# Partner's Salaries (Partners in a Business Partnership)

It has often been a contentious point that where partners in a partnership provide uneven contributions to the partnership (i.e. one partner works in the partnership all day, and the other works at a separate job), it is "unfair" that each partner shares equally in the profit of the partnership. Not only is this seen as unfair, but it also can have significant tax problems.

This document aims to explain the reasons behind this "unfair" concept, what we mean when we say "partners salary", and how we can lower our taxes while complying with the ATO's views on partners salaries.

## What is a partnership

It is important to first outline that a partnership is the relation which subsists between persons carrying on a business in common with a view of profit. This definition includes other entities (e.g. company, trust) as a "person", so for instance two companies could enter a partnership.

Often people set up a company or a trust in combination with a "business partner", where each person or family will own half of the shares in the company or similar arrangement. This type of scenario is not a "partnership", and therefore not covered by this document.

The most common type of partnership we come across is that of Mum and Dad running their small business together, and don't feel that the extra expense of a company or trust is warranted.

## The legal entitlements of partners

Most partnerships don't create a written agreement of any sort that outlines what each partner does in the partnership, and what the breakup of profits will be (even if they are to be equal). As such, the Partnership Act 1958 governs the rules surrounding the partnership in Victoria.

One of the rules is that unless a separate agreement exists, all profits and capital (i.e. assets) of the partnership will be shares equally by all the partners. Another rule is that no partner is entitled to be remunerated for acting in the partnership business.

Essentially, regardless of the amount of effort the partners put in, each partner will share equally in all profits and assets of the partnership unless an agreement exists to say otherwise.



## The taxation of partnership income

As a partnership is not a separate entity, but two or more parties combining efforts, the partnership does not pay tax as a separate entity. Each partner in the partnership adds their share of the partnerships income to their own taxable income.

## The benefits of a "Partner's Salary"

Let's face it, most Mum and Dad's set up their business as a partnership as a way of splitting their income. One person (let's say Dad) may work all day every day doing the labour, and the other (Mum) may do a little bit, plus the admin work while looking after the kids.

If Dad was to set up as a sole trader (as he is the one doing the work), then in a good year, Dad's taxable income may be very high and may push him into a high tax bracket, but as a partnership, he is only taxed on half, and Mum the other half.

In a few years' time, the kids got to school, and now Mum also works on a good salary. Now, splitting the partnership income half each doesn't work very well from a tax point of view.

For example, Mr. & Mrs. X run a partnership that earns $80,000 taxable income. Let's say Mrs. X works for the local solicitor and earns $100,000 herself in addition. Her taxable income will be $140,000 (her wage plus her half of the partnership income). The $40,000 partnership income is being taxed at 40% or higher tax rates, and as such she is now paying much more tax on the partnership income than Mr. X would be if he was a sole trader.

It is now that a "partner's salary" would be very handy, as it would essentially give Mr. X the first $x, and the balance distributed half each.

Following on, if Mr. X and Mrs. X decided that the value of Mr. X's work in the fruit stand was $50,000 per year, the partnership would make a "profit" of $30,000, and only $15,000 would be taxed on Mrs. X's higher tax rate, with $65,000 being taxed in Mr. X's hands.

### How do we get this to work?

As a partner cannot be paid a wage (as per one of the rules we mentioned that are in the Partnership Act 1958), the partners of the partnership must agree to vary the entitlements of the partners to the partnership income.

## The ATO's view

The ATO concede that a partnership can essentially pay a "partner's salary" by this method, but have the following notes and warnings for taxpayers:

- Constantly changing of the "salary" or other conditions will be seen as a scheme to avoid tax (which is very bad);
- As a "partner's salary" is actually an advance distribution of profits, you cannot create a loss by issuing a partner a "salary" that is greater than the profit; and
- Importantly, the ATO also state that for the agreement to be valid, it must have been made **before the end of the relevant financial year**.

We can assist our clients in complying with the ATO's view, and if you have a verbal agreement to vary your profit entitlements, we can provide a sample partnership minutes of a meeting for the partners to sign to acknowledge the previously agreed to terms.



## Disclaimer



If you have any questions, you can contact M.C.A. Accountants Pty. Ltd. by phone on 03 8689 9770, by email at admin@mcaaccountants.com.au, or by post at PO Box 8095, Carrum Downs, VIC, 3201.