TR 93/D6 - Income tax: rental property - division of net income or loss between co-owners

This document has been finalised by TR 94/29.

Australian Taxation Office

Draft Taxation Ruling
Income tax: rental property - division of net income or loss between co-owners

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IT 2316

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What this Ruling is about

1. This Ruling explains the basis upon which we will accept, for income tax purposes, the division of the net income or the loss from a rental property between the co-owners of that property.

2. The Ruling only examines the taxation position of co-owners whose activities do not amount to the carrying on of a business.

Ruling

3. Co-ownership of rental property is a partnership for income tax purposes but is not a partnership at general law unless the ownership amounts to the carrying on of a business.

4. Where co-ownership is a partnership for income tax purposes only, the income/loss from the rental property is derived from co-ownership of the property and not from the distribution of partnership profits/losses.

5. In these circumstances, the income/loss from the rental property must be shared according to the legal interest of the owners.

6. Because co-owners of rental property are generally not partners at general law, a partnership agreement, either oral or in writing, has no effect on the sharing of income/loss from the property.

Date of effect

7. This Ruling has both a past and future application (see Taxation Ruling TR 92/20). However, it does not have a past application for a

taxpayer who has agreed to a settlement of a dispute to the extent that the Ruling is less favourable than the settlement terms. To the extent that the Ruling is more favourable, it does not have a past application for the taxation years the subject of the settlement.

Explanations

Co-ownership

8. Ownership conveys an entitlement to exercise the maximum legally permissible rights over what is owned. A legal interest in land is achieved by the owner being the registered proprietor of the legal title to the land. Where there is more than one person with a concurrent legal interest in the same land, those persons are co-owners of the land.

9. Co-owners of rental property will generally hold the property as joint tenants or tenants in common. These tenancies are a further classification of the co-owners interests.

10. There are some significant differences between these alternative tenancies, but most of the differences (an explanation of which can be found in *Property Law and Practice in Queensland,* Duncan W.D. and Wallace A.E., The Law Book Company Limited, 1992 at page 641 et seq) are not important for the purpose of this Ruling.

11. An important feature of both a joint tenancy and a tenancy in common is the legal interest of the tenant. It is this legal interest which ultimately determines, among co-owners of property, the division of the net income or loss from the property.

12. Co-owners of a property who are joint tenants of that property will hold identical legal interests in the property. That is, their interest must be the same in extent, nature and duration - e.g., A and B, who each own an identical 50% share in a property are, provided the other requisite features are present, joint tenants of that property.

13. On the other hand, the legal interest of tenants in common need not be identical. That is, the extent, nature and duration of each co-owners interest need not be the same - e.g., C owns a 30% share of a property while D owns a 70% share of the property. C and D are, provided the other requisite features are present, tenants in common.

Partnership at general law

14. Partnership is defined in the various State and Territory partnership acts as "the relation which subsists between persons carrying on a business in common with a view of profit."(The

Partnership Act of 1891 (Qld; SA; TAS); The Partnership Act of 1892 (NSW); The Partnership Act of 1895 (WA); The Partnership Act of 1958 (VIC); The Partnership Ordinance of 1963 (ACT)) An important ingredient of the definition is "carrying on a business". Without this ingredient, there can be no partnership at general law.

15. In determining whether the respondent and his spouse in *F.C. of T. v McDonald* (1987) 18 ATR 957; 87 ATC 4541 were 'true' partners under the general law, Beaumont J said at p 968:

> 'The reference to "business" . . . indicates a "commercial enterprise as a going concern": see *Hope v Bathurst City Council* (1980) 144 CLR 1 at 8; 12 ATR 231 at 236 per Mason J. Purely domestic transactions are thus excluded from the definition: see Fletcher, *op cit* p 28. The "business" must be "carried on". This suggests some active occupation or profession: see *IRC v The Marine Steam Turbine Co Ltd* (1919) 12 TC 174 per Rowlatt J at 179.' . . . 'On the other hand, in the case of a private individual as distinct from a company, "it may well be that the mere receipt of rents from properties that he owns raises no presumption that he is carrying on a business." see *American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue* (1979) AC 676 per Lord Diplock at 684.'

16. Paragraphs 3 to 5 of Income Tax Ruling No. IT 2423 are also relevant in determining whether the letting of property amounts to the carrying on of a business. In particular, 'An individual who derives income from the rent of one or two residential properties would not normally be thought of as carrying on a business. On the other hand if rent was derived from a number of properties or from a block of apartments, that may indicate the existence of a business.'

17. The State and Territory legislation also contain a number of rules for determining whether a partnership does or does not exist. Among them are:

> 'Joint tenancy, tenancy in common, joint property, common property, or part ownership does not of itself create a partnership as to anything held or owned jointly or in common, whether the tenants or owners do or do not share any profits made by the use thereof;' and
>
> 'The sharing of gross returns does not of itself create a partnership, whether the persons sharing such returns have or have not a joint or common right or interest in any property from which or from the use of which the returns are derived;'

18. Professor Fletcher, in his book *The Law of Partnership in Australia and New Zealand,* 5th edition at page 43 says about these

statutory rules that they 'qualify the terms of the definition and provide guidance for persons interested in separating partnership from non partnership joint ventures and other relationships . . . which may exhibit similar characteristics.'

19. In relation to the first of these rules, *Lindley on Partnership,* 15th ed says at p 81: 'If each owner does nothing more than take his share of the gross returns obtained by the use of the common property, partnership is not the result. On the other hand, if the owners convert those returns into money, bring that money into a common stock, defray out of it the expenses of obtaining the returns, but then divide the net profits, partnership is created in the profits, if not also in the property which yields them.'

20. On this point, Professor Fletcher says at page 44: 'To remain within the ambit of the rule [that is, that "bare" co-ownership does not of itself, constitute a partnership], it is probable that the joint activity should require minimal involvement by the co-owners, such as a decision to lease a house property for a term of years rather than operating it as a boarding house, and be designed to cover costs rather than to return profits to the participants.' This approach is consistent with the approach taken in *Wertman v. Minister of National Revenue* (1964) 64 DTC 5158 at 5167.

21. As a general proposition, it is more accurate to describe the owners of rental property in the words of Beaumont J in *McDonald's case* at p.969 'as co-owners in investments rather than as partners in a business operation.' Consequently, co-owners of rental property are generally not partners at general law with the result that they are not subject to the general law applicable to partnerships including the division of profits and losses from the property. That is not to say that co-owners cannot carry on a business of property rental and therefore be partners at general law. As already noted, whether an activity constitutes the carrying on of a business is a question of fact to be decided on a case by case basis.

Partnership for taxation law

22. The definition of partnership is wider for income tax purposes than it is at general law. Subsection 6(1) of the *Income Tax Assessment Act 1936* (the Act) defines partnership as 'an association of persons carrying on business as partners or in receipt of income jointly but does not include a company.'

23. Under the extended income tax definition of partnership, it is not necessary that persons carry on a business for their association to be treated as a partnership for income tax purposes. They need only to be in receipt of income jointly. Therefore, co-owners of rental property

come within the definition of "partnership" for income tax purposes, not because they are necessarily partners at general law, but because they are in receipt of income jointly.

24. Whether a partnership exists at general law is of significance for taxation purposes as *McDonald's Case* at page 967 shows: 'For taxation purposes, the Act takes the taxpayer's income as it finds it, that is to say, subject to the general law in all its aspects. This will pick up the position at law and in equity modified by any relevant legislation, including the provisions of the Act itself: see *MacFarlane v. FCT* (1986) 17 ATR 808; 67 ALR 624 at 636.'

McDonald's case

25. The taxpayer and his wife owned, both legally and beneficially, two strata title units as joint tenants. Both units were rented out. A 'record of discussion' between them stated that net profits would be distributed 25 per cent to Mr McDonald and 75 per cent to Mrs McDonald. The whole of any net loss would be borne by Mr McDonald.

26. The taxpayer claimed that there was a partnership between himself and his wife both under general law and under the Act, that the two home units were partnership property, and that the net profit or net loss from the rental activity ought to be divided among them according to the partnership agreement.

27. The question in the case was whether an operating loss on the properties was wholly incurred by the taxpayer, or one-half of the loss was incurred by each of the taxpayer and his spouse. There was no question that a deductible loss had occurred.

28. On the other hand, we contended that there was no partnership at general law and that the only relevant relationship between the parties was that of co-ownership. Because the parties were joint tenants at law and in equity, the loss incurred in letting the premises should be shared equally with the consequence that the respondent was entitled to a deduction for one-half only of the loss. And lastly, that the private arrangement between the taxpayer and his spouse as to the sharing of profits and losses does not alter or over-ride their respective entitlements for income tax purposes.

29. In supporting our contentions, Beaumont J said at p 967-8:

'In my opinion, no partnership under the general law subsisted between the respondent and his wife. Their relationship was one of co-ownership, and even if they were deemed to be partners by reason of subsection 6(1) of the Act, this circumstance is immaterial for our purposes. As has been noted, their notional

"partnership" will carry with it the consequence that they are to be treated as a "partnership" for some purposes. It does not follow that the respondent can deduct the whole of the losses. He may only deduct his individual interest in the "partnership" loss. His "individual interest" is the interest to which a "partner" is solely entitled, as contrasted with his joint interest in the whole: see *FCT v Whiting* (1943) 68 CLR 199 at 204; 2 AITR 421 at 425-6. It is necessary therefore to determine whether the respondent and Mrs. McDonald were merely notional "partners" for the purposes of the Act (ie merely co-owners) or were "true" partners under the general law.'

30. At page 969, Beaumont J continued :

'In the present case, a number of indications point to the conclusion that the parties were not carrying on a business, with the consequence that their relationship was that of co-ownership rather than partnership. Their investment involved little, if any, active participation from either party. . . . This was not a case of the active joint participation by the parties in a business activity. Rather, it was a case of a renting out of premises without the provision of other services of the kind discussed in *Wertman, supra.* In my view, there was here a mere investment in property rather than a partnership in the properties or their profits.'

31. In relation to the division of rents and profits, Beaumont J said at p 967:

'It is common ground that the respondent and his wife were beneficially entitled to the premises as joint tenants. As joint tenants, they were entitled in equal shares to the rents and profits: see Helmore, *The Law of Real Property in New South Wales,* 2nd ed page 274.'

32. Beaumont J ultimately concluded that Mr. & Mrs. McDonald were co-owners rather than partners and that their income was derived from co-ownership of property, not from the distribution of partnership profits/losses. As there was no partnership at general law and, therefore, no distribution of profits/losses, they had to share the loss in proportion to their interest in the property. As joint tenants they owned the property in equal shares and therefore shared the profits and losses from that property in the same proportions.

Effect of partnership agreement

33. As an alternative argument, the taxpayer in *McDonald's case* contended that if no partnership existed, the agreement between himself and his spouse was a lawful contract which conclusively

governed the legal relations between them and that this contractual liability was itself sufficient to entitle him to deduct the total loss claimed.

34. To this, Beaumont J responded at page 969:

> 'But s51 does not permit a deduction merely by virtue of the agreement. In truth, it was a term of the agreement that the respondent actually give income to his wife. That involves none of the features required as a condition of deductibility under s51(1). In fact, the transaction, so far as concerned the respondent, involved two significant detriments. In the first place, he gave away one quarter of his income entitlement; secondly, he indemnified his wife against any loss from the investments. It can not be said, as the language of s51 requires, that a payment made pursuant to such an indemnity is a loss incurred in gaining or producing assessable income or is necessarily incurred in carrying on a business for the purpose of gaining or producing such income. Rather, the assumption of liability for the losses, voluntarily made by the respondent, was a purely domestic arrangement in which the respondent sought to advance his wife's finance: cf *Ure v FCT* (1981) 11 ATR 484 at 493; 81 ATC 4100 at 4108; *Magna Alloys & Research Pty. Ltd. v FCT* (1980) 11 ATR 276 at 284; 80 ATC 4542 at 4549; *FCT v llbery* (1981) 12 ATR 563 at 571; 81 ATC 4661 at 4668. In any event, there is expressly excluded from deductions allowable under s51(1) losses of a private or domestic nature and the wife's share of the losses now claimed by the respondent may be so described: see Parsons, *Income Tax in Australia,* Principles of Income Tax, Deductibility and Tax Accounting p 452-3.'

35. The effect of all these statements is that where income from rental property is derived from the co-ownership of the property rather than from a partnership interest , an agreement, whether orally or in writing, to vary the sharing of profits or losses from the property from what it rightly is under property law, is of no effect for income tax purposes.

Examples

Example 1

36. Mr. and Mrs. X purchase a rental property as joint tenants. Mr X is the sole income producer. They agree to share profits and losses from the property as follows:

	Mr. X	Mrs. X
profits	20%	80%
losses	100%	nil

Owning and renting out the one property does not amount to carrying on a business. Mr and Mrs X are not partners at general law although their relationship is treated as a partnership for income tax purposes. Net profits and losses from the property should be shared in the same proportion as their ownership interests, i.e., 50:50. Their agreement to share the profits and losses in different proportions is a private arrangement which has no effect for income tax purposes.

Example 2

37. If Mr. and Mrs. X each owned 50 % of the property as tenants in common, the result would be the same as that in Example 1.

Example 3

38. If Mr. and Mrs. X owned the property as tenants in common with Mr. X holding a 30% interest and Mrs. X holding a 70% interest in the property, they would be assessed on any profits or losses from the property in accordance with their respective interest in the property, i.e., Mr. X on 30% and Mrs. X on 70%.

Example 4

39. Mr. and Mrs. Y purchase a rental property. Mr. Y contributed 80% of the funds used to purchase the property while Mrs. Y contributed 20%. They register their purchase as joint tenants. They also sign a written agreement to share any profits or losses from the property in accordance with their capital contributions.

40. Owning and renting out the one property does not amount to carrying on a business. Mr and Mrs Y are not partners at general law although their relationship is treated as a partnership for income tax purposes. Net profits and losses from the property should be shared in the same proportion as their legal ownership interests, i.e., 50:50. Their agreement to share the profits and losses in proportion to their capital contributions is a private arrangement which has no effect for income tax purposes.

Example 5

41. Mr. and Mrs. Z rent out a house which they own as joint tenants. The rent is paid into a joint account from which expenses of the property are paid. The expenses of the property exceed the rental income from it each year. Mr. Z claims that as he is the sole income earner and had in effect paid all the expenses, he is entitled to claim 100% of the loss.

42. Owning and renting out the one property does not amount to carrying on a business. Mr and Mrs Z are not partners at general law although their relationship is treated as a partnership for income tax purposes. Net profits and losses from the property should be shared in the same proportion as their ownership interests, i.e., 50:50. The fact that Mr Z has paid all the expenses on the property is of no consequence for income tax purposes. We would simply treat the payment of Mrs Z's share of the expenses by Mr Z as no more than a loan by Mr Z to Mrs Z.

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case references
- F.C. of T. v McDonald (1987) 18 ATR 957; 87 ATC 4541
- Hope v Bathurst City Council (1980) 144 CLR 1; 12 ATR 231
- IRC v The Marine Steam Turbine Co Ltd (1919) 12 TC 174
- American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue (1979) AC 676
- FCT v Whiting (1943) 68 CLR 199; 2 AITR 421
- Wertman v Minister of National Revenue (1964) 64 DTC 5158
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