

CHAPTER IV

PARTNERSHIPS

Article 31 – Article 35

Definitions

- Article 31.
1. A partnership is an association of two or more persons joining under an agreement, in accordance with the provisions of the relevant laws, to carry on business and share the profit or loss.
 2. A partner is a person who has a share in the partnership.
 3. The partnership agreement is the body of provisions agreed to by the partners under which they operate the partnership.
 4. A general partnership (Sherkat-Tazamoni) is one in which the partners are liable for payment of all debts of the partnership individually and collectively.
 5. A special partnership (Sherkat-Tazamoni-Mekhtalet) is one in which one or more partners have unlimited liability for debts of the partnership and the rest of the partners have liability limited to their shares of capital in the partnership.
 6. A limited liability company (Sherkat-Mahdudul Masseliat) is a partnership in which the partners are not individually liable for debts of the company but each partner has liability limited to his shares of capital in the company.
 7. A corporation (Sherkat-Sahami) is a partnership which has its capital determined and divided by shares and liability of each partner is limited to his shares.

31.1 Corporation shares are negotiable. They may be sold by the owner without the consent of the remaining shareholders. The limited liability company is different. Shares of the partners (shareholders) in a limited liability company are not negotiable. The company determines whether a partner (shareholder) can sell his shares or not, and to whom his share may be sold. A limited liability company is taxed like a corporation. Please refer to Article 32 of the Income Tax Law and the regulations issued pursuant thereto with respect to the taxation of limited liability companies.

31.2 To have a partnership, two or more persons must join together pursuant to an agreement to carry on a business and share the profits thereof.

(a) The parties are not required to formalize their agreement in writing. The partnership "agreement" can be created through the course of conduct of the parties.

Example: *Adib and Wahid operate a series of fruit stands in Kabul City. They never formalize their agreement in writing. Nevertheless, every day, Adib provides the carts that are necessary to display the fruit and he provides the services of various vendors. Wahid provides the fruit to*

the vendors. Adib takes 60% of the profits (after expenses) from the venture and Wahid takes 40% of the profits (after expenses). Adib and Wahid are joined together in a partnership, even though they do not have a formal written agreement.

(b) Mere co-ownership of property is usually not sufficient, in itself, to create a partnership. Instead, there must also be a sharing of profits and losses.

Example: *Adib and Wahid are brothers. They inherited a parcel of land in Zabul Province from their father. Adib and Wahid jointly own the property, but the property is undeveloped. Neither Adib nor Wahid have any intention of developing the land. Instead, they intend to hold it for a period of time and eventually sell it. They may sell it separately or they may sell it jointly. Under these facts, Adib and Wahid are not joined together in a partnership.*

31.3 The partnership income (and loss) is reportable by the individual partners at the end of the taxable year whether the income is distributed or not. Each partner must recognize his or her distributive share of partnership income or loss.

Example 1: *Adib is an Afghan resident. Adib owns 15% of an Afghan partnership. Wahid is an Afghan resident. Wahid owns 85% of an Afghan partnership. The partnership generates Afs. 1,000,000 of profit during the year. The partnership does not make any distribution of profits during the year. Adib must recognize Afs. 150,000 of profit on his tax return. Wahid must recognize Afs. 850,000 of profit on his tax return.*

Example 2: *Adib is an Afghan resident. Adib owns 15% of an Afghan partnership. Wahid is an Afghan resident. Wahid owns 85% of an Afghan partnership. The partnership generates Afs. 1,000,000 of loss during the year. The partnership does not make any distributions during the year. Adib must recognize Afs. 150,000 of loss on his tax return. Wahid must recognize Afs. 850,000 of loss on his tax return.*

Limited liability company and special partnership

- Article 32. (1) A limited liability company is subject to the same provisions of this Law as corporations (Sherkat-Sahami). Partners in such companies are considered shareholders, and distributions of earnings are considered dividends for purposes of this Law.
- (2) A special partnership is subject to the same provisions of this Law as a general partnership.

- 32.1 The provisions of the Income Tax Law relating to shareholders of corporations apply to partners in limited liability companies. Similarly, provisions relating to dividends paid to shareholders by a corporation also apply to distributions of earnings to the partners in a limited liability company.

Example: A limited liability company has earnings of Afs. 1,000,000 in a taxable year. Afs. 900,000 in cash is distributed to the partners and Afs. 100,000 is retained by the company. The net income tax of the company will be 20 percent of Afs. 100,000, that is, Afs. 20,000; and the tax withheld from dividends will be 20 percent of Afs. 900,000, that is, Afs. 180,000.

- 32.2 The partners who have a limited liability in a special partnership will also have a limited liability with respect to fixed taxes under Chapter XI of the Income Tax Law. The fixed tax can be paid from any share of such partners to the extent of their earnings (undistributed or distributed) or assets, or from the partners who have an unlimited liability.

Example: After audit, it is determined that a special partnership owes an additional tax of Afs. 100,000 for the taxable year 1385. The special partnership made no profit in 1385 nor did it make any distribution of earnings in that year. There are no assets available for payment of this additional tax. In this situation the partners with limited liability cannot be assessed for any part of the tax, but the partners with unlimited liability are themselves liable for the entire tax.

Remark: If the partnership had assets available for the payment of the tax, or if it had distributed assets (earnings) in the same year (1385), the assessment of additional tax would be made first against the remaining assets and assets distributed that same year. If the tax liability were, nevertheless, not fully satisfied, the balance unpaid would be the liability of the partners having unlimited liability

General Partnerships

Article 33. A general partnership as a legal entity is not subject to the income tax imposed by this Law. Partners as natural persons are liable for income tax only in their separate and individual capacities. The income of the general partnership is taxable as income of the partners individually, each of whom is required to include his share of the partnership income in his taxable income.

- 33.1 Income of a general partnership is exempt from income tax if both of the following conditions are met:
- a. its income is from commercial activity subject to a fixed tax;
 - b. such fixed tax is in lieu of tax on income according to Chapter XI of the Income Tax Law.

Such income of a general partnership is exempt whether distributed to the partners or not distributed.

Remark: A business establishment is taxed under provisions of Chapter XI of the Income Tax Law and is owned and operated by a general partnership which pays the fixed tax. In some years profit from commercial activity of this establishment is distributed to the partners, and in some years it is not. The partnership's income is exempt from taxation.

- 33.2 An Afghan resident partner can receive a distribution of Afghanis from a partnership without tax to the extent of the partner's share of his basis in the partnership.

Example 1: *Azziz and Wahid are equal partners in an Afghan partnership. They each contributed Afs. 500,000 to the partnership upon the formation of the partnership. During the year, the partnership generated Afs. 200,000 of profit. At the end of the year, before considering distributions, Azziz and Wahid's share in their partnership interests increased from Afs. 500,000 to Afs. 600,000. During the year, the partnership distributed Afs. 50,000 to each partner. Azziz and Wahid must each recognize Afs. 100,000 as their distributable share of partnership profit. Azziz and Wahid do not have to recognize the Afs. 50,000 that is distributed to them during the year. After the distribution, Azziz and Wahid's share in the partnership will each be reduced to Afs. 550,000.*

Example 2: *Azziz and Wahid are equal partners in an Afghan partnership. They each contributed Afs. 500,000 to the partnership upon the formation of the partnership. During the year, the partnership generated Afs. 200,000 of profit. Azziz and Wahid must each recognize Afs. 100,000*

as their distributable share of partnership profit. At the end of the year, Azziz and Wahid's basis in their partnership interests increased from Afs. 500,000 to Afs. 600,000. The partnership did not make a profit or a loss during its second year of operation, but it did distribute Afs. 60,000 to each partner. After the distribution, Azziz and Wahid's basis in the partnership was reduced to Afs. 540,000.

- 33.3 If a partner in a partnership receives Afghanis in excess of the partner's basis in the partnership, the partner must recognize gain with respect to his or her partnership interest.

Example: *Azziz and Wahid are equal partners in an Afghan partnership. They each have a basis of Afs. 200,000 in the Afghan partnership. Due to accelerated depreciation deductions, the partnership generates a significant amount of cash without generating any significant taxable earnings. The partnership distributes Afs. 210,000 to each of Azziz and Wahid during the first year of operation. Azziz and Wahid must each recognize a Afs. 10,000 gain (Afs. 210,000 – 200,000).*

Determination of net income

Article 34. Every general partnership is required to make an annual report of all its receipts, expenses, and disbursements, and to determine its net income in the same manner as an individual. The partnership is required to report separately for each partner his share of the following items:

1. the net income or net loss;
2. the gains or losses from sale or exchange of movable and immovable property; and
3. salary, interest, dividends, advances, or similar payments.

34.1 All partnerships (general and special) must file an annual report whether engaged in activities covered by fixed taxes in lieu of income tax or not. A copy of the report of the partnership must be filed by each partner at the tax office of the district in which he is required to file his income tax return.

34.2 An individual engaged in business activities subject to fixed taxes in two or more locations which are taxed through different tax offices shall pay the fixed tax of each establishment at the tax office of the district in which such establishment is located. Such individual, if required to file an income tax return, shall file such return at the tax office in the district of either his permanent residence or at the office from which he received his commercial license. This rule shall also govern the filing of the income tax return of an individual who is a partner in a partnership.

34.3 A partnership annual report is required even though the firm has no taxable income for the taxable year. Each partner of the partnership must report his or her respective shares of partnership profit at the end of the taxable year whether the profit has been distributed or not.

Distribution of Receipts

Article 35. The income, expenses, and net earnings of a general partnership shall be deemed to have been shared by the partners according to the terms and conditions of the general partnership agreement.

35.1 Where the partnership agreement is verbal (or the partnership agreement is unclear) and the partners disagree about the division of income, the Ministry of Finance will apportion the assets, liabilities, and undistributed income equally unless facts and circumstances indicate otherwise. Factors that the Ministry may look to include, but are not limited to, the following:

- (a) The fair market value of the relative contributions of the partners.
- (b) The method in which profits and losses were shared in prior years.
- (c) The manner in which distributions were shared between the partners.

Example: *Jamal and his brother Wahid agree to begin selling vases and artistic crafts in Kabul. Jamal allows the business to use his store located on Shar-e-Now street and Wahid transfers various vases that he created to the store. The brothers never document their agreement. The store is worth Afs. 4,000,000 and Wahid's vases are worth Afs. 1,000,000. At the end of the first year of operation, the store is very successful. The brothers begin to argue about how much of the business they own and how much income each partner is entitled to. In this case, the Ministry of Finance may, for example, look at the relative contributions of the two brothers and conclude that Jamal owns 80% of the partnership and Wahid owns 20% of the partnership.*