PARTNERSHIP SALARIES AND TR 2005/7

By Ian Tregoning*

This article critically examines Taxation Ruling TR 2005/7 *concerning the income tax treatment of partners' salaries. An earlier ruling Income Tax Ruling* IT 2218 *is also considered as background to the current ruling, together with the relevant legislation and case law.* TR 2005/7 *is found to be without foundation in the law, being contrary to the scheme of the legislation and to case law. As a result, it is recommended that the ruling be withdrawn.*

1. INTRODUCTION

The treatment for income tax of so-called salaries paid to partners has presented an interesting turn for tax conjurors for many years. For example, being able to produce a distribution of income to a partner of a greater amount than the net income of the partnership requires a certain sleight of hand.[1] In these performances, it should be noted, the Commissioner of Taxation ("Commissioner") has acted most ably as the conjuror's assistant by his general administrative practice of allowing certain distributions even though they have had no foundation in the law.[2]

Now, however, the Commissioner has announced a departure from his old administrative practice by the release of *Taxation Ruling*

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[1] The type of situation specifically referred to here is illustrated in example 2 in Appendix 1.

[2] Examples of four different situations which may arise from the recognition of a partner's salary in a distribution of partnership net income or loss are provided in Appendix 1.

TR 2005/7[3] of 25 May 2005 which introduces an extraordinary new practice. This article examines this practice on the basis of the legislation and case law authorities to determine whether there is any foundation for the creative practice promoted in the ruling. It is found that it is without foundation in the law and outside the scheme of the income tax legislation. In effect, this article provides an alternative view to the ruling, but one different from the token alternative view[4] presented in the ruling.

2. BACKGROUND

It had been the Commissioner's understood practice for many years to allow a notional deduction of a partner's "salary" from net income, even while creating a partnership "loss", to give effect to a partnership agreement providing for such a salary. In the simplest case of a two-person partnership, the typical result would be an amount of assessable income distributed to the salaried partner and an offsetting loss to the other partner, as illustrated in example 2 of Appendix 1. This practice was without foundation in the law, as is

[3] This ruling was originally released in draft form as *Draft Ruling* TR 2004/D4 on 25 August 2004. *Taxation Ruling* TR 2005/7 is substantially the same as the draft, with some minor changes to the definition of "partnership salary" for the purposes of the ruling. In the ruling, a partnership salary is "drawn" against partnership "profits" (para 2), whereas in the draft the salary was "paid" from "partnership funds" (para 2). However, nothing of substance seems to turn on these changes; what is involved is an amount of payment for services drawn by the salaried partner.

[4] TR 2005/7 contains a section headed "Alternative views" (comprising paras 27-31), but it presents only one view, and as something of a token view which is demolished in short order by the Commissioner. This alternative view is based on the premise that a payment to a partner may be characterised as an expense in certain circumstances, in turn based on certain pieces of legislation which recognise some forms of "self-dealing" contracts. Therefore, the argument supposedly goes, any partner's salary in excess of the partnership profits may be treated as an expense of the partnership deductible under s 8-1. Why in such a case the whole of the salary should not be treated as an expense is not explained. Nevertheless, such a view clearly runs counter to settled authority that a partnership cannot employ a partner, thus making it untenable. Therefore, the Commissioner is, of course, right to reject this view in the face of this authority. However, ironically, the Commissioner has not been inhibited by settled authority in the ruling itself, as argued in this article.

admitted in TR 2005/7,[5] because it is clear that s 92 of the *Income Tax Assessment Act 1936* (Cth) ("ITAA36") does not accommodate the distribution of an amount of assessable income to one partner and an amount of loss as an allowable deduction to the other. However, it was apparently accepted in recognition of "commercial reality". The apparent recognition of this long-standing practice was promulgated in *Income Tax Ruling* IT 2218, dated 14 November 1985, and issued in response to the decision of the No 2 Board of Review in *Case* S75.[6] This case involved a husband and wife partnership where the partners agreed to pay the wife a salary for managing the partnership business, with the resultant profit or loss after charging the salary to be shared equally between them. The charging of the salary had created a partnership "loss" with the result that the wife had been distributed an amount exceeding the partnership's net income, calculated according to tax law, and the husband had been distributed his offsetting half-share of the "loss". The Board accepted the salary as a valid part of the partnership agreement concerning the sharing of profits or losses, but held that for tax purposes the salary could be paid to the wife only to the extent of the net income, with the husband consequently receiving nil. This decision, the Board declared, was in accord with the law contained in the Assessment Act. In making this declaration, the Board members recognized the Commissioner's administrative practice, but indicated that they were obliged to apply the law, even if it ran counter to that practice.[7]

Nevertheless, in IT 2218 the Commissioner reasserted his commitment to continue his practice, notwithstanding the Board's decision in *Case* S75.[8] Paragraph 4 stated:

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[5] See paras 7 and 8.

[6] 85 ATC 544.

[7] However, *Case* S75 was obviously an example of the Commissioner not adhering to his practice.

[8] The Commissioner is not bound by Administrative Appeals Tribunal decisions, and previously by Board of Review decisions, except with regard to the taxpayer in question. Furthermore, he is not bound by public rulings such as IT 2218: for example, see *Scott v FC of T* 2002 ATC 2158 (AAT).

> The decision of the Board is not to be taken as altering the long established practice of this office in relation to partners' salaries. Although a salary paid to a partner does not represent salary or wages for the purposes of the tax instalment deduction provisions in Div 2 of Pt VI of the Act and is not itself a loss or outgoing within the meaning of s 51(1), nevertheless it may well constitute a legitimate distribution of the profits of a partnership which should be taken into account in determining a partner's individual interest in the net income of a partnership.

Then in the following para 5 it stated:

> In genuine cases involving the payment of a salary to a partner, ie where the payment of the salary is bona fide and is not only reasonable in amount but has its origin in the terms of partnership agreement, it has been the practice of this office to take the salary into account in determining the individual interest of each partner in the net income or loss of the partnership. This practice will continue.

However, the ruling in para 5 in fact stopped short of expressly endorsing the type of distribution attempted by the partners in *Case* S75 where the notional deduction of a salary created a loss, with the consequent distribution of income to one partner and the distribution of a loss to the other. It rather more vaguely referred to taking the salary into account in determining the individual interest of each partner in the net income or loss of the partnership. Such a practice could simply mean that the salary could be applied to vary the sharing of either a net income or a loss, without necessarily creating the artificial situation represented by the distribution attempted by the partners in *Case* S75 (see example 1 in Appendix 1). Nonetheless, it may be taken that the implication was clear and that the practice was well understood.[9] Therefore, the wording of the

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[9] Reference to this practice may be seen in *Case* S75 and somewhat obliquely in *Scott v FC of T* 2002 ATC 2158, 2161 where the Administrative Appeals Tribunal said: "the Commissioner has a statutory obligation to apply the tax laws. His own conduct – no matter how unfortunate – cannot operate as an estoppel against him in the assessment and collection of the correct amount of tax …".

Commissioner's notice of withdrawal of IT 2218 on 22 May 2002 was somewhat curious. He stated:

> *Taxation Ruling* IT 2218 is withdrawn with effect from today. The [ruling] was issued following the Board of Review's decision in *Case* S75. The Commissioner's ruling was a statement of the long-standing practice relating to "partners salaries". There has been some misinterpretation of paragraph 4 of this ruling, causing some confusion. This problem has been compounded by the interpretation of the ruling by CCH as printed in the *Master Tax Guide* 2002. Paragraph 4 of IT 2218 does not say the salary should be taken into account in determining the net income of a partnership. It says the salary should be taken into account in determining a partner's individual interest in the net income of a partnership. In other words, the salary should be taken into account in determining the way in which the net income is to be distributed; not the way in which the net income is to be calculated.

However, the *2002 Master Tax Guide* did not say that the salary was to be taken into account in calculating partnership net income. Rather, it said that "the tax distribution is calculated *as if* non-deductible partners' salaries had been deductible in arriving at the net partnership income of loss".[10] In other words, the salary was to be treated as a notional deduction to give effect to the distribution, rather than to calculate net income of the partnership according to law. This was consistent with the understood meaning of IT 2218. Indeed, the whole tenor of the relevant paragraph (5-090) in the *Master Tax Guide* was consistent with that understanding, seeking to explain and illustrate the application of the ruling on that basis. The *Master Tax Guide* had provided the same analysis of the Commissioner's practice for many years, causing one to wonder why

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[10] CCH, *2002 Master Tax Guide* (33rd ed, 2002) 161 (emphasis added). In fact, the *Master Tax Guide* at least as far back as 1976 provided the same information and worked examples, but with the inclusion of a 4th example where a partnership loss under s 90 produced income to one partner and a loss to the other after the partners' salaries were taken into account. This type of situation is illustrated in example 4 of Appendix 1 to this article. This 4th example was retained until the 2001 *Master Tax Guide*, but was dropped for the 2002 edition.

it suddenly became a problem so late in the piece. Whatever the misinterpretation and confusion referred to in the Commissioner's notice of withdrawal might have been, it could not reasonably be blamed on this publication. And, after all, it was the Commissioner who had put in place his administrative practice and seemingly re-affirmed it in IT 2218. If he was not referring to the type of distribution attempted by the partners in *Case* S75, but only to allowing the salary to be taken into account to vary shares of net income, then there would seem to have been no need to issue IT 2218. Yet the Commissioner stated that "[t]he decision of the Board is not to be taken as altering the long established practice of this office in relation to partners' salaries". Nonetheless, regardless of the interpretation of IT 2218, it is the new ruling which is the focus of this article.

3. PARTNERS' SALARIES

It is well-established that a so-called salary paid to a partner is not deductible to the partnership. A partner cannot be an employee of the partnership at general law: see *Ellis v Joseph Ellis*.[11] This position was affirmed for Australian law in *Rose v FC of T* [12] where the High Court accepted the English law position that a partnership is not a distinct legal entity separate from its members. Thus it is settled law in Australia that a person cannot employ himself. The result is that payments to partners for services rendered to the partnership are not deductible under s 8-1 of the *Income Tax Assessment Act 1997* (Cth) ("ITAA97") in calculating the net income or loss of the partnership in accordance with s 90 of the ITAA36.[13]

In view of the settled position that a partnership cannot employ a partner, it must be concluded that the Board correctly applied the law in *Case* S75. Once the agreement to pay a salary was accepted as valid, it was taken into account in determining the distribution of the

[11] [1905] 1 KB 324.
[12] (1951) 84 CLR 118.
[13] This view, in fact, is accepted in TR 2005/7, para 7.

net income under s 92(1). A partner's salary simply represents a first claim on income: in income tax terms a first claim on net income as calculated under s 90. This meant that in *Case* S75 the "salaried" partner was distributed all of the net income because it was less than the agreed salary.

Paragraph 8 of TR 2005/7 accepts the position taken in *Case* S75 in stating:

> An agreement to allow a "partnership salary" to be drawn varies the recipient partner's interest in the partnership profits and losses. It is taken into account in determining that partner's interest in the net income of the partnership under s. 92(1) of the ITAA 1936. The recipient partner's interest in the net income will include the partnership salary to the extent that there is available net income.

So far the ruling is consistent with the law, although it is unclear why reference is made to "available" net income. The net income does not have to be "available", except in the sense that it has to have been calculated in accordance with s 90.[14] The above reference to "available" could be deleted without affecting the meaning of the paragraph, unless the Commissioner equates net income with funds available for distribution, which is possibly what he thinks in the following para 9. The ruling takes a distinct departure from the law in para 9 which states:

> If in a particular income year the "partnership salary" drawn by a partner exceeds the recipient partner's interest in the available net income of the partnership, the excess advanced to the partner is not at that time assessable income of the partner under s 92(1) of the ITAA36. Nor is an advance of future profits assessable under s 6-5 of the ITAA97. An advance of future profits is assessable to the partner in a future income year when sufficient profits are available

[14] In a technical sense, a partner's interest in partnership net income can only be ascertained at the end of the income year when the accounts are prepared and that net income is determined: see *FC of T v Galland* 86 ATC 4885 (HC). However, there is no indication that this is what is meant by net income being "available" in this ruling.

> the partners' interest is accounted for under s 92(1) of the ITAA36 in determining his or her interest in the net income of the partnership in that year.

Leaving aside the clumsy expression and the misplaced apostrophe of the last sentence in this paragraph, it is this sentence which contains the essence of the ruling. It rules that where a partner's salary exceeds the net income of the partnership in a particular income year, the amount of that excess shall form an assessable distribution to that partner under s 92(1) in a future year when there are "sufficient profits" available to cover the excess. This is illustrated in example 2 appended to the ruling. It is submitted that this ruling is incorrect because there is no basis in the law for such an approach. In fact, it runs counter to the scheme of the tax law, as argued in this article.

4. DIVISION 5 OF THE ITAA36

Division 5 of the ITAA36 provides the scheme for assessing the income derived by partnerships, as noted in para 11 of TR 2005/7. Section 90 provides the rules for determining the net income of the partnership or the partnership loss. It in effect proposes an hypothesis that the partnership is a resident taxpayer as the basis for calculating the partnership's net income or loss. That is, the net income or loss is the assessable income derived by the partnership, calculated as if the partnership were a taxpayer who was a resident, less allowable deductions (with limited exceptions of no account in this analysis). Then because a partnership itself is not a taxpayer, as is recognised by s 91, the net income or loss of the partnership is distributed to the partners, as the taxpayers, through the mechanism provided by s 92. Subsection 92(1) provides that a partner shall include his individual interest in the net income of the partnership of the year of income in his assessable income. Where a partnership loss is incurred in a year of income, on the other hand, s 92(2) provides that a partner shall be allowed a deduction to the extent of his individual interest in the partnership loss.

The key point to note is that the partnership net income or loss is calculated in respect of an income year and the appropriate share of the net income or loss is taken up by each partner as assessable income or an allowable deduction in that particular income year. As the Federal Court observed in *Rowe (B and H G) v FC of T*, "net income must ordinarily be related to a period. For taxation purposes, in the case of a partnership, that period is the relevant tax year".[15] This is consistent, of course, with the framework of the income tax system which provides for the calculation of taxable income and the imposition of tax on an annual basis.[16]

In view of the above framework, there is an issue with taxing an amount drawn in one year in a later year. Given that the scheme of the income tax system is based on determining taxable income and tax payable on an annual basis, there can be no basis for making the type of adjustment across income years as proposed in the ruling. In *Henderson v FC of T*, Barwick CJ said:

> … there cannot be any warrant in a scheme of annual taxation upon the income derived in each year of taxation for combining the results of more than one year in order to obtain the assessable income for a particular year of tax. … Once it is decided that the partnership income derived in the year in question will be the net amount of its earnings of that year, it is, in my opinion, only the earnings of that year which can be included in the computation.[17]

The issue in *Henderson* concerned the computation of annual income at the partnership level, but the principle must equally apply at the partners' level. That is, it is only earnings in the form of net

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[15] 82 ATC 4243, 4244 (per Deane, Fisher and Davies JJ). This was approved of as a fundamental point by the High Court in *FC of T v Galland* 86 ATC 4885, 4887 (per Mason and Wilson JJ).
[16] See ITAA97, ss 4-10 and 4-15.
[17] 70 ATC 4016, 4019.

income of a particular year that is included in a partner's assessable income of that year.[18]

5. NET INCOME VERSUS PROFIT

Net income is an amount determined in accordance with tax law, and is not necessarily the same as accounting profit. Once this amount of net income is calculated it falls to be taxed in the hands of the partners, rather than to the partnership. The sharing of the net income may be determined by the sharing of profits agreed between the partners, but the distribution determined on this basis is made to the net income of the partnership – a tax figure based on statutory rules. There is no basis for taxing an amount in excess of this net income, in the current year or any later year. The fact that the salaried partner has drawn an amount from the partnership in excess of its net income is irrelevant for income tax. It is only an amount calculated according to tax law that is subject to income tax. In the case of a partnership, it is the amount of net income distributed under s 92(1) to each partner that is included in that partner's assessable income where it bears tax as part of his taxable income.

In parts of the ruling it appears that the terms "net income" and "profit" are used interchangeably and confused as a result.[19] However, they are distinctly separate concepts. Net income, as noted earlier, is an amount calculated under s 90 in accordance with income tax law. Profit is an accounting concept and calculated according to accounting rules and practices which do not necessarily correspond with tax law. Deane J noted this distinction in *FC of T v Everett* where he observed:

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[18] The Full Federal Court in *Dormer v FC of T* 2002 ATC 5078 found Barwick CJ's statement in *Henderson* to be curious on the particular facts of that case. Nonetheless, the principle espoused by Barwick CJ may be taken as sound in the sense that each income year must be considered separately in the computation of income.

[19] See, eg, para 21. However, an underlying conceptual confusion between net income and profit seems to permeate the whole ruling.

> The "net income" which is apportioned among the partners by s 92 can readily be seen as a convenient parallel, for the purposes of the Act, to the "profits" in which the partners are entitled to participate. Plainly the two will not necessarily correspond.[20]

Accounting profit may influence the tax result, however, in that it is the agreed shares of the profit, including a partner's salary, which are typically used as the basis for determining the interests in net income distributed under s 92(1). But it is the net income which is distributed to the partners for income tax, not the accounting profit.

6. DRAWINGS VERSUS ASSESSABLE INCOME

As already noted, TR 2005/7 in para 9 refers to a partnership salary drawn by a partner and equates any excess of that drawn amount over the partner's share of net income as an advance of profits. This excess is then assessable in a future year. However, drawings as actual amounts drawn from the funds of the partnership do not bear any necessary relationship to assessable income distributed to partners under s 92. Drawings have no bearing on the calculation of partnership net income or on the amount of that net income distributed to each partner. As Meares J observed in *Everett v FC of T*, "s 92 is designed to catch the whole of a partner's interest in any year of income rather than merely the amount of his drawings".[21] Earlier, in *FC of T v Happ*, Williams J stated in similar vein:

> … Div 5 of Part III, which deals with partnerships, is based upon the view that the collective income earned by the partnership belongs

[20] 78 ATC 4595, 4610.

[21] 77 ATC 4478, 4481. This view was echoed by the Administrative Appeals Tribunal in *Case* 7/2000, 2000 ATC 168, 172. Furthermore, in *Case* Q78, 83 ATC 400, 404 the Board of Review noted: "… the observations of Meares J … were by inference accepted as stating correct principles by both the Federal and High Courts on appeal".

> according to their shares to the partners regardless of its liberation from the funds of the partnership, that is its actual distribution.[22]

Thus to take a partner's drawings as representing an amount of assessable income is an approach that has no basis in the law. As Bowen CJ stated in *Everett*, "the partnership agreement may provide for advances to be made from time to time against the ultimate annual share of profits but such an arrangement does not alter the position as I have stated it".[23] The position stated by his Honour related to each partner's share of net income determined for the purposes of Div 5, whether that share is detached or not.[24] Earlier, in 12 CTBR(NS) *Case* 110, member McCaffrey stated the same position in saying "[a] partner is … assessable on his individual interest in the 'net income' of the partnership whether he has received any payment or not".[25] Another example may be found in *Case* Q78[26] where the Commissioner had assessed the taxpayer on an amount of $20,325 shown in the return of the partnership of which he had been a member until its termination near the end of the income year. The taxpayer objected that he should have been assessed only on an amount of $12,705 representing his drawings from the partnership for that year. However, the Board affirmed the Commissioner's assessment, relying on authority including that of Meares J in *Everett*. The Board stated:

> … we consider that the taxpayer was correctly assessed as a partner on the amount of $20,325 which was his share in the net income of the partnership … . Clearly, in our opinion, the taxpayer was correctly assessable on the amount of $20,325 and not merely on the drawings of $12,705.[27]

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[22] (1952) 9 ATD 447, 451.
[23] 78 ATC 4595, 4597.
[24] This position was based on an observation in *FC of T v Happ* (1952) 9 ATD 447, 451.
[25] (1966) 12 CTBR(NS) *Case* 110, 641.
[26] 83 ATC 400.
[27] Ibid 404.

While the issue in *Case* Q78 involved an amount of drawings less than the share of net income and the ruling deals with drawings in excess of net income, the principle remains the same. That is, drawings do not necessarily represent a share of net income for income tax.[28]

7. CONCLUSION

In this article it has been has argued that *Taxation Ruling* TR 2005/7 is contrary to law in its ruling that a "salary" paid to a partner in excess of the partnership's net income in a particular income year should be assessed to the partner in a later year when there are partnership profits to cover that excess amount. The scheme of Div 5 and the Assessments Acts in general is to render assessable income derived by a taxpayer in particular income year. In the case of a partnership which has derived net income calculated in accordance with income tax law in an income year, that net income is assessed to the individual partners by way of distribution to them in relation to that year. There is no warrant in the income tax law to carry over an amount of assessable income to a later year in this type of situation.

Much of the conceptual confusion bedevilling TR 2005/7 stems from a failure to make appropriate distinctions between the concepts of tax net income and accounting profit, on the one hand, and between assessable income and drawings, on the other. While the terms "net income" and "profits" are routinely used interchangeably in general parlance and in case reports, net income is a tax term with a specific meaning and technical tax rules for its calculation. It is not necessarily the same as accounting profit. Drawings, clearly, have no

[28] A number of authors have recognized this fundamental position concerning drawings. For example, Waincymer stated that "[t]he liability of the individual partner to tax is not dependent on the level of … drawings but rather on entitlement to the share to the share of net partnership income" (J Waincymer, *Australian Income Tax: Principles and Policies* (2nd ed, 1993) 421). Similarly, Lehman and Coleman noted that the partner is assessed on his interest in the partnership's net income, not on the amount of his drawings (G Lehman and C Coleman, *Taxation Law in Australia* (4th ed, 1996) 729-730).

necessary connection with income and therefore should not be taken *per se* to represent distributions of net income for income tax purposes. Moreover, net income is an amount calculated according to legislation and an amount which falls to be assessed to the partners without the need for any actual payments to them. An agreement to pay a salary to a partner may represent a valid agreement concerning the sharing of partnership profits and thus determine the interests of the partners in the net income, but it is that net income which is distributed according to those interests, not the profits as such.

The problems attributed to “misinterpretations” of IT 2218 must be laid largely at the foot of the Commissioner. He issued this ruling, vague as it was, in a climate where the general understanding was that partners’ salaries could be taken into account in determining distributions of net income, or partnership loss, under s 92. If the Commissioner did not wish to condone and encourage this practice, he should not have issued the ruling. It would have been simpler, and moreover legally well-founded, to take the approach taken by the Board in *Case* S75, as it would also be the case now. TR 2005/7 does not rectify any problem in this area; it simply adds further confusion. Consequently, it should suffer the fate of its predecessor and be withdrawn. Some alternative approaches to the treatment of partnership salaries are discussed in Appendix 2.

Appendix 1

The following examples illustrate the four general types of situation which may occur where a partner's salary is taken into account in the distribution of the partnership net income or loss calculated in accordance with s 90. In a partnership of A and B it has been agreed that A should be paid a salary of $40,000, with the resultant profit or loss after charging this salary being shared equally between A and B. It is assumed that this salary is reasonable for the services provided to the partnership by A, that it has been agreed to at an appropriate time so as not to be retrospective, and that is has actually been paid to A. That is, it would have satisfied the conditions set down in para 5 of IT 2218.

Example 1

Partnership net income		$60,000
Less A's salary		$40,000
Notional net income		$20,000
Distribution		
A: salary	$40,000	
½ $20,000	$10,000	$50,000
B: ½ $20,000		$10,000
		$60,000

The situation in example 1 causes no problems because it simply varies the sharing of the net income between the partners under s 92(1).

Example 2

Partnership net income		$20,000
Less A's salary		$40,000
Notional loss		($20,000)
Distribution		
A: salary	$40,000	
½ ($20,000)	($10,000)	$30,000
B: ½ ($20,000)		($10,000)
		$20,000

The situation in example 2, unlike example 1, is not in accordance with the law because s 92 does not accommodate the distribution of income to one partner and a loss to the other partner. However, it is submitted that this is just such an example of the type of situation that was generally understood to be accepted by the Commissioner until the withdrawal of IT 2218. In fact, this was the type of situation which confronted the Board in *Case* S75, and on the basis of that decision the distribution under s 92(1) would constitute the total net income of $20,000 to A. This approach is addressed in Appendix 2.

Example 3

Partnership loss		($50,000)
Less A's salary		$40,000
Notional loss		($90,000)
Distribution		
A: salary	$40,000	
½ ($90,000)	($45,000)	($5,000)
B: ½ ($90,000)		($45,000)
		($50,000)

Similarly to example 1, the distribution in example 3 may be taken as acceptable in the sense that all the salary does is vary the sharing of the loss to each partner under s 92(2).

Example 4

Partnership loss		($20,000)
Less A's salary		$40,000
Notional loss		($60,000)

Distribution		
A: salary	$40,000	
½ ($60,000)	($30,000)	$10,000
B: ½ ($60,000)		($30,000)
		($20,000)

Example 4 is similar to example 2 in that the recognition of the salary has resulted in a distribution from the partnership loss of an amount of income to A and a loss to B. Again, this situation is not accommodated by s 92: see the discussion in Appendix 2.

Appendix 2

Alternative approaches

What becomes apparent from the examples in Appendix 1 is that consistency of treatment is difficult across the different situations. Where the partnership has a net income for the year, the salary does not cause any particular problem: the salaried partner is distributed the net income under s 92(1) to the extent of his salary and shares any balance in accordance with the partnership agreement. This approach also accommodates the situation represented by example 2 where the salaried partner is distributed all the net income in accordance with the decision in *Case* S75.

However, the situation becomes problematic where the partnership makes a loss. It has been indicated in example 3 that taking the salary into account in the distribution for s 92 does not cause a problem because it simply varies the sharing of the loss under s 92(2). This may be so, but the situation in example 4, where the salary is greater than the partnership loss in absolute terms, poses a challenge (which may be why the *Master Tax Guide* dropped this example for 2002, as noted in note 10 above). Two possible approaches to this type of situation may be suggested. One would be to ignore the salary (as discussed below) and the other would be to distribute the whole of the loss to partner B. The second approach maintains consistency of treatment in that the "maximum" amount available from a loss, ie nil, is distributed to the salaried partner A, leaving the entire loss to be distributed to the other partner B. Moreover, this type of distribution may be accommodated by s 92(2).

Another approach to the problem may be to ignore the salary where the partnership makes a loss. Thus in examples 3 and 4 the losses would be distributed according to the basis sharing agreement for amounts exceeding the salary (ie equal sharing in these examples). However, ignoring the salary introduces a different rule for losses as opposed to amounts of net income (unless the partnership agreement were to stipulate that a salary would only be paid when the partnership returned a net income rather than a loss). But is there any authority for different distribution rules for different situations? There is nothing directly relating to partnerships, but in *Richardson v FC of T*[29] Merkel J considered a somewhat similar question in respect of distributions of trust net income under s 97(1) where the net income for tax purposes differed from the net income in accordance with trust law. To give effect to the purpose of s 97(1) as he saw it, he proposed that the where trust income exceeded tax income the "proportionate" approach should be used to determine the distribution to beneficiaries under s 97(1), and the alternative "quantum" approach should used where tax income exceeded trust income. The details of his reasoning and the tax outcomes of this proposal are not relevant here. Suffice it to say that the application of different rules for distributions in different circumstances was expressed *obiter* by Merkel J and, moreover, was called into question, as being unsupported by authority, by Sundberg J in *Zeta Force v FC of T.*[30] Furthermore, s 97 deals with the distribution of

[29] 97 ATC 5098.
[30] 98 ATC 4671.

income only; it does not deal with losses as does s 92(2), thus reducing the relevance of Merkel J's view even more.

In the absence of authority, it is proposed that a consistent approach to the partnership salaries should be taken. This would entail accepting the salary as part of the distribution, consistent with the constraints of s 92 which effectively precludes a distribution of income to one partner and a loss to another (as illustrated in examples 2 and 4 in Appendix 1). Therefore, taking the salary into account where it does no more than vary the sharing of net income or loss, as in examples 1 and 3, should be acceptable. The problematic situations represented by examples 2 and 4 should be dealt with such that the salaried partner takes all the net income in example 2 and takes nil with the other partner taking the entire loss in example 4.