THE APPLICATION OF CAPITAL GAINS TAX TO PARTNERSHIP ASSETS: CHALLENGES AND REFORM

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Abstract

The legislation which applies Australia's capital gains tax regime to partnership assets is peculiarly designed. It diverges from the general law by treating partners as holding fractional interests in partnership assets while relying on the same general law to quantify these interests. This article argues that the design of the CGT regime was influenced by an assumption that the general law recognises partners as holding direct interests in partnership assets. It is then demonstrated that inconsistent elements in the regime's design have produced confusion concerning the meaning and application of its provisions. Finally, proposed reforms to the legislation which governs the regime and the primary Australian Taxation Office ruling relevant to these issues are suggested.

I INTRODUCTION

The interaction between Australia's capital gains tax ('CGT') regime and partnership law is neither clear nor conceptually consistent. On the one hand, the CGT regime disregards the general law of partnership by treating partners as holding fractional interests in partnership assets. On the other, it purports to rely upon partnership law to quantify interests that it proposes to tax. This article will argue three propositions. First, that the design of the CGT regime was influenced by a reading of the seminal High Court of Australia decision *The Commissioner of Taxation v Everett* ('*Everett*')[1] as establishing that partners hold a proprietary interest in individual assets. Second, that in recent years various courts have clarified that partners hold no such interest. Third, that the assumption partners hold proprietary interests in individual partnership assets has created imprecision and inconsistency in the CGT regime. Proposed reforms to the CGT regime will then be examined. In particular, the practice of His Majesty's Revenue and Customs ('HMRC') in the United Kingdom will be considered, and suggestions for aspects of this practice to be adopted and modified for the Australian regime put forward.

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[1] (1980) 143 CLR 440 ('*Everett*').

II THE STATUTORY REGIME

The law of partnership began as a derivative of contract,[2] almost entirely defined by the general law until the late 1890s.[3] Various 'Partnership Acts' have since been passed by each Australian State and Territory,[4] which govern the operation of partnerships at a high level. These Acts provide a framework within which a detailed body of general law largely defines the operation of partnerships.

At general law, partnerships have no separate legal personality from the partners who comprise them.[5] In contrast to the general law position that a partnership is not an entity separate from its partners, s 960-100(1)(d) of the *Income Tax Assessment Act 1997* (Cth) ('*ITAA 1997*') deems a partnership to be an entity for taxation purposes. However, partnerships are not *tax paying* entities separate from the partners that comprise them. Rather, partnerships are required to lodge an income tax return, while responsibility to pay tax on each partner's share of the partnership's net income 'flows through' the deemed entity to the individual partners themselves. The term 'partnership' is defined in s 995-1 of the *ITAA 1997* as follows:

> 'Partnership' means:
>
> > (a) an association of persons (other than a company or a *limited partnership) carrying on business as partners or in receipt of *ordinary income or *statutory income jointly; or
> >
> > (b) a limited partnership.
>
> Note 1: Division 830 treats foreign hybrid companies as partnerships.
>
> Note 2: A reference to a partnership does not include a reference to a corporate limited partnership: see section 94K of the *Income Tax Assessment Act 1936*.

Section 91 of the *Income Tax Assessment Act 1936* (Cth) ('*ITAA 1936*') provides: 'A partnership shall furnish a return of the income of the partnership, but shall not be liable to pay tax thereon.' Pursuant to s 92(1) of the *ITAA 1936*, this income or loss is included in the assessable income of each partner, in proportion to that partner's entitlement to the net income of the partnership:

> Section 92 Income and deductions of partner
>
> > (1) The assessable income of a partner in a partnership shall include:

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[2] Roderick I'Anson Banks, *Lindley & Banks on Partnership* (Sweet & Maxwell, 21st ed, 2022) 3 [1-03].

[3] Ibid.

[4] *Partnership Act 1963* (ACT); *Partnership Act 1958* (Vic); *Partnership Act 1892* (NSW); *Partnership Act 1997* (NT); *Partnership Act 1891* (Qld); *Partnership Act 1891* (SA); *Partnership Act 1891* (Tas); *Partnership Act 1895* (WA). See also the *Limited Partnerships Act 2016* (WA).

[5] *Global Partners Fund Ltd v Babcock and Brown Ltd (In Liq)* (2010) 267 ALR 144, 161 [87] (Hammerschlag J) ('*Global Partners Fund*'); GT Pagone, 'Capital Gains Tax and Partnerships' (1988) 17 *Australian Tax Review* 76, 77.

> (a) so much of the individual interest of the partner in the net income of the partnership of the year of income as is attributable to a period when the partner was a resident; and
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> (b) so much of the individual interest of the partner in the net income of the partnership of the year of income as is attributable to a period when the partner was not a resident and is also attributable to sources in Australia.

Further, partnerships are deemed to hold assets for certain taxation purposes. For example, Item 7 of s 40-40 of the *ITAA 1997* provides that a partnership, and not any particular partner, 'holds' a depreciating asset that is a partnership asset. Therefore, the deductibility of the depreciated value of such an asset[6] impacts the calculation of the partnership's income or loss in a given year (and, ultimately, each partner's assessable income).

The CGT regime in respect of partnership assets is built around ss 106-5 and 108-5 of the *ITAA 1997*.

Section 106-5(1) provides: - Partnerships.

> (1) Any capital gain or capital loss from a CGT event happening in relation to a partnership or one of its CGT assets is made by the partners individually.

Each partner's gain or loss is calculated by reference to the partnership agreement, or partnership law if there is no agreement.

> Example 1: A partnership creates contractual rights in another entity (CGT event D1). Each partner's capital gain or loss is calculated by allocating an appropriate share of the capital proceeds from the event and the incidental costs that relate to the event (according to the partnership agreement, or partnership law if there is no agreement).
>
> Example 2: Helen and Clare set up a business in partnership. Helen contributes a block of land to the partnership capital. Their partnership agreement recognises that Helen has a 75% interest in the land and Clare 25%. The agreement is silent as to their interests in other assets and profit sharing.
>
> When the land is sold, Helen's capital gain or loss will be determined on the basis of her 75% interest. For other partnership assets, Helen's gain or loss will be determined on the basis of her 50% interest (under the relevant Partnership Act).

Section 108-5 of the *ITAA 1997* provides: - CGT assets.

> (1) A CGT asset is:
>
> (a) any kind of property; or
>
> (b) a legal or equitable right that is not property.
>
> (2) To avoid doubt, these are CGT assets:
>
> (a) part of, or an interest in, an asset referred to in subsection (1);
>
> (b) goodwill or an interest in it;

[6] See *Income Tax Assessment Act 1997* (Cth) s 40-25 ('*ITAA 1997*').

(c) an interest in an asset of a partnership;

(d) an interest in a partnership that is not covered by paragraph (c).

While the assets captured by s 108-5(2)(c) (deemed proportionate interests in partnership assets) may be described without undue difficulty, the residual assets captured by s 108-5(2)(d) are less clear. A review of the history of these provisions provides some context for understanding the legislative intention behind their drafting. The precursor to s 108-5(2)(c) was proposed in the Taxation Laws Amendment Bill (No 6) 1990 (Cth). This Bill was then amended to include the precursor to s 108-5(2)(d). These sections were introduced into law in the *Taxation Laws Amendment Act 1991* (Cth) as ss 160A(d) and (e) of the *ITAA 1936* respectively.

It was observed several years before the *Taxation Laws Amendment Act 1991* (Cth) was passed that partners generally hold two kinds of assets.[7] First, interests in the assets of the partnership. Second, the bundle of rights that the partners have against each other (their rights *inter se*). These rights *inter se*, which comprise a chose in action and therefore an asset,[8] were said to be distinct from the assets of the partnership such that the 'danger in a blind application of Part IIIA may be a double counting of gains which could not have been intended by the legislature.'[9] The further supplementary explanatory memorandum to the Taxation Laws Amendment Bill 1991 (Cth)[10] confirms that this risk of double taxation inspired the introduction of s 160A(e) of the *ITAA 1936*.[11]

This explanation for the introduction of s 160A(e) sheds some light on its intended purpose. However, this section, and now s 108-5(2)(d), appear to be premised on a conception of partners as owning a percentage of a partnership 'entity' separate from the partners themselves.[12] This assumption is unknown to the general law.[13] With only a limited general law frame of reference for what this interest comprises, differentiating between the assets described in ss 108-5(2)(c) and (d) remains difficult.[14]

III THE VIEW OF PARTNERS AS FRACTIONAL INTEREST HOLDERS

The *Everett* decision concerned a determination that the assignment of a share in a partnership carries with it a present entitlement to a proportionate share of the profits of the

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[7] Pagone (n 5) 81.
[8] CCH Australia, *Income Tax Assessment Act 1997 Commentary* (online at 13 November 2023) ¶152-835 ('*ITAA 1997* Commentary').
[9] Pagone (n 5) 84.
[10] The Taxation Laws Amendment Bill (No 6) 1990 (Cth) was amended and retitled the Taxation Laws Amendment Bill 1991 (Cth).
[11] Further Supplementary Explanatory Memorandum, Taxation Laws Amendment Bill (No 6) 1990 (Cth) 2. See also *Hedges v Commissioner of Taxation* [2023] FCAFC 105, [23] ('*Hedges*') (application for special leave to appeal to the High Court of Australia dismissed: *Brent Hedges v Commissioner of Taxation* [2023] HCASL 182); *ITAA 1997* Commentary (n 8) ¶152-835.
[12] N Augoustinos, 'Partnerships and CGT: An International Comparative Analysis' (1993) 1(3) *Taxation in Australia Red Edition* 126, 133.
[13] Pagone (n 5) 77.
[14] Augoustinos (n 12) 133.

partnership.[15] As such, income corresponding to that share was found not to form part of the assignor's assessable income.[16] In coming to this conclusion, the High Court majority considered the nature of a partner's interest in the assets of their partnership.

The *Everett* majority stated that the members of a partnership have 'a beneficial interest in the partnership assets, indeed in each and every asset of the partnership.'[17] The majority then qualified this statement by adding that this interest 'consists of a right to a proportion of the surplus *after* the realisation of the assets and payment of the debts and liabilities of the partnership'.[18] Two authorities were cited in support of the proposition that a partner holds a beneficial interest in each and every partnership asset:[19] the decision of Kitto J in *Livingston v Commissioner of Stamp Duties (Qld)* ('*Livingston*')[20] and the decision of McTiernan, Menzies and Mason JJ in *Canny Gabriel Castle Jackson Advertising Pty Ltd v Volume Sales (Finance) Pty Ltd* ('*Canny Gabriel*').[21]

In *Livingston*, Kitto J both recognised that a partner's interest in partnership assets was an interest in a proportion of the surplus after realisation of the assets, and, like the majority in *Everett*, that it is a 'beneficial interest' held in 'every piece of partnership property'.[22] In *Canny Gabriel*, McTiernan, Menzies and Mason JJ used similar language to that seen in *Livingston*, but went further in emphasising that an interest is held by partners in every asset of the partnership.[23] Indeed, their Honours noted that 'it has always been accepted that a partner has an interest in every asset of the partnership and this interest has been universally described as a "beneficial interest", notwithstanding its peculiar character.'[24] On that basis, it was held that partners hold an equitable interest, and not a 'mere equity' (here being a right 'to set aside or rectify a transaction by means of a court order'[25]).[26]

To these two cases one example of older High Court authority may be added: *Sharp v Union Trustee Company of Australia Ltd* ('*Sharp*').[27] In this case, Rich J stated that partners hold a proprietary interest in each item of partnership property, albeit one that is indefinite and fluctuating in proportion to the partner's share in the surplus funds upon winding up of the partnership.[28]

Notwithstanding the qualification that a partner's interest in partnership assets can only be determined upon termination of the partnership, it was the *Everett* majority's description of a partner holding a beneficial interest in each partnership asset that most clearly impacted Australian law. This is especially so in respect of the position taken by the Commissioner of

[15] *Everett* (n 1) 454.
[16] Ibid.
[17] Ibid 446. The majority cited *Canny Gabriel Castle Jackson Advertising Pty Ltd v Volume Sales (Finance) Pty Ltd* (1974) 131 CLR 321, 327-328 ('*Canny Gabriel*') and *Livingston v Commissioner of Stamp Duties (Qld)* (1960) 107 CLR 411, 453 ('*Livingston*') in support of this proposition.
[18] *Everett* (n 1) 446 (emphasis added).
[19] Ibid.
[20] *Livingston* (n 17) 453.
[21] *Canny Gabriel* (n 17) 327–8.
[22] *Livingston* (n 17) 453.
[23] *Canny Gabriel* (n 17) 327.
[24] Ibid.
[25] Ibid 328.
[26] Ibid.
[27] (1944) 69 CLR 539 ('*Sharp*').
[28] Ibid 551.

Taxation ('Commissioner') concerning the interest held by partners in partnership assets at general law, and the taxation consequences that flowed from this.

IV THE COMMISSIONER'S INTERPRETATION OF *EVERETT*

On 22 June 1989, the Commissioner published Taxation Ruling IT 2540 ('IT 2540').[29] This ruling analysed *Everett* at length and set out the Commissioner's view of the law following the judgment.[30] IT 2540 first contextualises its discussion of a partner's interest by citing the *Everett* majority's judgment as authority for the proposition that as a partnership is not a separate legal entity, title to partnership assets is legally vested in the partners:[31]

> 2. Under general law in relation to partnerships, a partnership is not a separate legal entity distinct from the individual partners who comprise the partnership. Accordingly, the partnership does not own property in its own right; title to the partnership assets is legally vested in the partners, even though an individual partner may have no separate title to specific partnership assets. This view accords with the opinion expressed by the majority (Barwick CJ., Stephen, Mason and Wilson JJ.) of the Full High Court of Australia in *F.C.T. v. Everett* (1980) 143 CLR 440 at page 446:
>
> > Although a partner has no title to specific property owned by the partnership, he has a beneficial interest in the partnership assets, indeed in each and every asset of the partnership.

A view of partners as holding a proprietary interest in *each* partnership asset is apparent throughout IT 2540. In conflict with the *Everett* majority's clarification that a partner's interest in partnership assets is merely a right to share in asset surplus on termination of the partnership, IT 2540 expresses a partner's interest as a form of direct interest in each asset.[32] The ruling makes this direct interest explicit in stating that on 'the acquisition or disposal of a partnership interest it will be necessary for a partner to account for his or her interest in the partnership assets. The disposal of the partnership interest generally means that there is a disposal of the partner's interest in each of the individual partnership assets.'[33]

IT 2540 reinforces this view by explaining that where there is a disposal of a partnership asset (to a third party), each partner disposes of 'his or her fractional interest' in the asset.[34] The ruling provides an example of such a transaction, in which a block of land, said to be purchased by a partnership comprised of 10 partners for $90,000, is sold for $150,000. The

[29] Commissioner of Taxation, *Taxation Ruling IT 2540* (22 June 1989) ('IT 2540').
[30] David J Garde, 'Capital Gains Tax and Everett Assignments' (1993) 22(1) *Australian Tax Review* 28, 29; R Krever and K Sadiq, 'Non-Residents and Capital Gains Tax in Australia' (2019) 67(1) *Canadian Tax Journal* 1, 12 nn 57.
[31] IT 2540 (n 29) [2].
[32] Ibid [18].
[33] Ibid [9].
[34] Ibid.

ruling states that if 'the partners own equal interests in the land, each will be taken as receiving $15,000 as disposal proceeds.'[35]

It has been observed that IT 2540 followed the practice of Her Majesty's Revenue Commission (as it was then known) in adopting a 'partner level' or 'aggregate theory' approach to CGT liability.[36] These terms refer to the taxation consequences of a gain or loss being accounted for at the level of the individual partners.[37] This is in contrast to treating a partnership as an entity distinct from its partners for taxation purposes, referred to as an 'entity level' or 'entity theory' approach.[38] Even in light of that choice, the assumption found throughout IT 2540 that the individual members of a partnership 'own' fractional interests in the partnership assets is surprising.[39] Further, the *Everett* majority explicitly stated that the proportionate surplus of asset proceeds that each partner is entitled to must first have the debts and liabilities of the partnership paid out of it.[40] Therefore, whenever a partnership has debts or liabilities, a partner's entitlement to the net surplus of realised assets will always be less than the fractional interest in the assets that the partner is deemed to hold.

A *Section 160A of the ITAA 1936*

IT 2540 found legislative enactment in ss 160A(d) and (e) of the *ITAA 1936*. Section 160A(d) provided that a taxpayer's interest in a partnership asset is an asset for CGT purposes. Section 160A(e) provided the same in respect of a taxpayer's interest in a partnership as was not covered by s 160A(d).

The relationship between IT 2540 and s 160A(d) can be seen in the explanatory memorandum accompanying the Taxation Laws Amendment Bill (No 6) 1990 (Cth) ('Explanatory Memorandum'). The Explanatory Memorandum provided the following statement concerning the purpose of introducing sub-section (d):[41]

> In relation to the application of Part IIIA to partnerships, the Commissioner of Taxation issued a ruling on 22 June 1989, IT 2540, which sets out his views on how CGT liabilities are to be calculated on the disposal of partnership assets.
>
> This approach is based on the premise that a partnership is not a separate legal entity and that legal title to partnership assets must therefore remain vested in the individual partners, even though any one of those individual partners may not have separate title to any specific asset. Because the assets are owned by the individual partners, it is to the individual partners that gains or losses accrue on the disposal of any of the partnership assets.
>
> The purpose of the amendments is to remove any uncertainty relating to the treatment of partnership assets under the provisions of Part IIIA by making it clear that it is the individual partners who will account for capital gains and losses on disposals of partnership assets. The

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[35] Ibid.
[36] Augoustinos (n 12) 126.
[37] Ibid.
[38] Ibid.
[39] See, eg, IT 2540 (n 29) [4], [10], [14], [18], [31].
[40] *Everett* (n 1) 446.
[41] Explanatory Memorandum, Taxation Laws Amendment Bill (No 6) 1990 (Cth) 6 ('Explanatory Memorandum').

> amendments are not intended to alter the manner in which Part IIIA applies to such assets and instead are designed merely to clarify the existing operation of the law.

The Explanatory Memorandum's claim that s 160A(d) was intended 'merely to clarify the existing operation of the law' requires careful consideration. Academic commentary had been published prior to the passing of the *Taxation Laws Amendment Act 1991* (Cth) arguing that capital gains and losses in respect of partnership assets already applied directly to partners.[42] However, this result was not said to derive from a deeming effect in the then CGT regime. Rather, it was justified on the basis that at general law the individual partners of a partnership (and not the partnership itself) own the partnership assets and therefore the capital gains and losses on partnership assets accrue to those individuals.[43] Notably, the *Taxation Laws Amendment Act 1991* (Cth) did appear to change the operation of the law in at least one significant way: by creating 'statutory fictions that are not apparent from a study of the law of partnership such that the tax provisions must be said to exist in a parallel, but different, world from that of equity.'[44] Indeed, the innovation of this Act was to cause partners to be deemed to hold fractional interests in partnership assets for certain taxation purposes.

V The Refinement of the General Law Position

A *Danvest and the Cases Proceeding It*

The question of whether a partner holds a proprietary interest in each partnership asset came to a head in the 2017 decision of *Commissioner of State Revenue (Vic) v Danvest Pty Ltd* ('*Danvest*').[45] The *Duties Act 2000* (Vic) ('*Duties Act (Vic)*') applied duty to certain transactions concerning 'dutiable property'. These transactions relevantly included a 'transfer of dutiable property' (pursuant to s 7(1)(a) of the *Duties Act (Vic)*) and 'any other transaction that results in a change in beneficial ownership of dutiable property' (pursuant to s 7(1)(b)(vi)).[46] 'Dutiable property' was defined in s 10(1)(a)(i) of the *Duties Act (Vic)* as including 'an estate in fee simple' in land in Victoria. The appellant Victorian Commissioner of State Revenue ('Commissioner of State Revenue') had assessed certain partners for duty upon their purchase of interests in a land-owning partnership. As summarised by Santamaria JA, 'the Commissioner [of State Revenue] relied upon statements made in a line of High Court authority, which dates back some 70 years, to contend that the interest of a partner in partnership property is a presently existing, equitable, sui generis interest in each and every asset of the partnership which is proprietary in nature.'[47] Therefore, it was argued the purchase of interests in the partnership constituted a transfer of an interest in an estate in fee-simple within the meaning of the *Duties Act (Vic)*.

Justice Santamaria, with whom Tate JA agreed, conducted a detailed analysis of seven cases relied upon by the Commissioner of State Revenue in support of the proposition that a partner

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[42] Pagone (n 5) 79.
[43] Ibid.
[44] G Pearson, 'The Goodwill Roll-off Effect in Partnerships' (2000) 3(1) *Journal of Australian Taxation* 56, 57.
[45] (2017) 55 VR 190 ('*Danvest*').
[46] Ibid 193 [8].
[47] Ibid 192 [5].

holds a proprietary interest in partnership assets. His Honour found that contrary to the Commissioner of State Revenue's submissions, the principles deriving from those cases collectively support the proposition that partners do not hold a proprietary interest in individual assets. As a consequence of this analysis, his Honour determined that this interest is not an interest presently held in the assets, as it is not ascertainable prior to the termination of the partnership. As his Honour noted, 'the interest of each partner can be ascertained finally *only* upon completion of the liquidation and the identification of any surplus share'.[48]

In order to trace the development of the case law that led Santamaria JA to conclude that partners do not hold a direct interest in partnership assets, it is useful to identify the key principles in the cases reviewed. His Honour commenced his analysis by outlining the Commissioner of State Revenue's reliance on *Sharp*, *Livingston* and *Canny Gabriel.* His Honour noted that these decisions generally referred to a partner's interest in partnership assets as a species of 'beneficial interest'.[49] However, his Honour opined that this term is not sufficient to reveal the nature of the interest in question.[50]

His Honour then reviewed *Everett* and noted the 'significant weight' that its description of a partner's interest in partnership assets has had in subsequent case law.[51] The first of the post-*Everett* cases considered was *United Builders Pty Ltd v Mutual Acceptance Limited* ('*United Builders*').[52] In that case, Mason J noted the longstanding principle that a security interest over a partner's share in the partnership does not give security over the assets of the partnership.[53] Notably, Santamaria JA highlighted Mason J's articulation of a partner's interest in partnership assets:[54]

> Mason J later added that '[t]he vital consideration is that the partner's interest is in truth a chose in action, which, as *Everett* acknowledged, "consists of a right to a proportion of the surplus after the realization of the assets and payment of the debts and liabilities of the partnership"'.…
>
> The reasoning of Mason J in *United Builders* warrants attention. Having acknowledged the existence of a partner's 'special and non-specific' beneficial interest in each of the partnership assets, Mason J went further to expound the nature of such an interest: it is a chose in action which 'consists of a right to a proportion of the surplus *after* the realisation of the assets and payment of the debts and liabilities of the partnership'.

Second, Santamaria JA considered the judgment of Gibbs CJ in *Watson v Ralph* ('*Watson*').[55] In that case, Gibbs CJ found that a testatrix who had been a member of a partnership that held land as one of its partnership assets 'had an equitable interest in every asset of the partnership, including the land.'[56] However, as noted by Santamaria JA,[57] the Chief Justice then proceeded to clarify that as at her death the testatrix was 'not the owner of the freehold property', as it was 'then partnership property and she had in it the same interest as in any

[48] Ibid 214 [78] (emphasis in original).
[49] Ibid 194 [10].
[50] Ibid 194–195 [10].
[51] Ibid 208 [59].
[52] (1980) 144 CLR 673 ('*United Builders*').
[53] *Danvest* (n 45) 208 [60], citing *United Builders* (n 52) 687.
[54] *Danvest* (n 45) 209–10 [64]–[65] (citations omitted).
[55] (1982) 148 CLR 646 ('*Watson*').
[56] *Danvest* (n 45) 210 [66].
[57] Ibid 211 [70].

other partnership property'.[58] The Chief Justice specified that this interest comprised 'a half interest in the proceeds of sale of all the partnership property after payment of partnership debts, subject to any agreement between the partners as to distribution in specie.'[59]

Finally, Santamaria JA reviewed the decision of the High Court in *Commissioner of State Taxation (SA) v Cyril Henschke Pty Ltd* ('*Cyril Henschke*').[60] In his analysis of this case, Santamaria JA noted that to describe the interest a partner holds in partnership assets as a beneficial and *sui generis* interest in each asset of the partnership is 'plainly insufficient'.[61] His Honour then observed that the Court in *Cyril Henschke* stressed that the position was 'not sufficiently or accurately expressed merely by use of the term "beneficial interest".'[62] In light of this analysis, Santamaria JA concluded that the case law (and in particular, the Court in *Cyril Henschke* affirming Mason J in *United Builders*) established that the interest of a partner in partnership assets can only accurately be described by reference to the partner's interest in the surplus proceeds of assets upon realisation and after the payment of partnership debts and liabilities.[63]

Justice McLeish (with whom Tate JA also agreed) conducted a similar analysis to Santamaria JA. His Honour reviewed a range of High Court cases, including *Sharp*, *Livingston*, *Canny Gabriel*, *Livingston*, *Everett*, *United Builders*, *Watson* and *Cyril Henschke*. His Honour also considered *Perpetual Executors & Trustees Association of Australia Ltd v Commissioner of Taxation (Cth) [No 2] (Thomas' Case)*,[64] in which Kitto J endorsed the description of a partner's interest in partnership property expounded by Rich J in *Sharp*.[65] Notably, McLeish JA observed that the reasoning in *Cyril Henschke* demonstrates that 'references in the case law to partners having a "beneficial interest" in partnership assets must not be read too literally.'[66] Like Santamaria JA,[67] McLeish JA noted the authoritative endorsement in *Cyril Henschke* of Mason J's description of the interest held by a partner in partnership property in *United Builders* ('a right to a proportion of the surplus after the realization of the assets and payment of the debts and liabilities of the partnership'[68]).[69] On the basis of this analysis, McLeish JA relevantly determined that:[70]

> …the interest which a partner has in the assets of the partnership is not accurately described as presently existing, if by that is meant that a partner has a proprietary interest in those assets prior to dissolution. The equitable chose in action which the partner enjoys is rather directed to, and commensurate with, the protection of a future entitlement to a share of surplus assets. In other words, the partner has a presently existing equitable chose in action which does not, prior to dissolution, represent a proprietary interest in partnership assets.

[58] *Watson* (n 55) 655.
[59] Ibid.
[60] (2010) 242 CLR 508 ('*Cyril Henschke*').
[61] *Danvest* (n 45) 214 [78].
[62] Ibid.
[63] Ibid.
[64] (1955) 94 CLR 1 ('*Thomas' Case*').
[65] *Danvest* (n 45) 227 [133], citing *Thomas' Case* (n 64) 28.
[66] *Danvest* (n 45) 236 [155].
[67] Ibid 214 [78].
[68] *United Builders* (n 52) 688.
[69] *Danvest* (n 45) 236 [155], citing *Cyril Henschke* (n 60) 519 [28].
[70] *Danvest* (n 45) 238 [165].

This reasoning led his Honour to conclude that the interest held by a partner in 'a land-owning partnership is not an interest in an estate in fee simple in the land owned by the partnership'. [71] As noted by Tate JA, each member of the Court concluded that this interest is not dutiable property (for the purposes of ss 10(1)(a)(i) and 10(1)(ac) of the *Duties Act (Vic)*).[72] Therefore, transfer of this interest 'is thus not a transfer of dutiable property within the meaning of s 7(1)(a) or s 7(1)(b)(vi) of the Act attracting a liability to pay duty'.[73]

B *The Decision in Rojoda*

While the decision in *Danvest* provided clarification of partnership law at the intermediate appellate court level, the concept that a partner holds an interest in particular partnership assets has now been explicitly rejected by the High Court.

The majority decision in *Commissioner of State Revenue v Rojoda Pty Ltd* ('*Rojoda*')[74] concerned the application of duty by the *Duties Act 2008* (WA) ('*Duties Act (WA)*') on 'dutiable transactions'. 'Dutiable transactions' was defined by s 11 of the *Duties Act (WA)* to include a declaration of trust over 'dutiable property' (which relevantly included land in Western Australia). The majority (Bell Keane, Nettle and Edelman JJ) summarised the background to the matter as follows:[75]

> The appeal concerns declarations made in two deeds in 2013 between the partners and their successors in title of two dissolved partnerships that had not yet been wound up. The deeds provided that freehold titles registered in the names of two partners, which were part of the partnership property of the two dissolved partnerships, be held on trust for the former partners or their representatives in fixed shares according to their partnership shares. The appellant, the Commissioner of State Revenue, imposed duty upon the declarations of trust that were made in each of the two deeds.

The respondent submitted that the deeds were not a declaration of trust as they 'merely confirmed the existing position'[76] that the property 'had been held on trust for the partners in fixed shares and this position continued.'[77] The majority rejected the proposition that the former partners each held an interest in the land, finding that 'the interest of partners in relation to partnership assets is not an interest in any particular asset but is an indefinite and fluctuating interest in relation to the assets'.[78] Further, the majority emphasised that it is established that a partner's interest in a partnership asset is not an interest in any specific asset, other than a right to that partner's proportionate share of the proceeds of the sale of assets upon the termination of the partnership.[79]

The majority summarised this principle by stating that the only interest a partner has, either before or after the dissolution of the partnership, is a right to an account and distribution of

[71] *Danvest* (n 45) 192 [1].
[72] Ibid.
[73] Ibid.
[74] (2020) 268 CLR 281 ('*Rojoda*').
[75] Ibid 291–2 [1].
[76] Ibid.
[77] Ibid.
[78] Ibid 297 [21] (Bell, Keane, Nettle and Edelman JJ).
[79] Ibid 302 [33] (citations omitted).

the proceeds of the sale of an asset. Quoting the decision of Lord Eldon in *Crawshay v Collins*,[80] the majority noted that this right is 'not to an individual proportion of a specific article, but to an account: the property to be made the most of, and divided'.[81] The majority further confirmed the general law position by noting that it aligned with the treatment of partnership assets found in the *Partnership Act 1895* (WA) ('*Partnership Act (WA)*'):[82]

> The Partnership Act also preserved equity's unique treatment of the interest of partners under the trust. The partner's unascertained interest in relation to all of the partnership property is an equitable interest, not a mere equity, but the "partner's share" is defined in s 33 as being only "the proportion of the then existing partnership assets to which he would be entitled if the whole were realised and converted into money, and after all the then existing debts and liabilities of the firm had been discharged".

The *Rojoda* majority took issue with the use of the terminology of a 'beneficial interest' in respect of a partner's interest in partnership assets, stating 'a partner's equitable interest is not accurately expressed as a "beneficial interest", at least in the sense of being a right to any proportion of, or for the personal use of, or for the benefit from, any particular asset.'[83] The use of the expression 'beneficial interest' in this context has also been criticised in subsequent case law[84] and in academic scholarship.[85] As summarised in the current edition of *Lindley & Banks on Partnership*, 'the general consensus of the Australian authorities is that, at least in a technical sense, a partner does not enjoy a *beneficial* interest in the partnership assets'.[86]

This analysis has been taken a step further in some commentary, which has argued that the *Rojoda* decision, 'in denying that a partner's interest was an interest in or in relation to any specific asset and characterised as a personal estate' indicated a 'moving away from the historic position that allows a partner an equitable interest in partnership property.'[87] It should be noted, however, that the *Rojoda* majority repeatedly referred to a partner's 'equitable interest' in respect of partnership property.[88] As such, this commentary reflects a shift away from recognising partners as holding an equitable interest in *individual items* of partnership property, in favour of a view of partners as holding an equitable interest in respect of the partnership property *generally*.

Two recent cases have applied the *Rojoda* decision in a manner that confirms this trend away from recognising partners as having interests in individual partnership assets. First, Allanson J of the Supreme Court of Western Australia recently referred to the *Rojoda* decision as providing an authoritative statement of the nature of a partner's interest in partnership property.[89] Drawing on *Rojoda*, his Honour observed that in equity, like under the *Partnership Act (WA)*, a partner's interest in partnership property is 'the right to a proportion

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[80] (1808) 33 ER 736.
[81] *Rojoda* (n 74) 302 [33], quoting *Crawshay v Collin* (1808) 33 ER 736, 741.
[82] *Rojoda* (n 74) 304 [38] (citation removed).
[83] *Rojoda* (n 74) 302 [33] (citations omitted).
[84] See, eg, *Doherty v Bruce Ronald Sampey administrator of the estate of Patricia Adele Addison* [2023] WASC 10, [78] ('*Doherty*').
[85] See, eg, I'Anson Banks (n 2) 784–5 [19-07]; A MacIntyre, 'Unit Trusts and Partnerships – Where Goes Equity?' (2022) 51(2) *Australian Bar Review* 211, 217–8.
[86] I'Anson Banks (n 2) 784–5 [19-07].
[87] MacIntyre (n 85) 218.
[88] *Rojoda* (n 74) 302–3 [33], [35], [38].
[89] *Doherty* (n 84) [149].

of the surplus after the realisation of the assets and payment of the debts and liabilities of the partnership.'[90]

The implications of this view are seen in Allanson J's treatment of the plaintiffs' argument that an individual partner may suffer loss in the amount of their supposed share of money received by their partnership. His Honour noted that such a claim treats money received by the partnership as having been received by each partner.[91] As such, this argument was said to misconceive the nature of partnership property.[92]

The Full Court in *Hedges v Commissioner of Taxation* ('*Hedges*') also took from the decision in *Rojoda* that at general law a partner 'does not have an equitable interest in any particular asset of the partnership.'[93] Interestingly, the Full Court also described the nature of a partner's interest in partnership property as being 'indivisible'.[94] The *indivisibility* of a partner's interest cannot refer to an inability to assign part of that interest, as the assignability of fractions of this interest was recognised in that same judgment.[95] Rather, this expression must reflect the homogeneity of the interest, in the sense of the interest not being comprised of individual parts which may be associated with particular partnership assets. This conception of a partner's interest further reinforces the general law's rejection of any view of partners as holding a fractional interest in specific partnership assets.

VI CONSEQUENCES FOR THE *ITAA 1997*

Australian taxation law has been criticised in recent years for being drafted in terms that are 'vague and imprecise, leading to uncertainty and ambiguity'.[96] It is well established that in the drafting of legislation, and especially tax legislation, imprecision 'leads to obvious problems, both social and economic' including that 'imprecise rules do not set out rights and obligations clearly', 'are inconsistent with the aspirations of the rule of law' and mean 'a heightened need for advisors, which adds to the deadweight cost of the tax'.[97] Such views are founded on established conceptions of precision contributing to the clear application of legislation,[98] and thereby supporting the principle of legality.[99]

There is demonstrable imprecision in the terminology used in s 108-5(2)(c) of the *ITAA 1997*. It makes little sense to refer to a partner's 'interest in an asset of a partnership' when prior to dissolution partners do not hold any quantifiable interest in individual partnership assets. While we can deduce that this provision has the effect of deeming partners to hold the interest

[90] Ibid.
[91] Ibid [147]–[148].
[92] Ibid.
[93] *Hedges* (n 11) [17], citing *Rojoda* (n 74) 302 [33].
[94] Ibid [18].
[95] Ibid.
[96] GS Cooper, 'Income Taxation: An Institution in Decay – Still' (2023) 52(1) *Australian Tax Review* 15, 17.
[97] Ibid 24. See also J Middleton, 'Statutory Interpretation: Mostly Common Sense?' 40 *Melbourne University Law Review* 626, 633; David Wallis, 'The Tax Complexity Crisis' (2006) 35(4) *Australian Tax Review* 274, 285.
[98] Middleton (n 97) 633; DG Hill, 'A Judicial Perspective on Tax Law Reform' (1998) 72(9) *Australian Law Journal* 685, 689.
[99] James Spigelman, S*tatutory Interpretation and Human Rights* (University of Queensland Press, 2008) 88.

referred to, there is historical evidence indicating that this provision was drafted with an assumption that partners already hold such an interest at general law. As discussed in Part IVA above, the Explanatory Memorandum (which does not refer to the provisions it introduced as having any deeming effect, despite the significance of this aspect of their operation) states: 'The amendments are not intended to alter the manner in which Part IIIA applies to such assets and instead are designed merely to clarify the existing operation of the law.' In addition, the Explanatory Memorandum's explanation for gains or losses on partnership assets accruing to individual partners is not because the partners are deemed to hold interests in those assets for taxation purposes, but because 'the assets are owned by the individual partners'.[100]

Even greater problems of uncertainty and ambiguity arise when s 106-5(1) is considered. Pursuant to s 106-5, a partner's capital gain or loss upon a CGT event in respect of a partnership asset is to be 'calculated by reference to the partnership agreement, or partnership law if there is no agreement.' However, a partner holds no fractional interest in a partnership asset under 'partnership law'. The 'value' of the chose in action that a partner holds depends on the debts and liabilities of the partnership, and the value of all other partnership assets, not just the value of the asset in question.

Accordingly, the *ITAA 1997* employs a legal fiction in order to make partners responsible for the CGT consequences of capital gains and losses on partnership assets in proportion to their partnership interests. That is, its provisions intend that partners be treated as though they hold a fractional interest in partnership assets for CGT purposes. However, the fact that this legal fiction is being employed is not stated explicitly. Against the background of partnership law, an understanding of the history and purpose of this legislation is needed to appreciate its operation. Without reform, this provision is drafted in a manner such that, like other provisions of Australian tax law, only '[t]he cognoscenti know what the section is trying to say'.[101]

This drafting is made even more opaque by the use of a second (and contradictory) legal fiction in s 108-5(2)(d).[102] As noted in Part II above, s 108-5(2)(d) draws upon a fictional view of a partnership as an entity separate from the partners, in which the partners hold an interest.[103] It has been observed that this provision is a strange juxtaposition with s 108-5(2)(c), which looks to the partners' supposed interest in the partnership assets.[104] While it may be considered that s 108-5(2)(d) is merely a 'residual category…intended to overcome the possibility of double taxation',[105] it should be noted that s 108-5(2)(c) and (d) together 'combine the elements of two contradictory tax fictions'.[106] This stands in contrast with the United Kingdom's system, 'which, in attempting to implement a consistent regime based on underlying interests in assets, has altogether ignored the concept of a partner's interest in the partnership per se.'[107]

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[100] Explanatory Memorandum (n 41) 6.
[101] Cooper (n 96) 20.
[102] Augoustinos (n 12) 133.
[103] Ibid.
[104] Ibid.
[105] *ITAA 1997* Commentary (n 8) ¶152-835.
[106] Augoustinos (n 12) 133.
[107] Ibid.

There is no reason why the *ITAA 1997* cannot continue to deem partners to hold proportionate interests in partnership assets for CGT purposes. But it is noteworthy that this was not what this legislation was intended to do at the time the CGT regime was drafted. Rather, the Explanatory Memorandum describes s 160A as intending to tax gains and losses that are made by individual partners as a result of their ownership of partnership assets.[108] This surprising and apparently inadvertent change in the effect of the legislation demands careful attention. Indeed, the failure of these provisions to use what is now the dominant conception of a partner's interest in partnership assets has material consequences for the clarity and technical coherence of the legislation.

A *Judicial Consideration of the CGT Regime's Application to Partnership Assets*

The case law concerning the application of the CGT regime to partnership assets is limited. Despite this, two cases illustrate the practical difficulties that have arisen from the imprecise nature of the legislation.

White v Commissioner of Taxation concerned a dispute over the CGT consequences flowing from the sale of a pharmacy business.[109] The applicant claimed entitlement to a small business CGT concession provided for in sub-division 152-C of the *ITAA 1997* and sought to defer her resultant taxable gain under the small business roll-over provisions in sub-division 152-E.[110] Entitlement to enjoy the benefit of these provisions depended upon whether the applicant satisfied the maximum net asset value test set out in s 152-15 of the *ITAA 1997* (noting that this provision has subsequently been amended).[111]

Relevantly, the applicant had a 50% or greater interest in partnerships referred to as the 'White/Murphy Partnership' and the 'White/White Partnership'.[112] If these partnerships were entities within the meaning of that term in s 152-15(a)(ii), they would be connected with the applicant for the purposes of that provision.[113] The aggregate of the net asset values of the applicant's CGT assets and those of the White/Murphy Partnership and White/White Partnership exceeded $5,000,000 just before the sale of the relevant pharmacy business.[114] Accordingly, should a partnership be an 'entity' within the meaning of that term in s 152-15(a)(ii), the applicant would not have been entitled to a reduction in her taxable gain, nor to defer the resultant taxable gain under the small business roll-over provisions in sub-division 152-E.[115]

On 29 May 2009, Gordon J (then of the Federal Court of Australia) ordered that the issue of whether a partnership is an 'entity' within the meaning of that term as used in s 152-15(a)(ii)

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[108] Explanatory Memorandum (n 41) 6.
[109] *White v Commissioner of Taxation* (2009) 178 FCR 498, 499 [5(a)].
[110] Ibid 500 [5(d)].
[111] Ibid.
[112] Ibid 500 [5(e)].
[113] Ibid 500 [5(f)].
[114] Ibid 500 [5(g)].
[115] Ibid 500 [5(h)].

be determined as a preliminary question.[116] Justice Sundberg answered that question in the negative.[117]

The applicant submitted that s 152-30, which defines where an entity is 'connected with' another entity, contains specific mechanisms for determining the existence of control in relation to companies and trusts, but not partnerships.[118] The applicant submitted that this is so because a partner does not have a right to receive any distribution of income or capital by the partnership, 'because partners have direct ownership interests in the assets of a partnership and direct responsibility for its liabilities.'[119] Thus, the applicant argued, 'they own their proportionate shares of the net assets, including the income and capital.'[120] The applicant went on to submit that 'the absence of any test for control of a partnership shows that Parliament did not intend partnerships to be included in the range of entities that can be connected with a taxpayer for the purposes of the maximum net asset value test.'[121]

Uncertainty regarding when the CGT regime intends to treat a partnership as an entity underpinned the respondent Commissioner's submissions. The Commissioner challenged the applicant's assertion that the *ITAA 1997* ignores a partnership as an entity, and argued that the CGT regime expressly treats partnerships as entities despite not treating them as taxpayers.[122] The Commissioner's evidence for this construction of the *ITAA 1997* notably included the introduction to Division 106. The introduction describes the division as setting out 'the cases where a capital gain or loss made by someone other than the entity to which a CGT event happens', and explicitly includes partnerships in a list of affected entities.[123]

Justice Sundberg considered it to be plain that s 106 treats a partnership as an entity.[124] However, having reviewed the explanatory memorandum to the *Tax Law Improvement Act (No 1) 1998* (Cth), which introduced Division 106, his Honour determined that 'the extrinsic material shows that for "control" purposes a partnership is not treated as an "entity". In other words "entity" does not mean the same thing whenever it is encountered.' This analysis demonstrates the difficulty in distinguishing between the parts of the *ITAA 1997* which intend to depart from the general law and the parts that embrace it.

The problematic drafting of s 106-5 was also highlighted in the decision of the Full Court in *Hedges*. In particular, the Full Court noted the vagueness of the reference to 'partnership law' as a means by which a capital gain or loss on a partnership asset may be calculated.[125] This case concerned an appellant who retired from a partnership of solicitors. The appellant's retirement involved his receipt of 'retirement moneys' comprised of payment for partnership goodwill, work in progress and other sums owed to him and repayment (by the appellant) of a deficit in his capital account.[126] The Commissioner assessed the goodwill component of this

[116] Ibid 499 [4].
[117] Ibid 509 [55].
[118] Ibid 503 [17].
[119] Ibid.
[120] Ibid.
[121] Ibid.
[122] Ibid 504 [21].
[123] Ibid 504 [21], 508 [46].
[124] Ibid 508 [48].
[125] *Hedges* (n 11) [25].
[126] Ibid [5]–[6].

calculation as capital proceeds subject to CGT (after applying a 50% CGT discount).[127] The appellant argued that the source of the funds he received was the retirement deed he entered into with his partners.[128] As such, he contended the retirement moneys did not include a sum in respect of the disposal of a share of goodwill for the purposes of s 116-20 of the *ITAA 1997*.[129]

As this appeal turned on the interpretation of the appellant's partnership deed and retirement deed, the Full Court was not required to consider how 'partnership law' would calculate a partner's gain or loss in respect of a partnership asset. However, the Full Court stated that it may be 'fortunate' it did not need to construe s 106-5.[130] It was observed that the reference in s 106-5(1) to 'partnership law' 'must be a reference to the general law of partnership', and that the general law sits out of alignment with the CGT provisions in the *ITAA 1997.*[131]

The Full Court's observation that the reference in s 106-5(1) to 'partnership law' must be to the general law of partnership appears to be correct. However, the second example under s 106-5 implies otherwise, stating:[132]

> For other partnership assets [i.e. assets for which the partnership agreement does not provide the specific interests held by each partner], Helen's gain or loss will be determined on the basis of her 50% interest (under the relevant Partnership Act).

In light of the equal splitting of the asset provided in the example, the reference to a partner's gain or loss being calculated under the relevant Partnership Act appears to be a reference to s 24(1)(1) of the *Partnership Act 1892* (NSW) and the corresponding provisions in each of the other Partnership Acts. Section 24(1)(1) provides that subject to any agreement between the partners, all partners are entitled to share equally in the capital and profits of the business (and must contribute equally towards its losses). However, connecting the calculation of a partner's interest in a partnership asset with s 24(1)(1) (which concerns the equal sharing of capital and profits) conflates a partnership's capital with its assets. Even with the assistance of this provision, it is unclear how 'partnership law' would calculate a partner's supposed gain or loss.

VII POTENTIAL REFORMS

Arguments have been made for legislative amendment to change the CGT regime's approach to assessing CGT at the partner level to doing so at an entity level.[133] Reform of this kind would provide an opportunity to clarify and refine the alignment of the CGT regime and the law of partnership. It has also been argued that the regime should adopt specific entity level approaches for taxing particular transactions. For example, modelling the entity level approach taken in the United States and Canada in regard to the contribution of partnership

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[127] Ibid [7].
[128] Ibid [10].
[129] Ibid.
[130] Ibid [25].
[131] Ibid.
[132] *ITAA 1997* (n 6) s 106-5 (emphasis added).
[133] Augoustinos (n 12) 136.

property by a partner.[134] Such reforms would allow for a more targeted improvement in the aspects of the current regime that are unclear or imprecise.

There are two further approaches that may be taken in the short-term that would have a material impact on the clarity and precision of the CGT regime without requiring the significant and time-consuming step of large-scale legislative reform. These are the amending of IT 2540 and the revising of ss 106-5 and 108-5(2) in a limited way to clarify the operation of the current regime.

A *Amendments to IT 2540*

Three changes may be made to IT 2540 in order to clarify the Commissioner's interpretation of how the (existing) CGT regime interacts with partnership law:

1. In respect of s 108-5(2), the ruling should state *explicitly* that partners are deemed to hold fractional interests in partnership assets.
2. In respect of s 106-5, the ruling should state:
    a. in calculating a partner's gain or loss made on a CGT event 'by reference to the partnership agreement':
        i. a partner's capital gain or loss will be calculated according to the terms of any partnership agreement that specifies the partner's share of surplus capital generated by the disposal of that asset; and
        ii. if no agreement concerning the specific asset in question exists, the partner's capital gain or loss will be equated with the terms of any partnership agreement that specifies the partner's share of surplus capital upon the termination of the partnership;
    b. in calculating a partner's gain or loss made on a CGT event by reference to 'partnership law if there is no agreement', a partner's capital gain or loss will be equated with that partners' proportionate entitlement to share in surplus capital upon the termination of the partnership.

In light of the analysis above, these amendments would clarify the operation of the CGT regime, albeit only in the form of a statement as to how the Commissioner interprets the legislation and intends to enforce it.

B *Amendments to the* ITAA 1997

More consequential improvements to the regime could be made via legislative amendment, even without significantly altering large parts of the legislation. In particular, the tests used for calculating a partner's capital gain or loss on the occasion of a CGT event as described in points 2.a and 2.b above are simplistic, and a comparison with the approach to this issue taken by HMRC in the United Kingdom illustrates how these tests may be improved. While

[134] Ibid 134–5.

this approach derives from HMRC policy, lessons may be taken from it relevant to legislative reform in Australia.

1 *The Approach in the United Kingdom*

In the law of the United Kingdom, the interest of partners in partnership assets is ordinarily conceived of as a 'proportion of the partnership assets after they have been all realised and converted into money, and all the debts and liabilities have been paid and discharged'.[135] Section 59 of the *Chargeable Gains Act 1992* (UK) ('*Chargeable Gains Act*') provides for the taxing of partners for capital gains made on partnership assets. However, the details of the United Kingdom's CGT regime is governed by the practice of HMRC. This practice is set out in published 'statements of practice'. Like Australian Taxation Office rulings, these statements provide a guide to taxpayers and their advisors as to how the United Kingdom's regime will be enforced.

In 'Statement of Practice D12: Partnerships', HMRC embraces the deeming of partners as holding fractional interests in partnership assets for taxation purposes, but quantifies these interests as emphasised below:[136]

> 2.1 Where an asset is disposed of by a partnership to an outside party, each of the partners will be treated as disposing of his fractional share of the asset. In computing gains or losses, the proceeds of disposal will be allocated between the partners in the ratio of their share in asset surpluses at the time of disposal. Where this is not specifically laid down, the allocation will follow the actual destination of the surplus as shown in the partnership accounts; regard will of course have to be paid to any agreement outside the accounts.
>
> 2.2 If the surplus is not allocated among the partners but, for example, put to a common reserve, regard will be had to the ordinary profit sharing ratio, which is likely to be indicative in the absence of a specified asset-surplus-sharing ratio.

Statement of Practice D12 has been called 'superior' to IT 2540 in a number of respects.[137] One is that the Statement of Practice covers ground 'that is ignored by the Australian tax ruling' (IT 2540).[138] This includes 'the tax outcomes applicable in circumstances such as the division of partnership assets among the partners, revaluation of partnership assets followed by changes in partnership sharing ratios and payments made by partners outside the accounts.'[139]

As is apparent, Statement of Practice D12 describes the particular interest that is used in computing capital gains ('in the ratio of their share in asset surpluses at the time of disposal'[140]) with far greater specificity than s 106-5. This approach provides a greater level

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[135] *Brake v Swift* [2020] 4 WLR 113, 25 [123], citing *Sandu v Gill* [2006] Ch 456, [19]; I'Anson Banks (n 2) 785–6 [19-08] and the cases there cited.
[136] His Majesty's Revenue & Customs, 'Statement of Practice D12: Partnership', *Gov.UK* (Policy Paper, updated 14 September 2015) [2.1] (emphasis added) <https://www.gov.uk/government/publications/statement-of-practice-d12/statement-of-practice-d12>.
[137] Augoustinos (n 12) 131.
[138] Ibid.
[139] Ibid.
[140] IT 2540 (n 29) [2.1].

of cohesion between HMRC practice and partnership law. It also provides greater clarity to taxpayers and professionals looking to interpret this practice. The HMRC practice also diverges from the Australian approach by employing a 'waterfall' mechanism in order to determine the ratio in which partners share the CGT implications of a capital gain or loss. That is, the capital gain or loss is apportioned to each partner:[141] (1) in the ratio of their share in asset surpluses at the time of disposal (if specified in the partnership deed or other agreement); (2) in accordance with the actual destination of the surplus in the partnership accounts; and (3) where the surplus is placed into a common reserve, in accordance with the ordinary profit ratio.

2 *Reforming ss 106-5 and 108-5(2)*

Problematically, s 106-5 (unlike s 59 of the *Chargeable Gains Act*), requires a partner's capital gain or loss to be calculated by reference to 'partnership law', where no partnership agreement provides an answer. As such, it does not appear open to the Commissioner to issue a taxation ruling which implements a test for a partner's capital gain or loss by reference to the allocation of funds in the partnership accounts or by reference to the ordinary profit ratio. Such an approach would appear to require s 106-5 to be amended.

Further, s 106-5 could be made more precise by stating explicitly that a partner's gain or loss for CGT purposes is calculated by reference to the partner's proportionate share in asset surpluses at the time of disposal and after payment of partnership debts and liabilities. Undoubtedly, stating the interest partners hold in partnership assets with this level of specificity could be seen to increase the complexity of the section's drafting. However, it is well established that the need for precision in defining when and how a tax will be imposed gives rise to a level of complexity that is unavoidable.[142]

These reforms could be made in the following manner:[143]

> Section 106-5 Partnerships
>
> (1) Any capital gain or capital loss from a CGT event happening in relation to a partner's interest in a partnership or one of its CGT assets is made by the partners individually.
>
> (2) Subject to any partnership agreement, each partner is deemed, for the purposes of Part 3-1, to hold an interest in each asset of the partnership, equal to the partner's proportionate entitlement to the surplus of the realisation of the assets and payment of the debts and liabilities of the partnership.
>
> (3) Each partner's gain or loss in respect of a CGT asset is calculated by reference to the partnership agreement, or partnership law if there is no agreement where that agreement specifies the partner's interest relative to the other partners.

In order to account for circumstances in which no partnership deed exists, or where a partnership deed does not specify the allocation of capital between the partners, the fall-back

[141] His Majesty's Revenue & Customs (n 136) [2.1]–[2.2].
[142] Wallis (n 97) 285.
[143] Numbering has been added to the chaussette of s 106-5, and the proposed sub-section which accompanies it, for clarity.

quantification methods adopted by HMRC would also provide greater clarity to the Australian regime:

> (4) Where a partner's interest in a CGT asset relative to the other partners is not specified in a partnership agreement, any capital gain or loss is allocated between the partners in accordance with the actual destination of the surplus in the partnership accounts.
>
> (5) Where a partner's gain or loss in respect of a CGT event cannot be determined in accordance with sub-section (3) and the surplus capital generated by a GCT event is placed into a common reserve, the surplus capital is allocated between partners for CGT purposes in accordance with the ordinary profit ratio.

In a similar vein, s 108-5(2)(c) could be made clearer by the provision being amended to explicitly state that a partner is deemed to hold an interest in each asset of their partnership as provided in s 106-5:

> (2) To avoid doubt, these are *CGT assets*:
>
> (a) part of, or an interest in, an asset referred to in subsection (1);
>
> (b) goodwill or an interest in it;
>
> (c) the deemed interest a partner holds in each asset of the partnership pursuant to s 106-5 an interest in an asset of a partnership;
>
> (d) an interest in a partnership that is not covered by paragraph (c).

VIII CONCLUSION

A view of partners as holders of fractional interests in partnership assets was influential in the design of the CGT regime. It has been demonstrated by reference to recent case law that partners do not hold any such interest in partnership assets. Resultantly, the CGT regime lacks a principled basis guiding when it embraces, or diverges from, partnership law. This problem is exacerbated by the regime also failing to identify with clarity when it intends for such a divergence to occur.

Sections 106-5 and 108(2) of the *ITAA 1997* are ripe to be reformed. If it is proposed that the *ITAA 1997* continues to deem partners to hold fractional interests in partnership assets for CGT purposes, this should be done with clarity and technical precision. Foremost, this should be done by making explicit the deeming effect of the legislation. This article provides a proposed model for re-drafting these sections based on the United Kingdom's CGT regime. Even if the *ITAA 1997* is not revised, there is little stopping the Commissioner from beginning the process of clarifying the operation of this legislation by amending IT 2540. In the meantime, it appears likely that the inadvertent divergence in the law created by the current CGT regime will continue to be wrestled with by judges and practitioners.