Summary of a Partnership Operation and Taxation

A partnership is basically two or more people or entities (e.g. companies) acting together to achieve a common goal of running a business for a profit. This definition excludes "business partners" that have set up a separate entity together (e.g. a company) – and this concept confuses many people.

This brochure aims to explain when are you actually running a "partnership", and what this means from both a common law view and specifically a tax law view.

Disclaimer

Please note that this is not intended to be an exhaustive description of a partnership, or any other subject.

We have provided this document as a very basic guide to partnerships which is intended to assist people in improving their understanding of partnerships and how they operate.

This document is not to be taken as advice under any circumstances. If you are considering acting based on anything written in this document, we suggest you seek professional advice first.

We will not accept liability for anyone relying on the contents of this document

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What is a Partnership

The definition of a partnership is slightly different depending on whether you go by common law or taxation law.

The Common Law Definition

Under common law, a partnership is a group of people carrying on business in common with a view to make a profit.

This definition is contained within the Partnership Act 1958, which also goes on to specifically exclude those persons as members of a corporation or association that is registered and/or covered by another law. As such, companies, trusts, clubs, and the like are all excluded from being a partnership as they are all covered by specific pieces of legislation (*e.g. Corporations Act, Trusts Law, etc*).

Also under the Partnership Act, the following arrangements are not necessarily a partnership (but may be depending on the actual circumstances):

- Joint tenancy;
- Tenants in common;
- Joint ownership;
- Common ownership; and
- The basic sharing of gross returns.

A partnership under common law is generally referred to as a "firm" (e.g. a firm of solicitors). We will use this term throughout this document.

The Tax Law Definition

According to Tax Law, a partnership is an association of persons carrying on business as partners *or in receipt of income jointly*, but does not include a company.

It is important to remember that the tax law definition is only relevant for tax purposes. This definition mainly determines whether or not a separate "partnership" tax return is required to be lodged – and just because a partnership tax return is lodged, it doesn't mean that a partnership exists for common law purposes.

While both definitions seem very similar, the words "or in receipt of income jointly" extend the scope of a partnership from being just business related, to any form of joint receipt of income (i.e. income from investments).

The Legal Nature of a Partnership

The legal entitlements and responsibilities of the partners in the partnership is determined by common law. There are many cases on partners entitlements, and in Victoria (as well as other States), there is specific legislation covering partnerships – being the Partnership Act 1958.

Relationships between partners

The general rule in a partnership is that all partners are equals unless a partnership agreement states otherwise. All items listed below are stated as per common law, but a partnership agreement is able to modify any of the below terms (*e.g. a partnership agreement can state that partners do not share equally in the profits*).

Profits

Each partner in the partnership shares equally in the profits of the partnership. It is this item that many typical "Mum and Dad" partnerships want to vary via a partners salary (which is covered in detail in a separate brochure) – basically where one of the partners works full time in a separate occupation, for tax reasons they may wish to distribute less than half of the partnership profits to that person.

Capital (Assets)

All assets purchased with partnership monies are partnership assets, and all partnership assets are owned equally and jointly. A partner generally cannot sell their share of a partnership asset without the permission of the other partners.

Losses

All partners are required to contribute equally towards the losses of the partnership. The firm (partnership) also must indemnify each partner for personal losses incurred in conducting the ordinary business of the partnership.

Contributions to partnership capital

When starting a partnership, often initial capital is required (*e.g. monies to purchase initial stock or equipment*). Where a partner contributes more than the required and agreed amount, that partner is entitled to receive interest at 7% from the firm – but this can only be paid from the profits of the partnership (*i.e. it cannot be paid from a loss making partnership*).

Management

Each partner is entitled to participate in the management of the partnership.

Wages/Salaries

No partner is entitled to be remunerated for their participation and contribution towards the firm (*i.e. the partnership cannot pay a wage to one of the partners*). A "partners salary" was mentioned earlier – this is not a wage as such, but a variation to the terms of the partnership agreement to distribute profits. This is discussed in detail in the "partners salaries" brochure.

New partners

A new partner cannot be introduced without the consent of all partners. Technically when a new partner is added, the old partnership is dissolved, and a new one created. ***This is especially important from a tax point of view, and tax advice should be sought whenever the make up of the partnership is being discussed.***

Voting

As each partner shares equally in the partnership, each partner has an equal "vote" in partnership matters. All ordinary matters can be decided by a majority vote, but the decision to change the nature of the business must be unanimous.

Access to records

All partners have the right to inspect the books and records of the partnership at any time.

Expulsion of a partner

No partner can be expelled from the partnership without the leaving partners agreement.

Retirement of partner

A partner can retire or leave the partnership at any time.

Disclosure of personal benefits

Each partner is required to disclose all private benefits obtained by the use of partnership assets, whether deliberate, coincidental, authorised, or otherwise. This requirement continues even after the partnership has ceased.

Duty not to compete

Each partner is obliged to ensure that they do not compete with the partnership business without written consent. If a partner does compete, that person is required to pay all profits made to the partnership – essentially it is as if the partnership made that money.

For example, Mr. A is one of the partners in the ABC partnership, which is a solicitors firm. Mr. A does some small soliciting work on his own and earns income of $10,000. Mr. A will be required to pay this $10,000 to the ABC partnership.

Relationship between the firm and third-parties

There are also rules that all partners should be aware of when one or more partners deal with third-parties (*e.g. customers, suppliers, financiers, etc*). These rules **cannot** be altered by a partnership agreement as they concern parties other than just the partners.

Power to bind the firm

Each partner is an agent of the firm. This means that each partners actions bind the firm, including all partners.

For example, Mr. A signs a contract with a supplier for the purchase of goods that the partnership does not need. Regardless of whether Mr. A is one of two partners, or one of a hundred, his actions have bound all partners to the contract. This is the case even if every other partner disagrees with Mr. A's decision.

There are other laws surrounding contracts and agents that are applicable here that are too detailed to go into. In very general terms, unless both:

- the partner expressly had no authority (*e.g. via a partnership agreement*) to make that particular action (*e.g. sign that contract*); and
- either one of the following:
  - the third-party knew; or
  - the third-party should have known

the actions of that partner bind the firm.

Following on from the above example, lets say Mr. A had no authority to sign contracts over a certain amount, and he has broken that agreement. The partnership is still bound by Mr. A's action unless the supplier did know or should have known that Mr. A was not allowed to sign that contract.

In reality, the third-party will almost never be aware (or should have been aware) that the partner was not authorised to sign the contract/perform that action – so one partners actions will almost always bind the firm.

Provision of credit for personal purposes

If one partner promises some of the partnership assets (*e.g. money or an asset used as security*) for private purposes, the partnership **is not** bound to this unless that partner is expressly authorised to do so.

For example, if Mr. A promised to loan his father in-law $20,000 from the partnership, the partnership is not bound by this action.

Joint liability of all partners

<u>This is possibly the most important of all partnership rules</u>

Each and every partner is jointly liable for all debts of the partnership incurred while he/she is a partner.

For example, the ABC partnership gets sued for $20mil. No partner is limited in the amount of money they must personally contribute to the partnership to pay off this $20mil debt.

If Mr. A only has a house worth $400,000, then the other partners are liable for the remaining $19.6mil – they are not capped at $400,000 as an "equal" contribution, nor are they capped at an even share of the $20mil total.

When this rule is combined with the "power to bind the firm" rule from above, a partnership becomes a very ineffective business structure for unrelated business partners.

Since each partner is liable for the other partners actions, one person who does nothing wrong can end up losing all personal assets because of the actions of a "rogue" partner.

Liability of persons holding out as partners

Persons who make out to third-parties (whether expressly or implied) that they are partners of a partnership (regardless of whether they actually are or not), and that third-party provides credit to the firm, that party is liable as a partner for this credit.

*For example, Mr. D is **not** a partner in the ABC partnership, but a mere employee. Mr. D goes to the bank to borrow $50,000 and signs documents as a partner of the ABC partnership. Mr. D will be liable for the repayment of the $50,000 along with the actual partners of the ABC partnership.*

If the partnership cannot repay this $50,000 loan, then Mr. D will be personally liable (as will the other partners).

Liability limited to when you are a partner

A person who joins a partnership is not liable for liabilities incurred before he/she became a partner.

Similarly, a person leaving a partnership is liable for liabilities incurred while he/she was a partner – even after leaving the partnership.

However, a person leaving the partnership can be discharged of his/her liability if all other partners and the creditors agree that the other partners will be solely liable.

Special rules on dissolution of the partnership

There are a number of rules that govern when a partnership is dissolved, and when partners are liable and when they stop becoming liable for the actions of the partnership. The most important and common are summarised below.

Death of any partner

The death of any partner of the firm immediately dissolves the partnership. The surviving people are able to begin a new partnership from the date of deceased's death.

Dissolution by the court

The court may dissolve the partnership at the request of any partner under the following circumstances:

- when a partner is mentally ill;
- when a partner become permanently unable to perform his/her duties;
- when a partner is guilty of serious misconduct in relation to the partnership business;
- when the partnership can only be carried on at a loss; or
- any other reason that the court feels it is fair and equitable to dissolve the partnership.

Obligation to notify upon retirement of a partner

Where a partner retires from the partnership, and the other partners continue the business, the retiring partner may still be liable for the debts of the new partnership if no notice has been given to third-parties.

Notice can be given individually to parties that have been dealt with in the past, or an advertisement can be published in the newspaper.

Profits made after retirement, but before payout

Where a partner retires from a partnership and the other partners continue the partnership business, profits may be made by the new partnership before the retiring partner has been paid out.

In this case, the retired partner has the option of receiving:

- interest at a rate of 7%; or
- a share of the profits attributable to the use of his/her share of the assets used by the new partnership.

For example, Mr. A leaves the ABC partnership on 30/6/09, but gets paid out on 31/12/09. Mr. A was a 1/3rd partner and was entitled to a payout of $100,000. In that 6 month period, the partnership earns $45,000 profit.

Mr. A can choose to receive either:

- *$3,500 of interest (being $100,000 times 7% for 6 months); or*
- *$15,000 of profits (being 1/3rd of the profits earned for the 6 months).*

Importantly, the amount of the profits are not necessarily what are shown in the books of the partnership, but "as the court may find to be attributable to the use of his share of the partnership assets".

Basically the court could take into account any other factors that it sees fit, including a "notional wage" for the personal efforts of the continuing partners which would reduce the profit figure from those shown on the books.

Structures similar to a partnership, but are not a partnership

There are many terms used that reflect joint ownership or going into business together. Most of these are not considered a partnership under common law (although tax law may determine that a partnership tax return is required to be lodged).

We have listed and given a short explanation of the most common terms used below.

Joint Ventures

The term joint venture is normally used when referring to two or more unrelated parties doing business together.

Most joint ventures will also be partnerships under common law, however sometimes the term "incorporated joint venture" is used which actually means that two parties have formed a company or trust together.

Tenants in Common

Used almost exclusively when referring to property. When two or more parties own property it may be as either "tenants in common" or in "joint ownership". The main difference between the two is how you can deal with your share separate to the other holders.

Tenants in common denotes that your share is separate and you are able to transfer your share without the other holder also transferring theirs (*i.e. your share is essentially a separate asset*).

This difference extends to survivorship. Upon death, your estate is able to deal with your share of the property how it likes.

Tenants in common are able to own unequal proportions in the property. This is common with rental properties where the intention is to get one owner most of the income or loss (for tax purposes), and the other as little as possible.

Joint tenants

Also known as joint ownership. Basically your ownership of the property is not separately transferrable, and all owners have equal shares.

Upon death, your share defaults to the surviving owners, and does not go to your estate.

For example, Mr. A and Mr. B jointly own an investment property. Upon the death of Mr. A, Mr. B "inherits" the other half of the property and becomes the sole owner. Additionally, Mr. B is not required to compensate Mr. A's deceased estate for the value of this property.

"Business Partners" using a Company / Trust

Often people will be business partners and describe themselves as "partners" but are operating under a Company or Trust structure. (*e.g. the business partners are actually equal shareholders in a Company*).

A Company or a Trust is an entity established under other laws and are governed separately to partnerships. We have brochures that cover both of these arrangements.

Taxation of a Partnership

As discussed above, a partnership is not a separate entity to the partners, but merely two or more people combining efforts in business to make a profit. However, regardless of this fact, under Tax Law, a partnership is essentially treated as a separate entity.

A partnership is required to get a separate Tax File Number (TFN) and Australian Business Number (ABN), and is required to lodge a separate tax return to those of each partner.

A partnership is treated separately from a tax point of view mainly for administrative ease. Instead of all partners having to get a separate ABN and provide those to all suppliers and put on all tax invoices (*e.g. Mr. A with ABN 11111111111 and Mr. B with ABN 22222222222 and...*), the partnership registers as a separate entity would and obtains its own TFN and ABN.

Taxing Partnership Income

This is where the ATO stops treating a partnership as a separate entity. Yes the partnership does a separate tax return, but it does not pay tax separately.

Each partner pays tax on their share of the net income of the partnership.

This can have both its benefits and disadvantages – purely because the amount of tax each partner pays will be determined by what other income that partner has (or what entity that partner is).

Individual partners

Individuals pay tax at marginal tax rates that increase in line with an increase in taxable income. Importantly, different types of income are not taxed separately, all income is added together and then the above tax rates are applied.

As of the time of writing, the tax rates for individuals are listed on the following page:

Taxable Income			Tax Rate	Tax Payable		
$ 0	to	$ 18,200	0%	*$ 0*		
$ 18,201	to	$ 37,000	19%	*$ 0*	*plus*	*19% of the amount over $18,200*
$ 37,001	to	$ 80,000	32.5%	*$ 3,572*	*plus*	*32.5% of the amount over $37,000*
$ 80,001	to	$180,000	37%	*$ 17,547*	*plus*	*37% of the amount over $80,000*
$180,001	and above		45%	*$ 54,547*	*plus*	*45% of the amount over $180,000*

For example, Mr. A has wages of $80,000, and his share of the partnership income is $20,000 – Mr. A's taxable income is $100,000. Using the above table, Mr. A's tax payable is $24,947.

Given that if Mr. A received no partnership income his tax would be $17,547, it is reasonable to conclude that the tax due to the partnership income is the difference - $7,400.

Company partners

A partnership does not have to comprise of just individuals, other entities are able to be partners in a partnership. A company that is a partner will pay tax at 30% on its share of the partnership profits.

Using the above example, say B Pty Ltd is one of the partners of the ABC partnership and also has $80,000 of other income to go with a $20,000 share of partnership profits.

B Pty Ltd will pay $30,000 of tax in total, with $6,000 of this being attributable to the partnership income.

Trust partners

A trust is a little more complicated because a trust itself does not normally pay tax as a separate entity, instead the beneficiaries of the trust pay the tax on their share of the trusts income.

Basically the income of the partnership flows through the trust to the trust's beneficiaries and those beneficiaries ultimately pay tax on the partnership profit.

Following on the example, say the C Trust is the other partner in the ABC partnership, and as such has income of $20,000. The C Trust must destribute that $20,000 to its beneficiaries, and those beneficiaries pay tax on that income.

In addition to these, there are other less common types of entities that can be partners in a partnership, but these are outside the scope of this brochure.

Please note: There are many other factors that need to be considered above the tax implications implied above. While above the trust partner has the best tax result, it is not necessarily the case all the time, and may not be suited to the individual circumstances of many people.