Changes in a partner's interest

MODULE 5 | 5.6 | STUDENT COMPANION

Section 94 and Division 6AA stop partnership income being parked with people who do not really control it. A genuine Everett assignment does shift the income of the assigned share, but it is a CGT disposal at market value. Profit shares must be settled before the year ends, and any change in membership dissolves the old firm unless it qualifies as a reconstituted continuing entity.

Real and effective control

Why it matters. Family partnerships could split income by naming relatives as partners who had no genuine, effective authority over their share and no power to dispose of it.

Section 94 ITAA36. Imposes special rates of tax on a partner's share of uncontrolled partnership income.

Minors. Section 94 does not apply to a partner under 18. Division 6AA ITAA36 (Module 4) applies instead: a reasonable return for the minor's time, effort and capital is excepted assessable income at normal rates; the excess is eligible taxable income at special rates (generally 45% plus 2% Medicare levy).

Assigning a partner's interest (Everett assignment)

The principle. FCT v Everett: a partner's interest is a chose in action that can be assigned in whole or part. The assignor holds the assigned share as trustee; the assignee is assessed on it as a beneficiary, and the assignor is not.

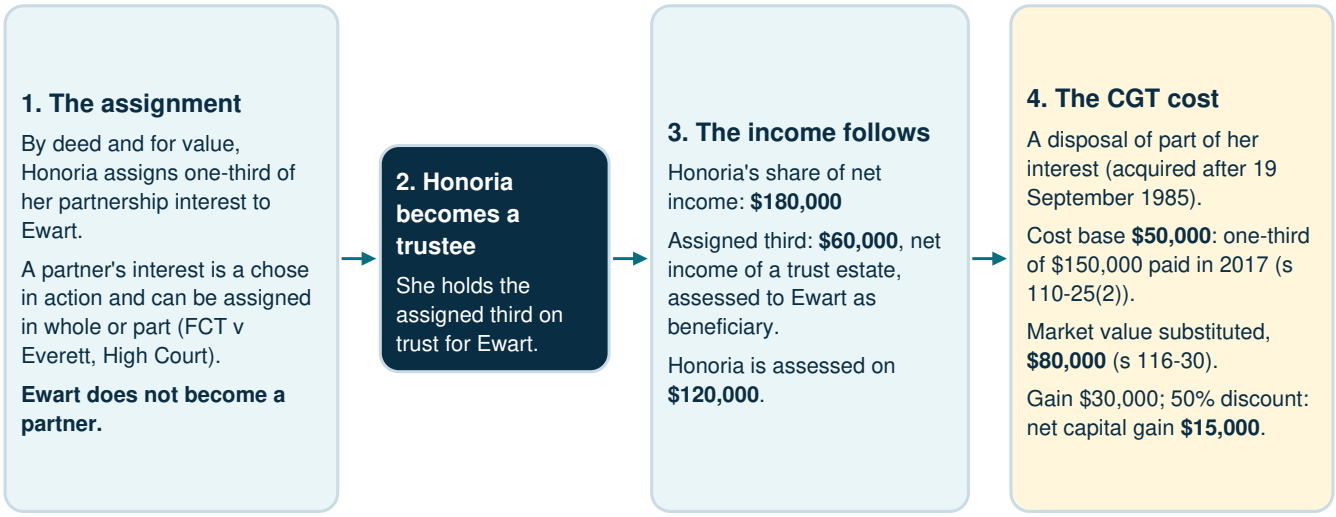
CGT. The assignment is a disposal of a CGT asset if the interest was acquired after 19 September 1985. Cost base = consideration paid to acquire the interest (s 110-25(2)). Because the assignment is usually not at arm's length, capital proceeds = market value (s 116-30), found by discounting the expected net cash flows of the assigned interest.

Expenses. Costs tied to the size of the interest (for example interest on a loan to buy it) are apportioned; only the unassigned part is deductible. Unrelated costs (subscriptions, travel, depreciation of a professional library) stay fully deductible.

Losses. The loss of the assigned share is deductible to the assignor as trustee, carried forward in the trust estate against future trust income; no deduction to the assignee that year (IT 2608).

Professional firms. PCG 2021/4 sets the ATO's compliance approach to allocating professional firm profits: Gateway 1 (commercial rationale) and Gateway 2 (high-risk features) must both be satisfied before the risk assessment framework applies. It applies from 1 July 2022.

How an Everett assignment shifts partnership income



Changing profit shares

- A decision after year end is too late: in Case W79 a salary decided after the year closed was an ineffective attempt to redistribute income already derived.
- Late-year attempts to adjust that year's sharing ratios have also been held ineffective (Cases P73 and Q53).
- In FCT v Nandan, a dissolution agreement signed on the last day of the year, giving one partner a fixed $15,000 of that year's profit, displaced the original 50/50 agreement.
- Rule of thumb: settle shares by genuine agreement before the year ends.

Work in progress and capital gains

Work in progress. For an accruals-basis partnership, WIP is not included in net income until it creates a recoverable debt. A payment for unbilled WIP on a partner's retirement or death, reflecting expected future profit, is assessable to the retiring partner or the trustee of the deceased partner's estate.

CGT. Partners, not the partnership, make capital gains and losses. Each partner owns a proportion of each CGT asset and calculates their own gain or loss, and claims their share of any foreign resident capital gains withholding credit.

Dissolution and reconstitution

Dissolved by agreement of the partners, death or bankruptcy of a partner, or a court on a partner's application. **Reconstituted** when a partner dies or retires and the others continue, or a new partner is admitted. Either way the original partnership ends and a successor firm begins: two returns for the year, and possibly a new TFN - unless the firm is a reconstituted continuing entity.

A change in membership: two returns or one?

A change in membership

A partner dies, retires or becomes bankrupt; the partners agree to end the firm; a court orders dissolution; or a new partner is admitted. At common law the old partnership is dissolved, whatever the agreement says.

→ **Did the agreement provide for changes in membership or shares, AND are all five factors present?**

General law partnership; a partner common before and after; never only one partner; continuity clause (or conduct consistent with it); no break in the business.

NO

Old partnership dissolved, new one formed

Two returns: old firm to the date of dissolution, new firm from reconstitution to year end. The new firm may need its own TFN.

YES

Reconstituted continuing entity

One return for the whole year, under the existing TFN. No new TFN or ABN needed.

Four areas affected

Trading stock (s 70-100 ITAA97)

Disposal taken into account at partnership level. Election to use tax value if at least 25% of the interests continue.

Depreciating assets (ss 40-340, 40-345)

Balancing adjustments at partnership level, unless a written joint election gives rollover relief.

Capital gains (ss 106-5, 108-5(2)(c))

Partnership ignored: each partner holds a fractional interest in every asset and is taxed on their own gains.

GST (GSTR 2003/13)

Reconstituted firm keeps its GST registration; no supply between old and new firm. On dissolution, an in-kind distribution is a supply.

CGT when a new partner is admitted

Studio building bought in 2019 for $300,000. Tiberius and Sylvan each own half: cost base $150,000 each. Ignace contributes $180,000 for an equal one-third interest.

1. What each existing partner disposes of

One-third

of their half share of the building

→

2. Capital proceeds (each)

$90,000

Half of Ignace's $180,000

→

3. Cost base of the part given up (each)

$50,000

One-third × $150,000

→

4. Capital gain (each)

$40,000

$90,000 - $50,000. Held more than 12 months: 50% discount = ($20,000)

Net capital gain (each partner)

$20,000

Taxed in Tiberius's and Sylvan's own returns, not the partnership's

Key references

Item	Rule
Uncontrolled partnership income	s 94 ITAA36 - special rates
Minor partners	Div 6AA ITAA36 - excess generally 45% + 2% Medicare
CGT on an Everett assignment	Interests acquired after 19 September 1985; s 110-25(2) cost base; s 116-30 market value
PCG 2021/4	Applies from 1 July 2022
Trading stock election on reconstitution	At least 25% of interests continue
CGT discount on a partner's gain	50% if held more than 12 months (individual)

Practice questions

MODULE 5 | 5.6 | TRY THESE BEFORE THE WORKED ANSWERS

Question 1 - An assignment in an engineering firm

Amaryllis Stellmach is a partner in Ravensdale Acoustics, a firm of acoustic engineers. She bought her partnership interest in 2014 for $240,000, financed by a bank loan. On 1 July 2024 she assigns one-quarter of her interest to her spouse by deed, for $1. The spouse does not become a partner. Based on its expected net cash flows, the assigned quarter is worth $100,000. For 2024-25: Amaryllis's share of the net income of the partnership is $200,000; she pays $8,000 interest on the loan used to buy her interest; she pays $1,200 in professional subscriptions and claims $800 depreciation on her professional library. (a) Who is assessed on the partnership income attached to Amaryllis's interest for 2024-25, in what capacity, and how much? (b) How much of her expenses can Amaryllis deduct? (c) Calculate Amaryllis's net capital gain from the assignment. (d) If in 2025-26 her share of the partnership is a loss of $40,000, how is the loss on the assigned quarter treated?

Question 2 - Admitting a partner to a brewery

Ms Cotterill and Mr Brennick, both Australian residents, are equal partners in Gallowglass Brewing. On 1 March 2016 the partnership bought its brewhouse premises for $480,000; they are now worth $780,000. On 1 February 2025 they admit Ms Wynstanley as an equal one-third partner, and she contributes $260,000. (a) Calculate the net capital gain made by each of Ms Cotterill and Mr Brennick. (b) Who reports these gains - the partnership or the partners? (c) What is Ms Wynstanley's cost base for her interest in the premises?

Question 3 - A partner retires from a landscaping firm

Ms Ziegler, Mr Thorne and Mr Ferrand run Bramblecombe Gardens, a general law partnership. Their written agreement allows for changes in membership and contains a continuity clause. On 31 January 2025 Mr Thorne retires; Ms Ziegler and Mr Ferrand carry on the business without interruption. On retiring, Mr Thorne receives $15,000 for his share of unbilled work in progress, reflecting expected future profit. (a) Is the partnership dissolved at common law? How many partnership tax returns are required for 2024-25, and is a new TFN needed? (b) How would your answer to (a) differ if the agreement had no provision for changes in membership? (c) Is the $15,000 assessable, and to whom? (d) In August 2025, Ms Ziegler and Mr Ferrand agree that Ms Ziegler should be treated as having received a salary of $20,000 for 2024-25. Is this effective?

Worked answers

MODULE 5 | 5.6 | WORKED ANSWERS - ATTEMPT THE QUESTIONS FIRST

Answer 1

(a) Under an Everett assignment, Amaryllis holds the assigned quarter as trustee for her spouse. One-quarter x $200,000 = $50,000 is net income of a trust estate, assessed to the spouse as beneficiary. Amaryllis is assessed on the remaining $200,000 - $50,000 = **$150,000** as her share of the net income of the partnership.

(b) Her deductions

Expense	Treatment	Deductible
Loan interest $8,000	Relates to the whole interest, so apportioned: only the unassigned three-quarters is deductible (75% x $8,000)	$6,000
Subscriptions $1,200	Unrelated to the size of her interest: fully deductible	$1,200
Library depreciation $800	Unrelated to the size of her interest: fully deductible	$800
Total deductions		**$8,000**

(c) The interest was acquired after 19 September 1985, so the assignment is a CGT disposal. Cost base of the quarter = 25% x $240,000 = $60,000 (s 110-25(2)). The $1 is not an arm's length amount, so market value of $100,000 is substituted (s 116-30). Capital gain = $100,000 - $60,000 = $40,000. Held more than 12 months, so the 50% discount applies: net capital gain = **$20,000** (assuming no capital losses).

(d) One-quarter x $40,000 = $10,000 of the loss belongs to the assigned share. It is deductible to Amaryllis in her capacity as trustee, carried forward in the trust estate and applied against future trust income. Her spouse gets no deduction in 2025-26 (IT 2608). Amaryllis claims the other $30,000 against her own income.

Answer 2

(a) Each existing partner's gain

Each existing partner owns half the premises and on the admission gives up one-third of their half.

Step	Working	Amount
Cost base of the half share	$480,000 / 2	$240,000
Capital proceeds (each)	Half of $260,000	$130,000
Cost base of the part disposed of (each)	One-third x $240,000	$80,000
Capital gain (each)	$130,000 - $80,000	$50,000
Net capital gain (each)	50% discount (held since 2016)	**$25,000**

Assuming no capital losses. Check: one-third of the $780,000 market value is $260,000, matching her contribution.

(b) The partners. For CGT the partnership is ignored: each partner holds a fractional interest in each asset and includes their own gain in their own return. The gain is excluded from the partnership's net income.

(c) Her cost base is what she paid to acquire her one-third interest in the premises: **$260,000**.

Answer 3

(a) Yes - at common law a change in membership dissolves the old partnership. But the agreement provides for changes in membership, and all five factors are present (general law partnership; Ms Ziegler and Mr Ferrand are common to the firm before and after; there is never only one partner; there is a continuity clause; no break in the business). The ATO will treat the firm as a reconstituted continuing entity: one return for the whole of 2024-25 under its existing TFN; no new TFN or ABN.

(b) Without provision for changes in membership, the firm is not a reconstituted continuing entity. The old partnership is dissolved on 31 January 2025 and a new partnership is formed: two returns are needed - the old firm from 1 July 2024 to 31 January 2025 and the new firm from 1 February to 30 June 2025 - and the new firm may need to apply for its own TFN.

(c) Yes. A payment for unbilled work in progress made to a retiring partner as a reflection of expected future profit is assessable income to Mr Thorne.

(d) No. A decision made after the end of the income year is too late to alter what each partner derived (Case W79). The 2024-25 net income is shared under the agreement in force during the year.