from the disposal, resulting in a lower aggregate tax liability for P1.

However, these Special Allocations do, in fact, satisfy the Substantiality Test for the following two alternative reasons:

1. the profit made after 5 years of these allocations is effectively ignored—(ie the 5-Years Presumption applies in this case); and

- owing to the Value Equals Basis Presumption, the FMV of the equipment is always deemed to equal its 'adjusted basis', and the property's FMV is presumed to decline in amounts equal to the corresponding reductions in its 'adjusted basis' because of depreciation. Accordingly, there cannot be a strong likelihood that depreciation deductions will be cancelled out by offsetting allocations of the profit on the PRS's disposition of the equipment.

In summary, in the author's view, for the Substantiality Test to fail, there must be first a Character Streaming distribution, and second, a degree of certainty (ie 'strongly likely') that this Character Streaming distribution is to take effect.

Thus, in Example 2.5, the Substantiality Test is met where:

- the potential Character Streaming distribution can be displaced—for example, if there is a likelihood that P2 becomes a taxable entity; or
- there is uncertainty about the amount and mixture of income to be derived—for example, exempt income can drop to \$50, and taxable income can increase to \$200, etc.

The application of the Substantiality Test can be complex, since it requires an assessment based on the tax effects in terms of net present value. This assessment relies on the somewhat vague concept of being 'strongly likely' and takes into consideration not only the tax circumstances of the partners, but also the tax circumstances of the owners of certain look-through entities, which own interest in a partnership in question. These entities may include an interposed partnership, S corporations, trusts, estates, entities disregarded for federal tax purposes and controlled foreign corporations (CFCs).<sup>22</sup>

However, there are well-defined and tangible rules that can be followed. In the author's view, these rules are unlikely to disturb allocations from partnerships engaged in genuine business activities, as such partnerships cannot be 'strongly likely' to predict taxable income and its components. The complexity of the rules increases when tax avoidance is involved. By their nature, tax avoidance schemes require a high degree of certainty regarding the amount of Tax Items and the impact of Character Streaming distributions. This certainty is not a characteristic of genuine business operations.

In the author's view, the Economic Effect test is a quantum measure for ensuring that the allocation of Tax Items remains consistent with the economic arrangement between the partners. The Substantial Test is designed to prevent Character Streaming; that is, the allocation of Tax Items from a partnership to a partner with matching Tax Items. The US Treasury Department should be congratulated for its admirable efforts in devising Safe Harbour Rules, which provide great flexibility for using partnerships as vehicles to conduct genuine business

activities without unduly compromising their anti-tax abuse objectives.

On the contrary, in Australia, after net income and partnership losses have been allocated to the partners, as pointed out by Cooper et al.<sup>23</sup>, "there are no rules in the tax law dealing with partnership distributions, and accordingly, they are disregarded". This seems to provide opportunities for Character Streaming distributions. However, in Australia, net income and partnership losses cannot be distributed fragmentally, thereby reducing the scope of such distributions. This will be returned for further elaboration in Part III.

### Subsection 3: Deemed to be in accordance with the partners' interests

The premise of the Safe Harbour Rule is that a Tax Item has its economic counterpart (ie the Economic Item), and therefore, the allocation of it to capital account of a partner determines her entitlements as against the partnership. This tie-up between partnership distribution and partners' entitlement is of vital importance to the effectiveness of the Safe Harbour Rules.

However, there are Tax Items that have no economic counterpart, and therefore, the Safe Harbour Rules are inapplicable. Treas. Reg. §1.704-1(b)(4) deems an allocation of such Tax Items in accordance with the partners' interests in the partnership, thus valid under a series of special rules set forth therein. In essence, §1.704-1(b)(4) prescribes specific safe harbour rules for each item described therein, and where specific safe harbour rules are not followed by the partnership, these items will be allocated according to the economic interest of partners in the partnership (ie in accordance with the Default Rule). This article only discusses two of those items, as contained in §1.704-1(b)(4).

The first of those two items is revaluation under §1.704-1(b)(2)(iv)(b) and §1.704-1(b)(2)(iv)(d)(f), which has been partially discussed above (see Example 2.3). Because some items, such as unrealised gains arising from the revaluation of a particular property and items such as depreciation and amortisation reflecting such unrealised gains, have already been entered into the capital account, the taxable gains arising from the realisation of the property, which duplicate items arising from the said revaluation, cannot be recognised in the capital account again. §1.704-1(b)(4)(1) and §1.704-1(b)(2)(iv)(d)(f) require that the realised gains in those instances be allocated according to the §704(c) principle (as discussed below).

The second one is allocations of loss or deduction attributable to a partnership's 'nonrecourse liability' (Treas. Reg. §1.704-1(b)(4)(iv) and §1.704-2). A partnership liability is a 'nonrecourse liability' to the extent that no partner or related person bears the economic risk of loss for that liability (§1.704-2 (b)(3) and §1.752-1(a)(2)).<sup>24</sup> Allocations of deductions attributable to property financed with 'nonrecourse liabilities' pose special problems to apply Safe Harbour Rules under §704(b) IRC.

### Example 2.9. Issues arising from the allocation of Tax Items in respect of nonrecourse liabilities

1. P1 and P2 formed an equal partnership (PRS), and each contributed \$100 as capital. PRS further borrowed \$800 to purchase a depreciating property for \$1,000 with an effective life of 5 years. Assuming that PRS is to break even with income and deductions, excluding depreciation, for the next 5 years, after the first year, the capital accounts of P1 and P2 will be in deficit owing to the allocation of the depreciation deduction. This indicates that the lender, rather than the partners, bears the economic burden.
2. The basic notion underlying §704(b) is that tax deductions should be allocated to the person bearing the corresponding economic burden. This suggests that any depreciation deductions exceeding the first \$200 of deductions should be allocated to the lender. In other words, no matter how a partnership allocates deductions attributable to nonrecourse debt, no partner bears the corresponding economic loss. This situation, therefore, calls for an exception from the general principles of §704(b).

Treas. Reg. §1.704-2 overcomes this dilemma by deeming allocations of ‘nonrecourse deductions’ as being in accordance with a partner’s interest in the partnership where, provided other Capital Account Rules have been met:

1. any ‘nonrecourse deductions’ are allocated consistently with the allocations of some other significant partnership item attributable to the property securing the ‘nonrecourse liability’ (the ‘Consistency Requirement’); and
2. there is ‘minimum gain chargeback requirement’ in place—that is, if there is a net decrease in ‘partnership minimum gain’ for a partnership taxable year, each partner must be allocated items of partnership income and gain among its partners in the same proportions as previous allocations of ‘nonrecourse deductions’.

Treas. Reg. §1.704-2(b)(1) defines ‘nonrecourse deductions’ as losses, deductions, or non-deductible and non-capitalised expenditures attributable to ‘partnership nonrecourse liabilities’. Under §1.704-2(c), the amount of ‘nonrecourse deduction’ is equal to the ‘partnership minimum gains’, which represents the loss that would have been made if the property was sold at the amount of the borrowing (ie the difference between the excess of a ‘nonrecourse liability’ over the ‘adjusted basis’ of the property securing the liability (§1.704-2(d))). Thus, ‘partnership minimum gain’ is often increased by depreciation deduction or other cost recovery deductions that reduce a property’s ‘adjusted basis’ below the amount of the ‘nonrecourse liability’ it secures. On the other hand, the ‘partnership minimum gain’ is often decreased where there is disposition of property securing a ‘nonrecourse liability’ or repayment of a ‘nonrecourse liability’. A net decrease in the ‘partnership minimum gain’ results in ‘minimum gain chargeback’ (§1.704-2(f)), under which, in essence, a partner must be allocated items of partnership income and gain for that year equal to the share of aggregated ‘nonrecourse deductions’ she has previously received (§1.704-2(g)).

### Example 2.10. Illustration of allocation of nonrecourse deductions and operation of the minimum gain chargeback

1. P1 and P2 contributed \$80 and \$120 each form a partnership (PRS). P1 is required to restore any deficit balance; P2 is not but subject to a ‘qualified income offset’ provision in the PRS agreement.
2. P1 and P2 share all other partnership items 40:60; but ‘nonrecourse deductions’ (NRD) 50:50. These ratios are complying with the Consistency Requirement. It has reasonable likelihood that the 40:60 and 50:50 allocation provisions will both apply to significant partnership items other than nonrecourse deductions *over the partnership’s life*.<sup>25</sup>
3. With a nonrecourse borrowing of \$1,000, it purchased a depreciating property of \$1,200, depreciable over 8 years (ie \$150 depreciation each year). In the first year and second year, the rental income was equal to expenditures, except for depreciation deduction, so that PRS made loss of \$150 each year equal to the depreciation deduction. The allocation of PRS is shown in the table below:

	P1	P2
<b>the first year</b>		
Capital account on formation	80	120
Less: net loss in year 1	(60)	(90)
Capital account at end of year 1	<b>20</b>	<b>30</b>
<b>the second year</b>		
Less: nonrecourse deductions in year 2	(50)	(50)
Less: net loss in year 2 (without nonrecourse deductions)	(20)	(30)
Capital account at end of year 2	<b>(50)</b>	<b>(50)</b>

4. In the first year, PRS has no NRD, since the book value of the property \$1,050 exceeds the \$1,000 loan, so that the loss is allocated on a 40:60 basis.
5. In the second year, the book value of the property (\$900) is less than the \$1,000 by \$100, which is a ‘partnership minimum gain’, since if the property had been sold, the PRS would have made gains of \$100. Thus, NRD was equal to \$100, which was allocated on a 50:50 basis, and the balance of \$50 was not an NRD, which was allocated on a 40:60 basis.
6. P2 had a deficit in her capital account, which would have violated the Deficit Makeup Rules of the Economic Effect test under the Safe Harbour Rules. In applying the ‘alternate economic effect test’, however, P2’s share of ‘partnership minimum gain’ (\$50) is added to the limited amount, if any, of P2 obligation to restore a deficit capital account balance. After having added back the \$50, the P2 capital account balance is nil and the ‘alternate economic effect’ test is met, since P2’s limited amount is nil.

7. On the first day of the third year, the property was sold for \$1,200, making a profit of \$300; PRS repaid the loan, which triggered the ‘minimum gain chargeback’. That first profit must be allocated to offset the minimum gains (accumulated), even if the general share ratio is 40:60 (ie the ‘minimum gain chargeback’ provision establish tiers of profit shares). The allocation, as shown in the table, put the P1 and P2 back to original position, since it is assumed that the property was sold for the original purchased price:

Third year		
Capital account at end of year 2	(50)	(50)
Minimum gain chargeback	50	50
Allocation of balance of profits	80	120
Capital account at end of year 3	<b>80</b>	<b>120</b>

Under the basic allocation scheme under the Safe Harbour Rules, deductions (with depreciation being a notable example) that are associated with property funded by ‘nonrecourse liabilities’ are allocated to a partner’s capital account (at Entry 4 of Table 1). When the property’s ‘adjusted basis’ has fallen below the outstanding nonrecourse loan, the economic risk of those deductions shifts to the lender, and therefore, the allocation of them to the capital account distorts the economic entitlements (represented by the balance of a partner’s capital account). The Treasury Regulation addresses this challenge with the ingenious device of the ‘minimum gain chargeback’. Since, at least in theory, the gains arising from the disposal of the property should not be less than the difference between the amount of ‘the nonrecourse liability’ and the ‘adjusted basis’ of the property, the ‘minimum gain chargeback’ should eventually neutralise the ‘nonrecourse deductions’ received by a partner. Therefore, the distortion appears to be temporary and can be tolerated.

In Australia, by contrast, it appears that planning opportunities exist for a partnership to allocate losses, produced by deductions associated with property funded by a nonrecourse liability, to one partner in an unlimited fashion, while allocating net income arising from a balance adjustment event in a later year to another partner. However, in the context of foreign hybrid entities (Div 830 ITAA97), the scope of this planning opportunity appears to be curtailed by Subdiv 830-C, which limits the partnership losses that can be distributed to partners to the balance of the loss exposure amount under s 830-60 ITAA97. This amount effectively represents their capital contributions, reduced by the limited recourse liability of a partner funding the contribution, as well as a partner’s revenue loss amount and net capital loss amount.

### Section 3: Contributed property rule

Generally speaking, in Australia, a contribution of property to a partnership is a taxing event, to be discussed in detail in Part V. On the contrary, in the US, a contribution made by a partner in exchange for an interest in a partnership is a

non-taxable event (§721 IRC), subject to detailed discussion in Part IV.

Where a property is contributed by a partner to a partnership, the partnership inherits the ‘adjusted basis’ of the said property in the hand of the partner (§722). As mentioned above, the FMV is required to be recorded in the capital account (Entry 2 of Table 1) and shown as the book value on the books of the partnership. The difference between ‘adjusted basis’ and book value gives rise issues, as illustrated in Example 2.11.

#### Example 2.11. Illustration of book value and ‘adjusted basis’ difference

1. P1 and P2 formed an equal partnership (PRS). P1 contributed \$100 in cash, while P2 contributed a property with an ‘adjusted basis’ of \$60 and an FMV of \$100 (ie built-in gains \$40).
2. P2 is not taxed on the contribution, and the partnership inherits the ‘adjusted basis’ of \$60 for the property. The partnership’s books show the property at a value of \$100, as does P2’s capital account.

The disparity between book value and ‘adjusted basis’ creates opportunities for Gain & Loss Shifting—an aspect of Partnership Tax Arbitrage, as defined above. In other words, the pre-contribution gains/losses, often referred to as built-in gains/losses, can be allocated to other partners. For instance, in Example 2.11, the \$40 built-in gains could have been allocated 50% to P1 and 50% to P2, even though they were wholly accrued during P2’s sole ownership period.

Consequently, a set of special rules contained in §704(c) was introduced to allocate built-in gains/losses in respect of contributed property. §704(c) ensures, for the tax purpose, that the gains/losses accrued prior to the contribution are attributed to the contributing partners, thereby nullifying Gain & Loss Shifting. §704(c) contains three discrete rules:

1. contributed property allocation rules;
2. pre-contribution loss rules; and
3. deeming sale rules.

The deeming sale rules will only trigger the tax at the partner level, so its discussion will be deferred to Part IV, devoted to Partner-Level Transactions (US).

#### Subsection 1: Contributed property allocation rules

The fundamental policy of §704(c) is to prevent shifts of taxable items from one partner to another that lack economic substance apart from taxes (ie anti-Gain & Loss Shifting). This requires that built-in gains/losses should be accounted for in the hands of the contributing partner. For instance, in Example 2.11, the \$40 in built-in gains should be fully attributed to partner P2 for tax purposes.

The general rule for contributed property allocations under §704(c)(1)(A) mandates that a partnership allocates Tax Items (ie income, gain, loss or deduction) related to contributed property in a way that takes account of the

variation between the property's 'adjusted basis' and its FMV at the time of contribution.

Treasury Regulations require a reasonable allocation method. There are three generally accepted methods under the Treasury Regulations: the 'traditional method', the 'traditional method with curative allocations' and the 'remedial allocation method'.

#### Traditional method

Under the 'traditional method', with the goal of allocating Tax Items attributable to contributed property to the contributing partner, Treas. Reg. §1.704-3(b)(1):

1. provides that when the partnership sells contributed property, the built-in gain or loss on the property is allocated to the contributing partner; and
2. prioritises the tax allocations in respect of contributed property to non-contributing partners by first allocating to them, if possible, an amount of Tax Items from the contributed property equal to the corresponding allocation of such item in their capital account (Book Item), and then any remaining Tax Items to the contributing partner.

#### Example 2.12 – Traditional method and non-depreciable property

1. P1 and P2 formed an equal partnership (PRS). P1 contributed \$100, and P2 contributed a property with an 'adjusted basis' of \$70 and an FMV of \$100.
2. Scenario 1: If the property is sold for \$100, P2 would be taxed on \$30, while P1 would have no tax liability.
3. Scenario 2: If the property is sold for \$120, each of P1 and P2 would be taxed on \$10, representing 50% of the post-contribution gains of \$20. However, in this scenario, P2 would be taxed on both the \$30 in built-in gains and an additional \$10, which is her share of the post-contribution gains.
4. The outcomes are summarised below:

Scenario 1						
	P1		P2		Total	
	Book	Tax	Book	Tax	Book	Tax
On formation	100	100	100	70	200	170
Gains allocation	0	0	0	30	0	30
Closing balance	100	100	100	100	200	200

Scenario 2						
	P1		P2		Total	
	Book	Tax	Book	Tax	Book	Tax
On formation	100	100	100	70	200	170
Gains allocation	10	10	10	40	20	50
Closing balance	110	110	110	110	220	220

#### Example 2.13. 'Traditional method' and depreciating property

1. The same facts as in the last example, except the property can be depreciated over 10 years. Consequently, the book depreciation is \$10 per annum, while it is \$7 for tax purposes.
2. P1, as a non-contributing partner, is entitled to the full tax depreciation of \$5, matching her Book Item, which is 50% of the book depreciation. Meanwhile, P2's tax depreciation is \$2, representing the balance of tax depreciation.
3. At the end of the next 6-year period, the property would have a book value of \$40. This book value is derived from the initial \$100 book value, reduced by accumulated depreciation of \$60. For tax purposes, over the 6-year period, there would be a depreciation deduction of \$30 for P1 and \$12 for P2. This results in P2 reporting additional profits (Extra Gains) of \$18. The 'adjusted basis' of the property would be \$28 at that time.
4. In scenario 1, where the property would be sold for \$40, with an adjusted tax basis of \$28, it results in gains of \$12 from the sale. These gains would be entirely allocated to P2. Thus, P2's total taxable gains amount to \$30, including the \$12 from the sale and the Extra Gains of \$18. This signifies that the built-in gains of \$30 have been fully assessed in the hands of P2, the contributing partner.

**Example 2.13. Continued**

5. In scenario 2, where the property is sold for \$50, the \$10 post-contribution gains are allocated equally to P1 and P2, with each receiving \$5. The rest of this scenario is the same as in scenario 1. The outcome is summarised in the table below:

Scenario 1						
	P1		P2		Total	
	Book	Tax	Book	Tax	Book	Tax
On formation	100	100	100	70	200	170
Depreciation	(30)	(30)	(30)	(12)	(60)	(42)
Gains allocation	0	0	0	12	0	12
Closing balance	<b>70</b>	<b>70</b>	<b>70</b>	<b>70</b>	<b>140</b>	<b>140</b>
Scenario 2						
	P1		P2		Total	
	Book	Tax	Book	Tax	Book	Tax
On formation	100	100	100	70	200	170
Depreciation	(30)	(30)	(30)	(12)	(60)	(42)
Gains allocation	5	5	5	17	10	22
Closing balance	<b>75</b>	<b>75</b>	<b>75</b>	<b>75</b>	<b>150</b>	<b>150</b>

Example 2.13 illustrates that the purpose of prioritising tax allocations to non-contributing partners is to gradually allocate built-in gains/losses to the contributing partner over time. For instance, the prioritised allocation of tax depreciation to non-contributing partners increases the taxable income of the contributing partner.

However, if the trajectory of the FMV of a particular property reverses after the contribution (ie if built-in gains/losses are reduced after the contribution), there can be a distortion in allocation under the traditional method. This distortion is caused by the so-called ‘ceiling rule’ (§1.704-3(b)(1)), as described below.

**Example 2.14. ‘Traditional method’ and ‘ceiling rules’**

1. The same scenario as that in Example 2.12, except the property was sold for \$90.
2. PRS realised a book loss of \$10, which was distributed equally to P1 and P2. However, it generated \$20 in gains for tax purposes, which had to be allocated to P2, the contributing partner. This increased P2’s ‘adjusted basis’ in PRS from \$70 to \$90 (§705(a)(1)).
3. This situation triggers the ‘ceiling rule,’ which prevents the allocation of the total amount of Tax Items (ie total income, gain, loss or deduction) to non-contributing partners (P1) from exceeding the total amount of Tax Items of the partnership (ie PRS).
4. In this scenario, the FMV of the property declined by \$10 after the contribution. As a result, on the sale of the property, the built-in gains attributable to P2 decreased from \$30 to \$20. On the other hand, P1 incurred a \$5 economic loss, which could not be recognised for tax purposes owing to having no loss to allocate under the operation of the ‘ceiling rule’—this resulted in a distortion.
5. The following table summarises the operation of the ‘traditional method’ constrained by the ‘ceiling rule’:

	P1		P2		Total	
	Book	Tax	Book	Tax	Book	Tax
On formation	100	100	100	70	200	170
Gains/loss allocation	(5)	0	(5)	20	(10)	20
Closing balance	<b>95</b>	<b>100</b>	<b>95</b>	<b>90</b>	<b>190</b>	<b>190</b>

6. If PRS were immediately liquidated, the \$190 cash would be distributed equally to P1 and P2. P1, with her interest in PRS having an 'adjusted basis' of \$100, would realise a \$5 loss for tax purposes, representing an unrecognised economic loss during the operational period of PRS.
7. Conversely, P2, the contributing partner, would realise an additional \$5 in gains. This is calculated as the \$95 cash received minus the 'adjusted basis' of her interest, which was \$90. Therefore, P2 would realise a total of \$25, representing the difference between the \$95 cash received and her original 'adjusted basis' in PRS upon its formation.

Example 2.14 demonstrates that a distortion may occur when applying the 'traditional method' owing to the operation of the 'ceiling rule'. This distortion should be rectified upon eventual liquidation, which, however, can occur many years later.

#### Traditional method with curative allocations

Under the 'traditional method with curative allocations' (Treas. Reg. §1.704-3(c)), curative allocation is used to correct distortions created by the 'ceiling rule' by allocating a Tax Item that differs from the partnership's allocation of the corresponding Book Items. Although the allocation of Book Items to a partner's capital account always reflects the partner's economic entitlement and follows the partnership agreement, the Tax Item used for curative allocation is shared differently. This aims to make the tax allocations to the non-contributing partner equal their corresponding book allocations. The traditional method with curative allocations embodies the general concept underlying all of §704(c), which is to equalise the overall allocations to a non-contributing partner of the Book Items and Tax Items attributable to contributed property. Curative allocations must be reasonable in terms of type, amount and timing – see Example 2.15.

#### Remedial allocation method

Under the remedial allocation method (Treas. Reg. §1.704-3(d)), the partnership makes a notional allocation

to the non-contributing partner in an amount equal to the difference between the Book Item and the ceiling-limited Tax Item allocated to her. Simultaneously, the partnership makes a notional allocation to the contributing partner in an equal and offsetting amount. These remedial allocations are fully offsetting and have no effect at the partnership level, affecting neither its computation of taxable income nor its basis in partnership assets. The 'remedial allocation' does not depend on the existence of other items – see Example 2.16.

#### Subsection 2: Pre-contribution loss rules

§704(c)(1)(C) is designed to counter a particular aspect of Gain & Loss Shifting, namely pre-contribution loss shifting. §704(c)(1)(C) operates to quarantine a built-in loss with the contributing partner, preventing the partnership from shifting this loss to any other partner. Only proposed Treasury Regulations have been promulgated in respect of §704(c)(1)(C).<sup>26</sup>

The central concept of the proposed Regulations is the so-called 'section 704(c)(1)(C) basis adjustment' (referred to as "Quarantine Basis" hereinafter).<sup>27</sup> The Quarantine Basis initially equals the excess of the 'adjusted basis' of the contributed property over its FMV immediately before the contribution, subsequently adjusted for the recovery of that basis adjustment (eg depreciation). The Quarantine Basis is personal to the contributing partners, thereby not being

#### Example 2.15. Traditional method with curative allocations

1. The same scenario as that in Example 2.14, except PRS purchased another property for \$100 and then sold it for \$130, resulting in gains of \$30, which had the same character as the built-in gains of the contributed property. The \$30 gains were distributed to P1 and P2 equally as Book Items. However, for tax purposes, instead of allocating \$15 to each, PRS allocated \$10 to P1 and \$20 to P2, effectively curing the distortion caused by the 'ceiling rule', as shown in the table below:

	P1		P2		Total	
	Book	Tax	Book	Tax	Book	Tax
On formation	100	100	100	70	200	170
Sale contributed property	(5)	-	(5)	20	(10)	20
Sale purchase property	15	10	15	20	30	30
Closing balance	<b>110</b>	<b>110</b>	<b>110</b>	<b>110</b>	<b>220</b>	<b>220</b>

2. After the above transaction, PRS has \$220 property in total. The 'adjusted basis' of P1's interest in PRS was \$110, which includes the \$100 'adjusted basis' established at the formation of PRS increased by an allocation of \$10 gains under §705(a)(1)(A). Similarly, the 'adjusted basis' of P2's interest in PRS was \$110, including the \$70 'adjusted basis' established at the formation of PRS increased by a total allocation of \$40 gains under §705(a)(1)(A).
3. In a hypothetical liquidation, P1 and P2 would each receive \$110, which would offset their individual 'adjusted bases' of \$110. This confirms the effectiveness of curative allocation in eliminating the distortion caused by the ceiling rule.

**Example 2.16. Remedial allocation method**

1. The same fact as those in Example 2.14. The PRS cannot allocate the tax loss to P1 under the ‘ceiling rule’. If the PRS adopts the ‘remedial allocation method’, it makes offsetting notional allocations—a \$5 taxable loss to P1 and a \$5 taxable gain to P2—to eliminate the ‘ceiling rule’ distortion reflected in partner P1’s accounts. Taking these remedial allocations into account, the partnership’s allocations are as follows:

	P1		P2		Total	
	Book	Tax	Book	Tax	Book	Tax
On formation	100	100	100	70	200	170
Sale contributed property	(5)	-	(5)	20	(10)	20
Remedial allocations		(5)		5	-	-
Closing balance	<b>95</b>	<b>95</b>	<b>95</b>	<b>95</b>	<b>190</b>	<b>190</b>

2. After the above transaction, PRS has \$190. The ‘adjusted basis’ of P1’s interest in PRS was \$95; that is, \$100 ‘adjusted basis’ established at the formation of PRS decreased by an allocation of \$5 taxable loss under §705(a)(2)(A). On the other hand, the ‘adjusted basis’ of P2’s interest in PRS was \$95; that is, \$70 ‘adjusted basis’ established at the formation of PRS increased by a total allocation of \$25 in gains under §705(a)(1)(A).
3. In a hypothetical liquidation, P1 and P2 would receive \$95 each, which would be offset by their individual adjusted bases of \$95. This confirms the effectiveness of remedial allocation in eliminating the distortion caused by the ceiling rule.

taken into the calculation of partnership items under §703 and hence excluded from allocation to other partners.<sup>28</sup> This special basis adjustment will be lost if a contributed partner transfers its partnership interest to another person.<sup>29</sup> In this way, the proposed Regulation is designed to ensure that the contributing partner is the only partner, current or future, who receives the tax benefit associated with the contributed property’s built-in loss – see Example 2.17.

Where the contributed property with a built-in loss is depreciating property, P2 gets separate depreciation from

**Example 2.17. Operation of quarantine basis under §704(c)(1)(C)**

1. P1 and P2 form an equal partnership (PRS), P1 contributed \$50 in cash; whereas P2 contributed a property, with a \$50 FMV and a \$110 adjusted basis.
2. The ‘adjusted basis’ of the property was broken down into the two components:
  - a. \$50 as the ‘adjusted basis’ of the property in hand of PRS (ie its FMV at the time of contribution);<sup>30</sup> and
  - a. \$60 as the Quarantine Basis of the property in the hand of P2—the built-in loss.<sup>31</sup>
3. If the PRS subsequently sells the property for \$90, it recognises a book and tax gain of \$40, which it allocates equally between partners P1 and P2 (ie \$20 each and increase their capital accounts accordingly). To determine P2’s ultimate tax consequences, P2’s allocated taxable gain is to be reduced by the built-in loss basis (ie \$60), which produces a \$40 tax loss on sale.

the Quarantine Basis each year, in addition to depreciation allocated to her from the PRS in respect of the contributed property.

Non-recognition, commonly known as roll-over relief in Australia, upon the contribution of property to a partnership, necessarily means that the variation between the ‘adjusted basis’ of the property and its FMV, in the form of built-in gains or losses, will be transferred from the contributing partner to a partnership, potentially being distributed among other partners. Thus, roll-over reliefs are the nidus for fostering Gain & Loss Shifting, necessitating safeguard rules, such as §704(c), to thwart it.

In Australia, there are elective roll-over reliefs available for contributing trading stock (s 70-100(4) ITAA97) and a depreciating asset (s 40-340(3) ITAA97) to a partnership. However, it seems that, apart from s 70-100(10), which has limited operation, no preventive measures similar to §704(c) are in place. Therefore, it seems that those roll-over reliefs are susceptible to being exploited. This will be returned to for a more detailed discussion later in Part V.

**Section 4: Limitation on allowance of losses**

Even if partnership distributions are valid under §704(b) IRC, tax distribution may nevertheless be out of step with economic arrangement. A typical example is that tax loss flowing through to a partner can get ahead of the economic loss the partner suffers.

§704(d) provides that a partner’s distributive share of partnership loss is allowed as a deduction only to the extent of the ‘adjusted basis’ for her partnership interest at the end of the partnership year in which the loss is incurred. Losses disallowed to a partner under §704(d) may be carried forward indefinitely by the partner until sufficient ‘adjusted basis’ of partnership interest is available to permit their deduction.

### Example 2.18. Potential tax benefits where the loss is greater than the ‘adjusted basis’ of partnership interest

1. P1 contributed \$50 and P2 contributed \$100 to a partnership (PRS). They share profits and loss 10%:90%, which meets the Safe Harbour Rule.
2. In the first year, the PRS made a loss of \$120—thus, P1 shared a loss of \$12 and P2 shared \$108; that is, at that point, P2 realised \$108 for tax purposes but only suffered an economic loss of \$100, which resulted in an \$8 deficit in her capital account. She may need to make up the \$8 loss eventually, but there could be significant delay for this to occur.
3. The \$8 would not be deductible to P2 under §704(d).

Without the limitation of §704(d), a partner can enjoy tax benefits beyond their economic loss, thereby undermining the Safe Harbour Rule discussed above. In Australia, in the context of foreign hybrid entities (Div 830 ITAA97), Subdiv 830-C ITAA97 serves a broad function similar to that of §704(d). However, beyond Subdiv 830-C, there is no equivalent provision in Australia to prevent the immediate recognition of losses by a partner that are not commensurate with the economic loss.

## Part III: Partnership-level transactions (Australia)

In Australia, the rules governing the taxation of Partnership-Level Transactions are contained in Div 5 of Pt III ITAA36 (Div 5). Compared with the elaborate provisions of Subchapter K in the US, Div 5 is both rudimentary and abstruse. In essence, the operation of Div 5 comprises the following three stages of the process:

1. Compute the ‘net income’ or ‘partnership loss’. In general terms, ‘net income’ refers to the assessable income derived by the partnership, minus all allowable deductions. This calculation is based on the hypothesis that the partnership is a resident taxpayer (s 90 ITAA36). ‘Partnership loss’ occurs when allowable deductions exceed assessable income.
2. The ‘net income’ and ‘partnership loss’, as calculated in (1), are then distributed to partners based on their individual interests (s 92 ITAA36).
3. Partners include their respective shares of ‘net income’ in their assessable income, while shares of the ‘partnership loss’ are allowed as deductions (s 92).

Whereas it appears that Div 5 has a similar basic distribution scheme to Subchapter K in the US, as described in Part II, it is in a primitive form and succinctly elusive. The key concepts underpinning its operation need to be unpacked and discussed below.

### Section 1: ‘Net income’ and ‘partnership loss’

‘Net income’ and ‘partnership loss’, as defined in s 90 ITAA36, are indisputable tax concepts;<sup>32</sup> that is, they are not accounting profits and accounting losses (reference

to “accounting profits” hereinafter includes accounting losses unless otherwise separately stated), calculated according to the partnership agreement (Partnership Accounting). Deane J noted this distinction in *FCT v Everett* (*Everett* case)<sup>33</sup> where his Honour observed:<sup>34</sup>

“The ‘net income’ which is apportioned among the partners by s 92 can readily be seen as a convenient parallel, for the purposes of the Act, to the ‘profits’ in which the partners are entitled to participate. *Plainly the two will not necessarily correspond.*” (emphasis added)

Surprisingly, it seems that Partnership Accounting concepts and tax concepts have not been clearly distinguished, or worse, have been conflated in many judicial decisions and rulings issued by the Commissioner<sup>35</sup> (referred to as ‘Tax/Accounting Confusion’). The epitome of such conceptual confusion can be seen in the judgment of Dawson J in *FCT v Galland* (*Galland* case),<sup>36</sup> where his Honour stated:

“The Act speaks of ‘net income’ rather than the profits of the partnership business although *the two things are conceptually the same* in this context” (emphasis added)

In the author’s view, this Tax/Accounting Confusion infests the other key concepts of Div 5 and pervades all its operation, which is the main source of myriads of operational anomalies of Div 5 and other partnership taxation rules in Australia (as discussed in Part V).

### Section 2: Computation of ‘net income’ and ‘partnership loss’ of hypothetical taxpayer

The partnership is treated as if a taxpayer for the purpose of calculating the ‘net income’ and ‘partnership loss’ (s 90 ITAA36). In the author’s view, owing to Tax/Accounting Confusion, this statutory requirement that a partnership should be regarded as a distinct entity (ie the taxpayer) has been judicially watered down. An influential statement on this matter can be found in the Full Federal Court’s decision in *Rowe (B. and H.G.) v FCT* (*Rowe* case):<sup>37</sup>

“A partnership is not a company. It has no personality independent of those who constitute it. The gross income of a partnership is earned jointly by the partners. The outgoings of a partnership are joint outgoings of the partners. The profits of a partnership are their profits.

....

There is nothing in the Act which denies or alters the basic legal principle that the profits or net income of a partnership are the profits or net income of those who constitute it.”

The paragraph above appears to conflate, or at the very least, fails to clearly distinguish between, Partnership Accounting concepts and tax concepts, echoing Dawson J’s observations in the *Gallant* case, as cited earlier. This conflation seems to have led to the assimilation of the fundamental general law principle that a partnership is not a legal person into the tax context. In the author’s view, this assimilation undermines the statutory requirement that a partnership should be regarded as a distinct entity for the

purpose of computing ‘net income’ and ‘partnership loss’. This, in turn, gives rise to two key issues.

First, the ‘net income’ or ‘partnership loss’, as an artificial amount, is better to be regarded as derived by the partnership, rather than by partners. Because it is conceptually difficult to conceive that a factitiously generated income or loss can be derived by partners and then somehow imbued with a character as ‘net income’ or ‘partnership loss’ of a partnership.

### Example 3.1. Illustration of ‘net income’ as an artificial amount

1. A partnership (PRS) derived \$100 in income, which was used to entertain a client. Thus, the accounting profits of PRS were nil; however, it had \$100 in ‘net income’, since the entertainment expense was not deductible under s 32-5 ITAA97.
2. As a practical matter, the \$100 in ‘net income’ does not reflect in any asset, whether money or property—it is an artificial amount.

The application of the statement in the *Rowe* case, cited above, appears to encounter a considerable challenge. This is because, although the partners jointly derived \$100 in income and collectively incurred \$100 in entertainment expenses, the \$100 in ‘net income’ was artificially generated by the tax legislation. In other words, it is difficult to assert that it originated from the partners.

This challenge becomes overwhelming when pure artificial tax amounts are involved. For example, when the partnership is an attributable taxpayer (as per s 361 and s 366 ITAA36), its ‘net income’ includes attributable income under s 456 ITAA36 by the force of the controlled foreign company rules in Pt X ITAA36—in this statutory process, it is impossible to assert that a partner derives attributable income.

Under Div 830 ITAA97, a foreign hybrid can be treated as a partnership in Australia. Where a foreign hybrid is a legal entity in another country—a typical example is a limited liability company formed in Delaware—an issue is emerging (see discussion in Part VI) regarding how the tax principles derived from the context of partnership law in Australia (where the partnership is not a legal entity) apply to a foreign hybrid that conducts business, owns assets and incurs liabilities in its own right as a distinct legal entity.<sup>38</sup>

Second, the statement in the *Rowe* case quoted above indicates that a partnership differs as a taxpayer from a company but does not articulate what the differences are. It somehow circumscribes the concept of a taxpayer as defined in s 6(1), which means that a “person deriving income or deriving profits or gains of a capital nature”. This raises a fundamental question—namely, how and when the income and outgoings derived by partners are imbued with the requisite characteristics, thereby entering into the calculation process of ‘net income’ or ‘partnership loss’.

This question becomes acute in cases where partners pool their assets together to form a partnership and thereafter share the profits arising from the use of and/or disposal of those assets.

This is essentially the unanswered question in the *Rose v FCT* (*Rose* case),<sup>39</sup> where the High Court did not rule on the tax consequences arising from trading stocks and the adjustable value of depreciable assets brought into a partnership. This partnership was formed as a consequence of a father, who initially operated as a sole trader, gifting two-thirds of his pastoralist business to his two sons.

The High Court did rule that there were no tax implications arising from the father’s gift of two-thirds of trading stocks and depreciating assets to his two sons. The issues arose from the disposal of trading stock and depreciating assets in the *Rose* case, which are now subject to specific statutory rules (s 70-100, s 40-295(2), s 40-300(2) item 5 and s 40-340(3)–(7) ITAA97). The *Rose* case and these statutory rules will be discussed in Part V.

### Example 3.2. ‘Net income’ of a partnership with contributed assets from a partner

1. P1 and P2 each separately operated investment businesses, similar to the one conducted by the taxpayer in *London Australia Investment Co Ltd v FCT*.<sup>40</sup> The profits derived from the realisation of their investment businesses were treated as on revenue account.
2. P1 and P2 decided to form an equal partnership (PRS) to continue their businesses jointly. P1 contributed A shares with a cost of \$10 and a market value of \$100, while P2 contributed B shares with a cost of \$120 and a market value of \$100.
3. It appears that there may be an argument that there were no tax implications on the contribution of A shares and B shares to establish the PRS based on the *Rose* case (see the detailed discussion in Part V).
4. In the current income year, the PRS disposed of the A shares for \$150. Since the PRS is only required to calculate ‘net income’ and ‘partnership loss’ after its formation, it logically seems that the profits should amount to \$50, representing the gains accrued during the partnership period. However, if this were the case, it does not seem that the \$90 of built-in gains would be assessable to P1. If the ‘net income’ is \$140 (ie \$150 – \$10), P2 would share 50% of the gains, which provides significant opportunities for Gain & Loss Shifting—a form of Partnership Tax Arbitrage, as defined in Part II.

It does not seem open to calculate ‘net income’ for P1 and P2 separately. Brennan J in the *Galland* case<sup>41</sup> made clearly that the “net income of a year of income is a single amount ascertained for the whole year on a basis appropriate for the particular partnership business”.

In the US, contributions of assets to a partnership by a partner are subject to elaborate rules contained in §721 to §724 IRC (to be discussed in Part IV). There are specific rules (§704 which, as discussed in Part II) dealing with the allocation of taxable income of a partnership, concerning property contributed by a partner with built-in gains and losses attributed to a pre-contribution period.

By contrast with US rules, it is apparent that there is a lacuna in Div 5 in the computation of the ‘net income’ and ‘partnership loss’ in respect of assets contributed by a partner, except where there are statutory rules, such as rules pertaining to trading stock and depreciating assets (s 70-100, s 40-295(2), s 40-300(2) item 5 and s 40-340(3)–(7) ITAA97). As the US experience demonstrates, these issues do not render themselves for easy resolution.

In 1997, at the very beginning of the rewriting of ITAA36 into ITAA97,<sup>42</sup> a definition of ‘entity’ was introduced into s 960-100 ITAA97, which, inter alia, includes a partnership, on an equal footing with other entities such as a company.

As the Full Federal Court in *Sunlite Australia Pty Ltd v FCT*<sup>43</sup> pointed out, the concept of an entity is “fundamental to the structure of ITAA97 because the legislation imposes many taxpayer obligations and confers taxpayer benefits upon entities”.

This important development has not attracted any specific comments from the court and the Commissioner. That is probably because a partnership does not have assets and liabilities, nor does it derive income or incur outgoing expenses, according to the *Rowe* case. Thus, even if a partnership is treated as an entity, it is an empty concept without any practical implications.

### Section 3: Individual interest

The author finds it difficult to comprehend the meaning of ‘individual interest’ in ‘net income’ and ‘partnership loss’, as ‘net income’ and ‘partnership loss’ are artificial amounts. The phrase ‘individual interest’ in ‘net income’ and ‘partnership loss’ seems to be rooted in the Tax/Accounting Confusion when drafting the legislation.

Justice Sundberg J in *Zeta Force Pty Ltd v FCT*<sup>44</sup> in a statement quoted by the High Court in the *Bamford* case<sup>45</sup> provided:

“The contrast between the expressions ‘share of the income of the trust estate’ and ‘that share of the “net income” of the trust estate’ shows that the draftsman has sought to relate the concept of present entitlement to distributable income, and not to taxable income, which is, after all, an *artificial tax amount*. Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate.” (emphasis added)

The above statement is made in the context of Div 6 ITAA36, which pertains to trust income (referred to as “Div 6”). It highlights the conceptual difficulty of allocating ‘net income’ or ‘partnership loss’, which is, after all, an artificial amount. However, this difficulty can be overcome by using a ‘real amount’ as a basis for allocation purposes, and profits for Partnership Accounting purpose appear to be the most suitable candidate for determining ‘individual interest’.<sup>46</sup>

An examination of several judicial decisions<sup>47</sup> reveals that ‘net income’ has indeed been allocated based on the share of profits within a partnership. Unfortunately, the author has failed to discover a specific judicial decision that

clearly articulated the rationale that the share of profits is equivalent to, or can be used as a basis for determining, ‘individual interests’. However, the Commissioner did state in IT 2316<sup>48</sup> (also refer to IT 2218<sup>49</sup>) that the ‘net income’ of a partnership should be distributed in accordance with the basic agreement between the partners for the sharing of profits and losses.

In the author’s view, the allocation based on the share of profits in judicial decisions and the Commissioner’s rulings, as mentioned in the last paragraph, is due to Tax/Accounting Confusion rather than being the theoretically best measure of the ‘individual interest’ in ‘net income’. There are several issues associated with determining the ‘individual interest’ based on the share of profits agreed upon by the partners.

First, should the share of profits be determined under the proportionate view or the quantum view? The quantum view seems to have been implicitly adopted in *FCT v Nandan*,<sup>50</sup> where, on dissolution of a partnership after an acrimonious dispute, one of two equal partners agreed to limit his profit share to \$15,000 in the financial year ending on 30 June 1992. The court ruled that the \$15,000 constituted the share of the 1992 net profits. Quantum view<sup>51</sup> appears to be unattractive in the partnership taxation context, since it is not clear where a partner’s ‘individual interest’ in the ‘net income’ exceeds that partner’s share of profits, who is to be taxed on the excess of ‘net income’ over the profits. In the author’s view, the proportionate view should be preferred, consistent with the taxation of trust income.<sup>52</sup>

Second, when the partnership agreement specifies different ratios for sharing profits and losses, how should the ‘net income’ be allocated when the partnership incurs a loss for Partnership Accounting purposes, and vice versa?

#### Example 3.3. Profits or losses for Partnership Accounting purposes vs ‘net income’ or ‘partnership loss’

1. P1 and P2 formed a partnership (PRS). They agreed to allocate 100% of the profits to P1 but 100% of the losses to P2 in a particular year.
2. In that particular year, PRS had profits of \$100 but a ‘partnership loss’ of \$50.
3. It seems unreasonable for P1 to receive \$100 in profits, while also enjoying the \$50 deduction. It is not clear how ‘net income’ should be allocated in this situation and similar scenarios.

Third, if the profit is nil but there is ‘net income’ or a ‘partnership loss’, as illustrated in Example 3.1, how should the allocation be made? In the context of trust taxation, the trustee may either be taxed on the ‘net income’ or carry forward the loss. However, in contrast, partnership taxation is predicated on the principle that all of the partnership’s ‘net income’ and ‘partnership loss’ must be allocated to the partners. Once again, there is no clear path to resolving this conundrum.

Until recently, it seemed that the ‘individual interest’ means the share of the profit of partnership (refer to “Indirect

Allocation”). However, a new development occurred in in *FACT v McNally*, where Jessup J said:<sup>53</sup>

“Once the ‘net income’ has been determined in accordance with the taxation law, any agreement between the partners as to *the allocation of that amount is binding upon the partners for the purposes of section 92*” (emphasis added)

The above statement seems to suggest that the ‘individual interest’ is a term created by the ITAA36—in other words, it is not an integrated concept of partnership law. Therefore, partners can agree on the ‘individual interest’ without constraints from other terms of the partnership agreement and partnership law. This approach is termed “Direct Allocation” hereinafter, in contrast with Indirect Allocation. In the author’s view, because it is devoid of an association with the economic entitlement of a partner, Direct Allocation is a perilous step towards creating opportunities to exploit the structural weaknesses of a partnership, as discussed below.

As explained in Part II, in the U.S, taxable income can be divided and distributed in fragments. This gives rise to a question regarding how to determine ‘individual interests’ when taxable income in the U.S. has been distributed in this manner. This matter will be revisited for further discussion in Part V.

#### Section 4: Allocation of component of ‘net income’ and ‘partnership loss’

In the context of Div 6, there had been a long-standing practice of distributing the components of ‘net income’ (referred to as “streaming”) of trusts under the auspices of TR 92/13, which came to an end after the *Bamford* case.<sup>54</sup> However, the streaming of franked dividends and capital gains is later allowed under the statutory scheme, specifically under Subdivs 115-C and 207-B ITAA97. The *Thomas* case<sup>55</sup> can be regarded as an unsuccessful attempt by the taxpayer to break down a particular income for tax purposes (ie separation of franking credits from the dividend) to distribute the components differently. However, as far as the author is aware, the streaming of components of ‘net income’ or ‘partnership loss’ in the partnership tax context has never attracted any discussion.

In the *Bamford* case,<sup>56</sup> as further explained in the *Greenhatch* case,<sup>57</sup> the courts established the following two principles:

1. the ‘net income’ (in the context of Div 6) should be allocated to beneficiaries proportionately; and
2. ‘net income’ cannot be breakdown and distributed—only a portion of which can be allocated to the partners.

As to the second principle, the *Greenhatch* case, the full court made it clear that (Edmond, Greenwood and Robertson JJ) “once the trust law distribution gave the share, it should not be used to determine, in a causative sense, the components of the s 97(1)(a) assessable income”.<sup>58</sup>

For the sake of consistency between the taxation of partnerships and taxation trusts in Australia, it seems to the author that the above reasoning should be incorporated into Div 5 regarding the distribution of ‘net income’ and

‘partnership loss’. In the author’s view, the *Greenhatch* case has foreclosed the possibility of fragmental distribution of ‘net income’ and ‘partnership loss’, as can be done in the US, as discussed in Part II. This divergence will pose significant challenges for a US ‘foreign hybrid’ (as defined in s 830-5 ITAA97), which is required to determine the distribution of taxable income or tax losses (as in general terms) of a partnership for both US and Australian tax purposes, as discussed in Part VI.

#### Section 5: Physical distribution of profits

It has been long settled<sup>59</sup> that the allocation of ‘net income’ or ‘partnership loss’ is notional process, and that there is no further tax implication in terms of physical distribution whether in cash or in specie.<sup>60</sup>

It seems to the author that the segregation of economic benefits and tax burden, along with the discriminatory allocation among taxpayers, is the quintessential technique underpinning many tax-abusive schemes. The severance of physical distribution of profits from the allocation of ‘net income’ or ‘partnership loss’, which can be notionally made without a foundation of economic entitlement under the Direct Allocation method, positions the partnership structure as the optimal candidate to implement the said technique.

In contrast, as mentioned in Part II, Treas. Reg. §1.704-1(b) in the US is devoted to the goal of ensuring that the allocation of a partnership’s taxable income among partners accurately reflects the economic arrangement of the partners. To achieve that goal, the US Treasury introduced the Capital Account Rules under the Safe Harbour Rules to ensure a watertight tie-up between partnership distribution and the economic entitlement of a partner (extensively discussed in Part II).

In the author’s view, the development of Div 5 has been unduly influenced by partnership law in Australia. Under this influence, a partnership is somehow a ‘less’ taxpayer,<sup>61</sup> an amorphous concept, and Tax/Accounting Confusion pervades through the operation of Div 5, generating anomalies and uncertainties in its operation. Further, the physical distribution of economic benefits (in cash or in kind), without being constrained by having substantial economic effects as required in the US, is a loophole that must be closed.

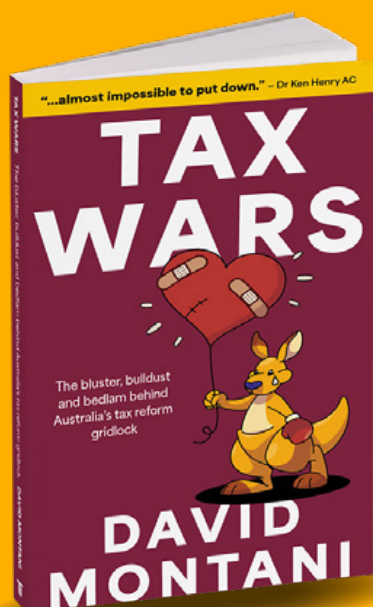
**Buck Xiao, CTA**  
Director Tax  
Hall Chadwick Melbourne

#### References

- 1 Denote: Code of Federal Regulations, title 26, Chapter 1, Subchapter A, Part 1.
- 2 S 91 ITAA36.
- 3 In this article, income and gain also imply loss if not expressly stated separately and juxtaposed.
- 4 Treas. Reg. §1.702-1(a)(8).
- 5 §957(c) IRC.
- 6 §957(a) IRC.
- 7 §954(d) IRC.
- 8 §954(c) IRC.
- 9 §951(a) IRC.
- 10 W McKee, W Nelson and R Whitmire (n.d.). *Federal taxation of partnerships and partners*, Thomson Reuters, para 9.01. Available at <https://1.next.westlaw.com> (accessed 10 January 2024).
- 11 *Ibid*, para 11.02[3].

- 12 Ibid, para 6.04; B Bittker and L Lokken (n.d.). *Federal tax of income, estates and gifts*, Warren, Gorham and Lamont, para 87.2.2. Available at <https://1.next.westlaw.com> (accessed 10 September 2023).
- 13 Contributed property by partners is dealt with under §704(c), which is discussed extensively below
- 14 The Treas. Reg. also made some adjustment because of the operation of some specific regimes; for example, depletion allowances with respect to oil and gas properties of the partnership, which only accounted at the partners level.
- 15 §1.704-1(b)(5), Example 15.
- 16 §1.704-1(b)(5), Example (10)(ii).
- 17 W McKee, W Nelson and R Whitmire (n.d.). *Federal taxation of partnerships and partners*, Thomson Reuters, para 87.2.5. Available at <https://1.next.westlaw.com> (accessed 10 January 2024).
- 18 Treas. Reg. §1.704-1(b)(2)(iii)(c) and example 2 in para (b)(5).
- 19 §1011 IRC. Adjusted Basis is equivalent to 'cost base' and 'reduced cost base' as defined in Div 112 ITAA97.
- 20 Treas. Reg. §1.704-1(b)(2)(ii)(d) and §1.704-1(b)(5), Example 1(vi).
- 21 Treas. Reg. §1.704-1(b)(5), Example 1(xi).
- 22 §1.704-1(b)(2)(iii)(d)
- 23 G Cooper, M Dirkis and M Stewart (2020). *Income taxation: commentary & materials*, 9th edition, Thomson Reuters, [13.110].
- 24 The definition of "nonrecourse liability" also includes §1.752-7 liability (as defined in §1.752-7(b)(3)(i)), which is not subject to discussion in this article.
- 25 B Bittker and L Lokken (n.d.). *Federal tax of income, estates and gifts*, Warren, Gorham and Lamont, para 87.4.3. Available at <https://1.next.westlaw.com> (accessed 10 September 2023).
- 26 REG-144468-05, 79 Fed. Reg. 3042 (16 Jan 2014)—*Disallowance of Partnership Loss Transfers, Mandatory Basis Adjustments, Basis Reduction in Stock of a Corporate Partner, Modification of Basis Allocation Rules for Substituted Basis Transactions, Miscellaneous Provisions*.
- 27 §1.704-4(f)(2) of proposed Regulations.
- 28 §1.704-4(f)(3)(ii) of proposed Regulations.
- 29 §1.704-4(f)(3) of proposed Regulations.
- 30 §704(c)(1)(C)(ii) IRC; §1.704-3(f)(3)(ii)(A) of proposed Regulations.
- 31 §1.704-3(f)(2)(iii) of proposed Regulations.
- 32 I Tregoning, "Partnership salaries and TR 2005/7", (2005) 8(2) *Journal of Australian Taxation* 351, under heading "5. 'NET INCOME' VERSUS PROFIT".
- 33 78 ATC 4595.
- 34 78 ATC 4595 at 4610. This distinction was also noted by Bowen C.J at 4600.
- 35 Para 9 of TR 2005/7. I Tregoning, "Partnership salaries and TR 2005/7", (2005) 8(2) *Journal of Australian Taxation* 351, footnote 19.
- 36 (1986) 162 CLR 408 at 428.
- 37 82 ATC 4243 at [4243].
- 38 *Anson v Commissioners for Her Majesty's Revenue and Customs* [2015] UKSC 44 at [10].
- 39 (1951) 84 CLR 118.
- 40 (1977) 138 CLR 106; 77 ATC 4396.
- 41 (1986) 162 CLR 408, at 418.
- 42 *Australian Income Tax 1997 Commentary* (online), Thomson Reuters, at [960-E.1020].
- 43 [2023] FCAFC 43 at [24].
- 44 (1998) 84 FCR 70 at 74-75.
- 45 *FCT v Bamford* [2010] HCA 10 at [45].
- 46 It is conceivable that the allocation can be made on other accounting concept such as gross income.
- 47 Such as *FCT v Happ* (1952) 9 ATD 447, *FCT v Beville* (1953) 10 ATD 170, *Jones v FCT* (1963) 109 CLR 342 and *McNally v FCT* [2007] FCA 51.
- 48 At para 5.
- 49 At para 6.
- 50 96 ATC 4095.
- 51 In the trust taxation context, this was the view taken by the court in *Richardson v FCT* (1997) 37 ATR 452.
- 52 *FCT v Bamford* [2010] HCA 10.
- 53 *FCT v McNally* 2007 ATC 4150 at [47], which is adopted by para 22 of TD 2015/19.
- 54 *FCT v Bamford* [2010] HCA 10.
- 55 *Thomas v FCT* [2017] FCAFC 57.
- 56 *FCT v Bamford* [2010] HCA 10.
- 57 *Greenhatch v FCT* [2012] FCAFC 84.
- 58 At para 36.
- 59 *FCT v Whiting* (1942) 68 CLR 199 at 204; *Rose v FCT* (1951) 84 CLR 118 at 125.
- 60 G Cooper, M Dirkis and M Stewart (2020). *Income taxation: commentary & materials*, 9th edition, Thomson Reuters, [13.110].
- 61 *Rowe* case at [4243]—see further discussion in Part IV.

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