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# ***TR 2017/D4 – when an amount is ‘credited’ by Corporate Limited Partnerships***

16 June 2017

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## ***In brief***

On 17 May 2017, the Australian Taxation Office (ATO) released a draft taxation ruling which deals with the question of when a corporate limited partnership (CLP) credits an amount to a partner in the partnership. Until the issue of the Draft Ruling, there has been little guidance as to what ‘credits’ means in the context of the application of the tax rules applicable to CLPs. The uncertainty has historically resulted in additional potential risk for Australian limited partners of CLPs in determining the amount and time at which they should recognise amounts allocated to their accounts as assessable dividends.

Whilst clarity provided by the Draft Ruling is welcome, affected investors in CLPs now should consider a number of critical questions and potential actions which are raised by the ATO’s preliminary views.

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## ***In detail***

*Draft Taxation Ruling TR 2017/D4* intends to clarify the meaning of ‘credits’ for the purposes of section 94M(1) of the *Income Tax Assessment Act 1936* (ITAA 1936). This provision operates to ensure that an amount which a CLP pays or credits against the profits or anticipated profits of the partnership, or otherwise in anticipation of the profits of the partnership, to a partner will be a deemed dividend paid out of profits.

Submissions can be made on the ATO’s draft view until 30 June 2017.

## ***Overview of the current tax treatment of CLPs***

For context, it is important to understand the current provisions that govern the taxation of CLPs, which are contained in Division 5A of the ITAA 1936. These provisions broadly state that:

1. A CLP is treated as a company for Australian income tax purpose (other than CLPs that are treated as foreign hybrid limited partnerships under Division 830 of the *Income Tax Assessment Act 1997* (ITAA 1997),
2. Subject to limited exceptions, a reference to dividends in the Australian income tax law includes a reference to a distribution made by a CLP to a partner in the CLP, and

3. If a CLP pays or credits an amount to a partner in a partnership against the profits or anticipated profits of the CLP or otherwise in anticipation of the profits of the CLP, the amount paid or credited is taken to be a dividend paid by the CLP to the partner out of profits derived by the CLP.

The Draft Ruling focuses exclusively on the third point, specifically when an amount is ‘credited’ under section 94M(1) of the ITAA 1936.

### ***The Commissioner’s view in the Draft Ruling***

Under section 94L and 94M(1), a deemed dividend can arise in relation to a CLP where an amount is distributed, paid or credited. Because the provisions specifically refer to three different scenarios, the Draft Ruling contends that the term ‘credits’ in the context of the section means neither paid, nor distributed.

The Commissioner’s preliminary view is that a CLP ‘credits’ an amount to a partner for the purposes of section 94M(1) if it applies or appropriates its resources to confer a benefit to that partner which:

- is not subject to a condition precedent and is legally enforceable by the partner, and
- is separate and distinct from the partner’s existing interest in the CLP and its assets

The Draft Ruling reasons that this approach is consistent with the purpose of Division 5A to tax the partners of a CLP as if they were shareholders in a company. Furthermore, to suggest that a mere accounting credit entry (in the absence of the above factors being satisfied) gives rise to a crediting under section 94M would align the tax treatment of CLPs with the tax treatment applicable to a normal partnership. This is inconsistent with how shareholders of a company are taxed, and would also mean that a partner of a CLP is taxed on amounts that they have no right to demand from the CLP, which they may never receive.

Where a CLP has ‘credited’ an amount, the Draft Ruling indicates that this ‘crediting’ holds true even if a future event occurs which requires the credited amount to be relinquished or returned to the partnership (although it does not provide examples of circumstances in which this may occur).

In applying the principles in the Draft Ruling, the Commissioner recommends that the following questions are asked:

<b><i>Relevant Question</i></b>	<b><i>Comments</i></b>
Has the CLP, in substance, applied or appropriated its resources to confer a benefit on one or more of its partners?	This benefit can be any type of right, as long as it is legally enforceable. Examples noted in the Draft Ruling include: <ul style="list-style-type: none"> <li>• an act or transaction that creates an irrevocable and legally enforceable debt owing from the CLP to the partner,</li> <li>• A legally enforceable forgiveness by the CLP of a debt owed to it by one of its partners, and</li> <li>• where permitted by the relevant partnership law, a limited partner giving up a right to receive a distribution of profits from the CLP: <ul style="list-style-type: none"> <li>○ in return for a legally enforceable discharge of their unpaid obligation to contribute to the CLP’s partnership liabilities, or</li> <li>○ as a means of making an additional contribution of capital to the CLP.</li> </ul> </li> </ul>
Is the benefit conferred on the partner legally enforceable?	Consideration will need to be given to the relevant limited partnership agreement (LPA), as well as the laws governing the partnership and the benefit in question.
Is the benefit conferred on the partner subject to a condition precedent?	If it is, it will not be credited until the condition precedent is satisfied and the benefit becomes legally enforceable.

Is the benefit conferred on the partner separate and distinct from the partner's existing interests in the CLP and its assets?	Examples noted in the Draft Ruling include a new interest in the partnership and its profits, or the extinguishment of a debt owing.
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The application of the above principles is demonstrated by seven examples in the Draft Ruling. The examples consider a wide range of scenarios and principles which are summarised very briefly below:

<b>Example number</b>	<b>Brief summary</b>
Example 1	A mere credit entry in a CLP's accounts does not of itself constitute a 'credit' for the purposes of section 94M(1).
Example 2	Foregoing a distribution in exchange for additional capital in a CLP can be considered a 'credit', assuming it is in accordance with the relevant law that applies to the CLP.
Example 3	Where the finalisation of accounts creates a debt unconditionally payable on demand to the partner, the relevant amount will be considered a 'credit'.
Example 4	Where a general partner has a right to retain profits, this will be a condition precedent and any 'credit' will not occur until after the condition precedent has expired or been waived.
Example 5	Where rights of a partner to draw an amount are partly exercised, the unpaid balance will only be 'credited' if there is an unconditional and legally enforceable obligation to pay it under the LPA.
Example 6 and 7	Where partnership profits are applied to discharge debts owed by a partner to the CLP, this can constitute a 'credit'.

### ***The takeaway***

In our view, the Draft Ruling provides helpful clarity regarding when an amount is 'credited' for the purposes of section 94M. However, it also should prompt limited partners to consider the following:

- a) whether their method for recognising dividends from a CLP aligns with the methodology outlined in the Draft Ruling (including reviews of existing LPAs to confirm when amounts should be 'credited'),
- b) whether there are any specific facts and circumstances that are not considered in the Draft Ruling, for which additional clarity should be requested as part of the consultation process, and
- c) Follow up discussions with custodians or general partners to check that their process for declaring and recognising dividend income from these investment is in accordance with the Draft Ruling.

Where the taxpayer's approach has differed to the approach outlined in the Draft Ruling, consideration should be given to whether amendments are required to prior period calculations.

For taxpayers that have historically treated 'mere credits' as assessable, they should consider whether historic amendment periods have closed, and whether there is any risk of double taxation when amounts are subsequently 'credited' in accordance with the Draft Ruling.

The discussion regarding the term 'credited' may also be relevant for other parts of the income tax law (for example, the term is also used with reference to dividends, and in the context of withholding taxes). The Draft Ruling is silent on its application to other parts of the income tax law.

Submissions can be made to the ATO in response to the Draft Ruling by 30 June 2017 to highlight different approaches or request clarity on circumstances not contemplated by the Draft Ruling.

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As part of this process, taxpayers may also wish to revisit or reconfirm the positions that they have taken in relation to other practical and technical nuances associated with the taxation of CLPs. These include:

- Distinguishing between returns of capital and dividends, including the level of analysis of underlying information that is required to make this assessment.
- Considering the application and overlap with other provisions of the law (including the capital gains tax provisions, section 45B of the ITAA 1936, and section 94M(2)) to ensure that distributions from a CLP are not double taxed at the partner level.

### ***Let's talk***

For a deeper discussion of how these issues might affect your business, please contact:

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