Response from ICAS to the HMRC Consultation ‘Partnerships: A review of two aspects of the tax rules’

9 August 2013
Partnerships: A review of two aspects of the tax rules

About ICAS

The Institute of Chartered Accountants of Scotland (“ICAS”) is the oldest professional body of accountants. We represent around 19,000 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.

General introductory points

1. ICAS welcomes the opportunity to comment on the consultation ‘Partnerships: A review of two aspects of the tax rules’ issued on 20 May 2013.

2. The Exchequer concerns and the tax planning arrangements described in the consultation document are arguably the consequence of the markedly different tax outcomes provided for in different parts of the UK tax code. Corporate tax rates are reducing and the differential between income and corporate tax rates is marked. Also, employment usually carries more tax and national insurance burden than self-employment. Whatever view is formed of behavioural responses to different taxes, they are unlikely to change, and whilst specific legislative responses may be appropriate, wider strategic consideration should be given to long term structural reform to remove or reduce these distortions. In relation to the proposition that there should be ‘fairness’, 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.

3. The proposals in this consultation paper seek to address perceived tax avoidance but not affect the majority of commercial operations and family businesses. As the legislative structure develops this needs to be kept in clear view; to minimise administrative burdens requires that only the targeted population should be caught, any proposed provision that catches significant numbers of businesses and then aims to exclude them over a number of exemptions should be avoided.

General comments on LLPs – salaried members

4. In policy terms the objectives of the proposal to treat certain members of LLPs as salaried members rather than self-employed members are acknowledged. There are however points of detail in the proposals where further consideration is required and these are listed below; responses to the particular consultation questions are set out later. The difficulty, of course, is in establishing a clear legislative division for those who in law have the same status as LLP members, but for tax purposes will be treated in two very different ways.

5. The consultation paper proposes that there should be two conditions and if either applies the member will be treated as a ‘salaried member’. Condition two is more useful because it considers whether the member has joint exposure to economic risk, both profits and losses, which is the test of partnership; Condition one does not appear particularly useful or necessary because the employed/self-employed tests do not have a clear application to the situations in a contemporary partnership; for example, the tests of substitution, control, and use of own tools etc.

6. In some LLPs particularly those that provide professional services, incoming members may not have a full profit or loss share from the outset, simply to offer a limited financial safeguard to attract highly paid employees to take on the additional financial and business risks and responsibilities of changing status to become a member of the LLP, such as being responsible for their own pension arrangements and losing employment rights. Commercially and in the spirit of the tax legislation they are still true members with future, long term exposure to profit and losses and the need to contribute capital, so should not be adversely affected by a focussed anti-avoidance attack; the exclusion
intended in 2.13 is an essential safeguard and care will be required to ensure legislative drafting encapsulates this appropriately.

7. The application of the conditions tests for salaried members should be based on the Members Agreement and the substance of the working relationships and should not be, say, an annual test.

8. For those salaried members who will be liable to employment taxes on their income, it needs to be clear whether this is simply PAYE and NIC or whether it extends beyond employment taxes to for example entrepreneurs relief, employee related securities legislation, and how it interacts with pension relief provisions.

9. Transitional measures will be required to ensure that salaried members are not taxed twice on profits that are generated before this measure is introduced but are paid afterwards.

10. The provision of clear guidance will help reduce areas of uncertainty and the need for clearance; this should be published with draft legislation for comment.

11. Our responses to questions 1 – 5 in the consultation paper are included below.

General comments on mixed member partnerships

12. ICAS members have expressed a number of concerns about the mixed partnership proposals. Ideally, taxation should be neither a barrier nor a driver to an individual's choice of commercial structure. Business owners should be able to decide what commercial vehicle is most suitable for their needs and this should not be constrained by general anti-avoidance provisions.

13. There may be unintended consequences of this. Overly onerous proposals could push a number of partnerships into incorporating to avoid the additional tax complexity. Coincidentally, it would increase the administrative and cost burden for those businesses whilst potentially reducing the tax take.

14. The proposals may impact legitimate commercial structures, particularly with family businesses and farming businesses, and not just tax avoidance arrangements. Partnerships offer an attractive commercial vehicle for many businesses and particularly so in the following sectors:

- for the professions where clients continue to find the personal responsibility of each partner a form of security; and
- in family businesses where a partnership offers a measure of flexibility to cater for changing family circumstances.

15. Flexibility, personal responsibility and also a regard for privacy (when there are no outside interests) can be vital elements for running successful businesses and therefore partnership is an important commercial vehicle which should be retained and respected. Furthermore, some businesses are unable to incorporate; for example, due to the nature of agricultural tenancies or the overall expense and upheaval of restructuring, not least because it would require consent from lenders who would inevitably seek more demanding terms.

16. A company may be introduced, resulting in a mixed partnership, for a number of reasons including:

- to limit exposure to certain liabilities by ring fencing certain operations. For example, a trust (which owns the farm) may set up a company in order to go into partnership with a member of the settlor's family. Although there will potentially be a tax advantage as the trust's partnership share will be taxed within the corporate, the usual driver is to give limited liability to the trust and to protect the trust assets;
- to retain profits for reinvestment into the business (see below); and/or
• to increase the operational and commercial flexibility of the business particularly for family enterprises.

These are valid, commercial purposes and there should be a commerciality test and, if applicable, the mixed partnership should not be subject to the proposed anti-avoidance measures.

17. Whilst the consultation explicitly acknowledges that tax charges may be managed to retain profits for reinvestment, ICAS members do not agree that this is necessarily tax avoidance.

18. There are significant differences in the funds available for reinvestment in a business because of the significant differences in tax rates between an incorporated and unincorporated 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. This restricts unincorporated businesses from building up working capital and limits growth investment. The introduction of a corporate partner has been one method of mitigating this tax system distortion in that it allows profits generated in the corporate partner to be taxed at a maximum of 23% if they are to be retained in the partnership to build up working capital and develop the business. When individual partners need income from the partnership to fund their living costs etc. they take it by either increased partnership shares which result in income tax and national insurance or dividends from the corporate partner which attract an income tax charge. Essentially the corporate partner is a tax deferred, business funding arrangement. For trading businesses in particular such funding is generally looked on favourably by the tax system and its availability should not be discouraged as a matter of policy.

19. In the current economic climate where small and medium enterprises find external finance very difficult to obtain it is vital that businesses can reinvest, as encouraged by government departments such as the Department for Business, Innovation and Skills and HM Treasury. If there is a tax efficient way in which to do this it should not be blocked; nor should there be a more expensive regime for one type of commercial structure compared to another. The tax efficiencies stem from timing differences and such commercial arrangements should be outwith the proposed partnership anti-avoidance rules. Furthermore, existing anti-avoidance provisions would apply, and indeed once profit is extracted from the company it would be subject to income tax.

20. It is accepted that there may be situations where there is aggressive use of companies in a mixed partnership so that subsequent profit extraction is not subject to income tax. Legislation to prevent this may be necessary and a targeted anti-avoidance rule may well be appropriate but where there are genuine commercial arrangements with the company making a genuine contribution to the profit earning capacity of the partnership the proposed anti-avoidance provisions should not apply. Generally, the use of a company in a mixed partnership should be effectively policed by the newly extended reach of section 455 CTA 2010 and section 682 ITA 2007.
Questions in the consultation paper

**Question 1:** Whether the current definition of "salaried members" set out in 2.19 is appropriate to catch those members who should be subject to employment taxes and thereby provide a more equitable tax and NIC treatment?

The definition in 2.19 is appropriate and, as discussed in the general comments above, ICAS considers that the second condition is all that is required in order to identify 'salaried members'.

**Question 2:** Is there a simpler alternative for delivering the same policy objectives, whilst reducing uncertainty and preventing avoidance?

All parties including the LLP, the members, and HMRC will benefit from certainty. A clearance facility is strongly recommended, or a ruling system similar to that in the employed/self-employed status test.

**Question 3:** Are the conditions as currently framed clear enough or are there other criteria that you consider should be added that would more clearly achieve the policy aims?

See above regarding condition one.

**Question 4:** Is there an alternative to the proposed TAAR which would prevent attempts to sidestep the rules? How could a TAAR be expressed so as to ensure that it has the desired effect but does not apply inappropriately?

Comments as above.

**Question 5:** Guidance will be issued to indicate how the test will be applied. We would welcome views on any specific scenarios or points this guidance should cover.

Guidance would be useful in the following scenarios:

- Where the member may have an ‘entry’ period on a fixed rate; perhaps with no initial capital requirement and/or a guaranteed minimum profit share ratio.
- In the context of LLPs and family businesses it is rare for one generation to retire wholly in favour of the next and there may be a very gradual introduction of younger members, usually without the formality seen in non-family businesses.

**Question 6:** HMRC would welcome views on this approach to counteraction, particularly what other specific indicators should be taken into account and possible alternative approaches that would counteract the tax advantages (including timing advantages).

As noted in the general comments above, there are situations where a mixed partnership is used to encourage flexibility, investment in the business, and/or to ring fence certain operations. In such instances, where there are legitimate commercial considerations, the proposed approach is too broad.

As part of these proposals there should be:

- a bona fide commerciality test for the existence or introduction of a corporate partner rather than directing anti-avoidance legislation at all mixed partnerships
- consideration given to the use of hallmarks to separate the commercial from the pure tax avoidance motive structures (for example, is it trading, are the retained profits used in the business); and
- a deminimis test in a profitable partnership.

A proposal to restrict loss relief where there is aggressive use of losses, for example, resulting in relief effectively being given twice is understandable. A basic question, however, is why, or when, loss relief should otherwise be blocked: generally it is simply a timing difference resulting from the use of a relief that was designed to be used. For instance, if a mixed partnership utilises a Business Premises Renovation Allowance at 100% it seems...
contradictory to apply anti-avoidance measures to counteract it. It is also the case that using a particular commercial vehicle is a part of the pricing of the investment and if the tax relief in a mixed partnership is restricted then the amount that will be invested will be restricted. In summary, any restrictions of loss relief should be targeted more directly on specific nuisances.

Question 7: Would the legislative approach set out above provide an effective deterrent and counter the schemes described?

Yes, but it may also adversely affect legitimate operations and particularly so for small and medium sized enterprises. It also introduces complexity and costs.

Question 8: Would the proposed changes impact on situations that are not in line with the stated policy objectives? If so, HMRC would welcome detailed explanation of why you believe these situations fall outside the intended target areas.

These are discussed above; the proposed changes are too wide and a bona fide commerciality test could be used which, if applicable, would remove inoffensive mixed partnerships from these proposed measures. In addition, if a mixed partnership has been in place for many years and was set up without any tax avoidance motive it should not be brought within the ambit of this legislation.

In the example in the general comments above, of a trust that owns a farm and the trust sets up a company in order to go into partnership with a member of the settlor’s family, there will potentially be a tax advantage as the trust’s partnership share will be taxed within the corporate, but the usual driver is to give limited liability to the trust and to protect the trust assets. Any competent tax adviser would point out that this would allow profits to be accumulated at corporate rates. It is not clear how this example should be distinguished from situations where the tax advantage is one of the main reasons for the mixed partnership.

There is a problem regarding the lack of clarity as to those situations HMRC view as being caught and those not intended to be.

It is recommended that HMRC prepares initial draft guidance for further consultation as soon as possible.

The following points of concern also arise:

- if there is a corporate partner that also happens to conduct its own trade these trading profits should be excluded from the proposed provisions; and
- the provisions deeming a profit share should be limited by the distributable profits of the corporate partner, where it has a wider business role, as well as a normal return on capital.

Question 9: Do you consider that there are circumstances in which this rule would give rise to outcomes inconsistent with the policy objectives and, if so, in what circumstances and how might these situations be addressed?

A major objective for policy makers and tax practitioners is to simplify tax legislation and to bring certainty to business, particularly important for small and medium sized enterprises. Consequently, safe harbours should be available for smaller businesses to prevent unnecessary complexity and where costs of compliance with these proposals may become disproportionate. For example, safe harbours could be introduced for a profitable partnership either where profits are below the small profit thresholds for corporation tax, or the turnover is below a certain level.

Likewise, structures involving those who might be associated in terms of the close company provisions should be within the safe harbour. For example, if all members of the partnership and the shareholders were members of the same family the new legislation should not apply. This might be one way of implementing the proposed limitation in 3.1 with the reference to the ‘Arctic Systems’ case.
Combined with the above commercially test and/or safe harbours, there should be a facility whereby an advance clearance could be obtained, a discussed in response to Question 2 above.

**Question 10:** As described above, it is proposed that the profit deferral arrangements will be tackled in the same way as the other mixed membership arrangements. HMRC would welcome views on whether relief could be given retrospectively in the event that a contingent profit awards does not ultimately vest. To prevent the risk of abuse, such relief would be confined to clearly defined circumstances and would also need to provide for additional tax charge to be imposed on other members in the event that those profits are re-allocated to other members.

There are some commercial situations where deferral arrangements are used, for example, where a business that has been bought ties in certain key personnel by retaining profits in a corporate partner pending evidence of successful post acquisition business performance. It is essential that commercial situations such as this should be taxed only in accordance with the earnings entitlement; a partner should pay tax only on income that is his. Cash flow considerations arise if a partner were to be taxed on contingent profits he did not control, even if there was a future, retrospective relief which, it is suggested, might only be available in very limited circumstances. That is inequitable and ICAS would certainly oppose any suggestion that relief be limited to certain regulated financial partnerships.

Whilst partnership accounts might deal with some of these allocation issues, the corresponding complexity should only apply in non-bona fide commercial circumstances.

A mechanism needs to be found to accommodate deferred profit; alternative methods could be considered such as:

- the profit could be allocated to an individual for tax purposes (as indicated in the consultation paper) but the individual would then have a right to claim the tax from the company. This leaves the profit correctly accounted for where it actually is, in the company, but the tax advantage has been countered. However, the solution proposed in the consultation document does not reflect the reality that legally the profit is the company's.
- Alternatively the company could be assessed to an additional tax charge equal to difference between the corporation tax rate and the top rate of income tax. In due course if the profits are paid out to shareholders a tax credit could attach to this.

**Question 11:** A possible alternative to the approach suggested in question 10 would be to allow a member subject to a profit deferral arrangement to elect to be taxed as a salaried member, with the consequences then being as set out in paragraphs 2.24 and 2.25 above. Views on this proposal would be welcome.

This solution is not appropriate and adds a potential layer of confusion to already complex proposals; either the member is a partner or he is not. The issue here is how to treat amounts that have not yet been allocated to a partner; the existing treatment via a corporate partner with, at most, the proposals at Question 10 give a sensible solution to prevent short termism.

For the impact assessment, consideration would need to be given to the considerable accounting complexities that would arise from this.

**Question 12:** Should there be any other exceptions to the proposed treatment? If so, please provide information why these cases should be excluded and suggestions on how these exclusions can be effected.

Consideration should be given to the provision of a clearance mechanism especially if there is doubt as to whether the arrangement is potentially caught or not by other legislation (para 3.52 of the consultation document).

**Question 13:** Would there be situations that are not in line with the Government objectives? If so, the Government would welcome detailed explanation of why you believe these situations fall outside the intended target areas and, if possible, any suggestions on how these situations may be effectively excluded from the legislation?
Comments as above.

**Question 14:** Do you agree that the legislation can help the Government to meet with the wider objectives of fairness without adversely affecting the flexibility of the partnership structure?

No, this is introducing complexity when the core issue is the significant difference between the rates of corporation tax and income tax. Many express a deep sense of unfairness about the lack of a level playing field across business taxes, including for example that Annual Investment Allowances are not available to individual or corporate partners in a mixed partnership, and this strategic level needs to be addressed. For those matters which might be seen as genuinely abusive a TAAR is the correct approach and, if implemented, these proposals will adversely affect the flexibility of partnership structures and increase unfairness.

**Question 15:** Can interested parties offer views on any other likely costs that partnerships and their partners may incur in order to implement the changes?

*If the proposals are implemented there may be significant costs to restructuring businesses.*

Legal advice will be required to ensure neither the partner nor the partnership loses out. This will be the case in relation to both existing and future partnership agreements. Clearly tax and accounting advice on the continuing appropriateness of particular structures will be needed and on how best to meet commercial objectives in other ways, for example on contingent profits.

In addition, there will be costs of compliance. Any partnership with a corporate partner will have to consider if it is caught or not by the legislation; if it is caught then it will need to make a just and reasonable allocation of profit of loss. This will not necessarily be easy to do and the costs of compliance will be wholly disproportionate for small and medium enterprises, especially for smaller businesses.

Similar comments apply to the proposals on LLPs.

**Question 16:** Will the proposals described above provide a comprehensive response to all schemes involving manipulation of partnership profit and loss allocations (including but not limited to the arrangements described in Annex C)? If not, what other types of scheme should be tackled?

No comment.