Submission to the House of Lords Economic Affairs Committee: Finance Bill Sub-Committee 2014

Taxation of Partnerships
New Approach to Tax Policy Making

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About ICAS

1. The Institute of Chartered Accountants of Scotland ("ICAS") is the oldest professional body of accountants. We represent around 20,000 members who advise and lead businesses. Around half our members are based in Scotland, the other half work in the rest of the UK and in almost 100 countries around the world. Nearly two thirds of our members work in business, whilst a third work in accountancy practices. ICAS members play leading roles in around 80% of FTSE 100 companies. ICAS is also a public interest body.

Taxation of Partnerships

General comments

2. ICAS welcomes the opportunity to comment on the legislative proposals regarding two aspects of the taxation of partnerships, those relating to LLPs and to mixed partnerships.

3. ICAS recognises the need for a proportionate and effective anti-avoidance approach in UK tax law, applied consistently. This will support the Government’s policy of deterring and countering tax avoidance, whilst retaining a tax regime that is attractive to business, in terms of certainty and practicality. The measures necessary in this approach are:
   a. Clearly written tax legislation, supported by policy statements as to its purpose and limitations, introduced after appropriate consultation.
   b. A simpler tax system, with the minimum of rate differences, reliefs or exemptions, thus limiting the opportunity for tax avoidance.

4. This topic, the taxation of partnerships, has generated significant and widespread interest and concern amongst our members and challenges as to whether the measures in paragraph 3 above are present. In relation to the proposed 2014 measures, ICAS has received some very strongly felt comments from its members on their own behalf and on behalf of their clients, particularly in the rural and professional sectors. Their concerns focus on the complexity of the provisions, and the widespread application that will affect commercial structures regardless of tax avoidance intentions. Partnership remains an attractive commercial vehicle for many family businesses and there is no wish to see it taxed out of existence.

5. ICAS questions the approach towards partnerships adopted in the Government's current proposals on a number of levels.

   a. First, the specific anti-avoidance measures appear to be heavy handed and, if necessary to counter certain practices, need to be better targeted. Widespread application of complex anti-avoidance legislation leads to tax system complexity and increases administrative burdens for taxpayers.

   b. Secondly, the timing of the consultation about the two partnership measures in summer 2013 leading to the 2014 Finance Bill proposals, with the complicated measures that they entail, is discomforting when the Office of Tax Simplification (OTS) had undertaken to conduct a review of partnership taxation to identify the main complexities. The OTS review was announced at the same time as the Budget Statement on 20 March 2013. This gives the appearance that policy in this area is not well coordinated and risks the different strands of work being contradictory and counterproductive.

   c. Thirdly, but at a more fundamental level, the measures in the Finance Bill clauses in relation to partnerships are mainly addressing symptoms rather than the underlying causes. These causes are:
      i. the differential in tax and NIC costs for employees compared with the self-employed,
      ii. the employment law burdens for those at the lower end of the income spectrum,
      iii. the differential in tax rates, combined with the different timings of payment, between income tax for the unincorporated business and corporation tax for the incorporated business. Corporate entities only pay corporation tax at a maximum rate of 23% (and reducing) on profits generated but retained in the business to provide working capital. Partnerships have to pay income tax and national insurance at a maximum rate of 47% on similar profits, which is more than double the corporation tax rate.
6. These underlying causes may drive certain behaviours, such as using a mixed partnership in order to have the advantages (commercial and tax) of both a company and a partnership. Likewise, the cost of employers’ national insurance and pensions, and employment law at the lower end of the income scale, drives much of the avoidance behaviour and the desire to have workers categorised as self-employed members of an LLP.

7. A significant proportion of consultation documents in 2013 claim to be about ‘fairness’; however, many argue that there should be fairness across the taxes levied on business structures. Piecemeal, reactive and highly detailed legislative provisions increase the complexity of the UK tax code and one question raised by members is whether the new rules will drive large LLPs away from the UK.

Specific comments - Limited liability partnerships (LLPs)

8. The reasons for the LLP proposals were documented in the HMRC’s summer 2013 consultation document ‘Partnerships: A review of two aspects of the tax rules’ (paragraphs 2.9 and 2.10), indicating that there were problems in certain low paid sectors and also with some of the most highly rewarded individuals. A more detailed analysis of the mischief should have been part of the consultation to prompt wider consideration of the range of possible solutions. However, the draft legislation which has now been published with its three conditions in tests A – C has been described as a ‘sledge hammer to crack a nut’. Its consequences go much further than the original targeted mischief. We have not seen evidence to support taking a wider approach.

9. In relation to LLPs, the effect of the Finance Bill clauses is that the tax status of many members will change despite the fact that they are ‘true’ members and would currently be considered to be partners should they be in a traditional partnership. Condition A may affect incoming members who are relatively junior, as such individuals sometimes receive a fixed profit share for a short period before becoming entitled to an equity share. In most circumstances there is no intention of any disguised salary; this is simply long established commercial practice. Likewise, a similar situation occurs for many members who are approaching retirement and who go onto fixed profit shares as they move towards withdrawing from the partnership. Our members emphasise that normal commercial practice is that partnership shares are, and have always been, split with an element based on performance. That was the case in general partnerships and is now the case for LLPs. Equally, reward for sector or office performance has always been key. In summary, this test will not function as intended to exclude the majority of commercial practices.

10. There will be further commercial consequences arising from the Finance Bill 2014 clauses as many LLPs are looking to refinance and/or restructure. Particularly in the larger LLPs where Condition B might not be met, members are examining whether they need to reconsider Condition C, with one possibility being to increase capital, despite the fact that it may not really be needed in the business. Business owners should be able to decide what commercial vehicle is most suitable for their needs and how to finance this without being constrained by targeted anti-avoidance provisions. It is also unsatisfactory for the proposed legislation detailing conditions A, B and C with such significant implications to be announced in December and effective within four months, leaving insufficient time for larger firms to reorganise if so desired.

11. If members are treated as employees but only for tax and NIC purposes as proposed, the tax law will be different from the underlying LLP law and also employment law. As a result, individuals will be treated for some purposes as an employee and for other purposes as a member. This can only lead to complication and confusion, whereas clarity of purpose ought to be an overriding aim. If this were set against a wider background, Government policy should aim to streamline the treatment of self-employment and employment across tax, NIC and employment legislation.

Specific comments - mixed partnerships

12. ICAS members have expressed concerns that HMRC is overly narrow in its view of partnerships, seeing them as simply anti-avoidance vehicles. Responding to the summer 2013 consultation document in relation to mixed partnerships, ICAS noted that:

a. The HMRC proposals would impact on legitimate commercial structures, particularly with family businesses and farming businesses. This has been acknowledged in the HMRC response to the consultation document that was issued on 10 December but nevertheless has not led to a change or fine-tuning of the proposals;
b. Overly onerous proposals could push a number of partnerships into incorporating to avoid the additional tax complexity. Coincidentally, this would increase the administrative and cost burden for those businesses whilst potentially reducing the tax take; and

c. There are significant differences in the funds available for reinvestment in a business depending on its structure because of the significant differences in tax rates between an incorporated and unincorporated business. There should not be a more expensive regime for one type of commercial structure compared to another.

13. Although it is accepted that there may be some tax ‘schemes’ where there appears to be no or very little commercial purpose other than tax saving, ICAS members have said that in the majority of mixed partnerships this is not the case. There has been no evidence from HMRC to support the contention that a widespread set of anti-avoidance measures are needed. It is noted that HMRC anticipates raising significant amounts of tax from the measure but the basis for this is not known.

14. Concerns have been expressed that the Finance Bill clauses lack clarity. Whilst guidance is to be welcomed if this is the legislation that is to be worked with, it is nevertheless an unwelcome move to have legislation that is drafted in such a manner that guidance is required in order to know how it will be applied. Many members have also commented that there are various scenarios that are not covered by the guidance. Nor is the guidance clear on how loss relief will be denied. More fundamentally there is a question mark over whether tax should be levied based on guidance which has no statutory authority.

Office of Tax Simplification (OTS) review

15. The OTS is to be commended for its collaborative approach and its willingness to meet with ICAS members. John Whiting met with members of ICAS in October 2013, when there was an open and wide ranging discussion.

16. At the meeting there was an initial discussion about why partnerships were considered an area that should be considered by the OTS for simplification. It is understood the factors included that the law had not been reviewed in recent years, nor was it self-contained, and it applied to a huge range of partnerships (from small, two partner firms to huge, multinational firms). It was noted that whilst the taxation of partnerships might benefit from a review, equally it might be found to be satisfactory and not in need of simplification measures.

17. It is our understanding that many of our concerns have been raised in the OTS report but at the time of submitting this evidence the report has just been published and we have not yet had time to canvass the views of our members.

Tax policy making approach

General comments

18. ICAS welcomed the Government’s new approach to tax policy making when it was brought forward in 2010; ICAS also welcomes this review.

19. The new tax making policy set out to enhance the quality of tax law with a view to bringing about predictability, stability, and simplicity. In relation to how effective the new policy has been ICAS has the following observations.

Overall strategy

20. Providing a clear longer term strategy for the tax system was one aspect of the new tax making policy. This was particularly offered with the corporate tax road map. However, a broader strategy needs to be formulated and adopted across the taxes so, for example, there would be a ‘business’ tax roadmap that could aim to examine how to level the rates of taxation across incorporated and unincorporated businesses. Likewise, it would be helpful to have a strategic roadmap for taxing individuals with a view to levelling the inconsistencies between employment and self-employment.
21. Without the overall strategy, policy initiatives can feel piecemeal and reactive: whilst companies become increasingly attractive as the full rate of corporation tax is lowered to 20%, income tax remains at more than double this, resulting in the pendulum continuing to swing between companies and unincorporated vehicles. This prevents stability, and is aggravated when complexity sets in with measures to counteract those who wish to benefit from the more advantageous rates, for example, through a mixed partnership.

**Predictability and stability**

22. ICAS noted in its evidence in 2011 that the Government's new approach recognised the need to reduce frequent changes to the legislation. As a statement of intention this was welcomed but it remains the case that there continues to be a very significant volume of change: this intention has not yet been met and, in fact, both Finance Acts 2012 and 2013 are two of the longest finance acts in history.

23. Changes to rates and allowances can also create uncertainty. Whilst an increase in the Annual Investment Allowance (AIA), as occurred with effect from 1 January 2013 to 31 December 2014 from £25,000 to £250,000 may look attractive, this was effected on a calendar year basis rather than a tax year basis and has led to unduly complicated calculations. It is a short term measure, and the amount is continuously changed, which makes it difficult in practice to work out what expenditure will attract what relief. It causes a great deal of uncertainty relative to its value.

**Simplification**

24. ICAS is a strong supporter of the work of the Office of Tax Simplification (OTS). We are concerned however that more of the recommendations of the OTS are not adopted from the outset. For example, in the consultation document 'Consultation: Office of Tax Simplification: Review of unapproved share schemes' which related to a notoriously difficult area of taxation, there were a number of OTS recommendations being proposed for adoption but there were also a number that were not being implemented at the same time. Likewise, the cash accounting proposals put forward by the OTS were not adopted in their entirety, which ICAS believes is a matter of regret in terms of simplicity and ease of administration for those with small incomes. Simplification and removal of anomalies should be a driving principle and not held up by procedural nicety or minor financial considerations.

25. Certain measures also suffer from a lack of consideration of their impact on the administrative side. For example, the restrictions on those higher rate taxpayers who may receive child benefit have created administrative complexities by bringing many into self-assessment.

**Scrutiny and the consultative process**

26. In general, the Government seeks to operate in line with the tax making policy approach as can be seen, for example, with the significant number of measures that were the subject of consultation documents over the summer period in both 2013 and in 2012.

27. ICAS responds to many, but not all, consultations. Those to which ICAS responds, are where there is a significant interest from members and/or where it is considered that there is a public interest issue involved. ICAS technical committees are pleased to have the opportunity to:
   a. Have sight of prospective policy changes, and
   b. Debate the proposed measures and contribute their views.

28. Some consultations feel genuine whereas some others leave the sense that they are observing the process rather than the spirit. This can happen, for example, where a short consultation period is used, such as ‘HMRC digital strategy: legislative changes to enable paperless self-assessment’, which was issued on 27 November 2013 with a one month consultative period (including the Christmas holiday). Also, in this particular consultation it was indicated that the relevant regulations were to become effective from 1 January 2014, the consultation having closed on 27 December 2013, and it was not clear that there would have been time to have taken on board any of the responses.
Meetings with interested parties

29. In some instances offers to meet with the professional bodies and their members are more accommodating than others. For instance, some HMRC officials ask to meet with the relevant ICAS tax committee (in for example which the consultation on ‘Inheritance Tax: Simplifying Charges on Trusts – the next stage’ issued on 31 May 2013 was discussed, along with other topics of current interest) whereas others will only meet representatives in London or only participate in phone calls (such as with the ‘Partnerships: A review of two aspects of the tax rules’). With the more detailed, technical legislation it is always helpful to be able to have a face to face meeting to discuss the proposals. Face to face meetings are also helpful in judging the reaction to proposals, in a way in which might not necessarily be committed to paper as easily or as fully as an exploratory discussion.

Evaluation and outcomes

30. The outcome of the consultation can influence the sense of whether the policy making approach has been fully adopted but this is also influenced by whether a policy is perceived to be an anti-avoidance measure. For example:
   a. ICAS welcomed the decision of the Government in 2013 not to proceed with broad reform of the rules for close company loans to participators following detailed representations and the consultation that closed at the beginning of October 2013.
   b. Likewise, the outcome of the 2013 consultation to simplify charges on trusts has resulted in draft legislation that goes a considerable way towards meeting the concerns of consultees, HMRC having changed the original proposal to treat cumulated income as capital after two years, to a period of five years.
   c. Returning to the partnerships measure, however, despite widespread opposition from consultees, these measures have proceeded.

31. It may be that the tax making policy should be fine-tuned to recognise that there are two streams of policy making, which are:
   a. where legislation is detailed and in a technical area perhaps there is a more effective adoption of the tax making policy. For example, the new Statutory Residence test has been conducted in the spirit of the new tax making approach and it has worked well, having been taken outwith the annual legislative cycle, had a number of collaborative meetings, and there is a sense that the professional bodies and HMRC have worked collectively to revise these rules.
   b. Anti-avoidance legislation where the aim is to stop a particular mischief with immediate effect. By its nature, proposed legislation that is deemed to be necessary to stop tax avoidance is unlikely to be the subject of a full consultation process. Nevertheless, there are occasions when it would benefit from this and there are also questions to be raised as to whether certain proposals are in fact correctly targeted as anti-avoidance. For example, as discussed above, the consultation on ‘Partnerships: A review of two aspects of the tax rules’ has been treated as anti-avoidance and, therefore, the initial analysis around the policy design was not fully explained, nor has there been transparency and full collaboration with interested stakeholders. Adopting the new tax making policy whole heartedly might have led to a more open mind set by Government and, for example, being open to the notion that the causes, rather than the symptoms, of the identified mischiefs should be addressed.

32. ICAS does note however, that despite being an anti-avoidance measure, the General Anti-Abuse Rule (GAAR) in Finance Act 2013 has been introduced in line with the new tax making policy. It was also advantageous to have used a working group of experts: something similar would be helpful with the reform of the taxation of partnerships.

33. In summary, ICAS supports the tax making policy objectives that the fiscal environment should be stable, consistent and certain. Our disappointment is that yet again, this year’s Finance Bill adds considerable volume and complexity to a legislative framework which is already burdensome for a self-assessment regime.