



TAXREP 35/13

(ICAEW REP 101/13)

ICAEW TAX REPRESENTATION

PARTNERSHIPS: A REVIEW OF TWO ASPECTS OF THE TAX RULES

Comments submitted on 9 August 2013 by ICAEW Tax Faculty in response to HM Revenue & Customs consultation document Partnerships: A review of two aspects of the tax rules published on 20 May 2013

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation document [Partnerships: A review of two aspects of the tax rules](#) published by HM Revenue & Customs (HMRC) on 20 May 2013.
2. We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.
3. On 7 June and 3 July 2013 we attended meetings with HMRC, jointly with various representatives of farming and land owning bodies in the case of the 7 June meeting, in which we were able to put forward some key comments and concerns and discuss aspects of the consultation paper.
4. Information about the Tax Faculty and ICAEW is given below. We have also set out, in Appendix 1, the Tax Faculty's Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system.

WHO WE ARE

5. ICAEW is a professional membership organisation, supporting over 140,000 chartered accountants around the world. Through our technical knowledge, skills and expertise, we provide insight and leadership to the global accountancy and finance profession.
6. Our members provide financial knowledge and guidance based on the highest professional, technical and ethical standards. We develop and support individuals, organisations and communities to help them achieve long-term, sustainable economic value.
7. The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including TAXline, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.

KEY POINT SUMMARY

8. We are concerned that the proposals are a sledgehammer to crack a nut and will have a detrimental effect on several small businesses at the lower end of the "food chain". The stated intentions of the proposals are to level the playing field and to tackle tax avoidance. We fully support those objectives but are not convinced these proposals support the objectives.
9. We agree that there should not be a presumption of self-employment for a member of an LLP but nor should there be a presumption of employment. The existing rules for determining an individual's status could be used for an LLP without introducing an additional swathe of legislation.
10. As far as mixed partnerships are concerned we would like to see a de minimis in order to exclude many of the small businesses from the proposals; we would prefer to see them excluded by legislation rather than by guidance.

MAJOR POINTS

Disguised employment

11. We agree that it is anomalous to always treat LLP members as self-employed; the taxation of LLP members is based on the presumption introduced by HM Revenue & Customs that members are self-employed. In our view the removal of that presumption and relying on existing provisions for deciding if an individual is employed or self-employed would be preferable to introducing a new body of legislation.
12. If new legislation is to be introduced to determine the employment/self-employment status of members for profits arising after 6 April 2014 several LLPs will have already started an accounting period that will end after the introduction of the new regime and as the new rules are unknown they may well face complex accounting adjustments to reflect the changes. It would be preferable if the changes were introduced for accounting periods starting after 5 April 2014.
13. There is no recognition in the test that some types of partnership have no need for significant capital accounts, a small professional partnership has less need of capital within the business than one where significant capital investment is required in say plant and machinery.
14. It is important that employment law and tax law have a coordinated definition of employment/self-employment.
15. We welcome the comment at 2.13 that the conditions are not intended to apply members who are in essence partners of a traditional partnership that is now carried on as an LLP. This is particularly important with regards to junior partners and senior partners moving towards retirement as these two groups are likely to have less of their income from a variable percentage profit share. Other than the comment at 2.13 we cannot see what measures are included to ensure that such partners are not caught.

Profit and loss allocation

16. Whilst we agree that the use of mixed membership partnerships for the sole purpose of avoiding tax on the profits drawn out of a business should be addressed to ensure that a fair amount of tax is paid we do not agree with all the changes proposed. The consultation document does not show a clear understanding of the commercial and historic reasons why some businesses have a mixed partnership structure.
17. The proposals are the proverbial sledgehammer to crack a nut and the introduction of a de minimis such that small partnerships are excluded and can continue as before would make the proposals more workable. It is stated at 3.1 that the proposals “do not cover cases where family members use partnership structures to allocate profits between them tax efficiently in circumstances such as those in the Arctic Systems case” but it is not clear how they will be excluded. Will it be akin to a de minimis rule?
18. Where the conditions are met the allocation of profits to the lower rate tax payer has to be just and reasonable, commensurate with the contribution made. In our view this will lead to protracted and costly arguments. For example what is an appropriate notional rate of interest payable to a corporate providing finance, or if the corporate owns the goodwill of the business what is the goodwill value and what is a fair payment for the use of the goodwill. Negotiations around questions such as these will incur professional costs for the business and costs for HMRC.
19. There is existing framework to tackle tax avoidance when income has been allocated in an inappropriate manner including in the form of legislation, the general anti-abuse rule (GAAR),

s773 ITA 2007 and case law Hadlee and another v Commissioner of Inland Revenue begging the question is additional legislation necessary?

20. The proposals are designed to prevent a mixed partnership from accessing cheap finance to invest in the business; they will be unable to shelter profits at a corporate tax rate to enable them to finance expansion and growth of the business. This seems perverse and contrary to other Government policies which are designed to promote growth.
21. In the current economic climate some partnerships are unable to access the cash needed to pay the individual partners' their share of the profits but by allocating the profits to a corporate partner the actual cash requirement is less and this could be the difference between the partnership staying in business and being put into liquidation.
22. The consultation document implies that all mixed partnerships are for tax avoidance purposes but there are several reasons why a business may be structured as a mixed partnership including:
 - 22.1. Setting up a company to operate a part of the business through that has regulatory requirements such as financial services
 - 22.2. Service companies set up historically to limit liabilities before LLPs were introduced
 - 22.3. International partnerships which may require a corporate because of the different tax rules in the different countries where some structures seen as transparent for tax in one country are opaque in another
 - 22.4. Using a company to allow employee participation in an LLP business
 - 22.5. Using a company to enable external financing to be accessed for expansion, particularly important at present given the difficulty in obtaining bank finance
 - 22.6. To obtain the benefit of limited liability a sole trader may set up a company so that an LLP can be set up with the sole trader and the company as members
 - 22.7. Alternative business structures were introduced in the Legal Services Act 2007 and are professional firms that provide reserved legal services, they will commonly be structured as a mixed partnership
 - 22.8. Within the farming industry mixed partnerships may be used such that non family members can operate a discreet part of the business without getting entitlement to the underlying assets
 - 22.9. Where two firms may have merged, one being a partnership and the other being a limited company and it is preferred to have a partnership but the tax costs of disincorporation are prohibitive so it continues as a mixed partnershipWe understand that many of these types of operations will be excluded from the proposed legislation but that will be by guidance; we would prefer legislation to exclude those businesses intended to be excluded to remove all doubt.
23. One of the aims of the proposed legislation is to "force" businesses to be either a partnership or a company and not straddled across the two. That said, the tax impact assessment does not appear to factor in the reduction in tax resulting from partnerships deciding to incorporate as a result of the proposed measures. In addition is there any intention of introducing a general disincorporation relief to allow existing mixed partnerships to restructure?

RESPONSES TO CONSULTATION QUESTIONS

DISGUISED EMPLOYMENT

Q1: 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?

24. We understand that the third leg of the second condition is to be dropped and we welcome this amendment. The three legs of this condition made it a very low bar that few partners would come under; the third leg in particular may be difficult to prove as there may be very few assets on a winding-up so the entitlement could well be insignificant.
25. The test would be better framed as a positive rather than a negative so a member is one that has an economic risk, is entitled to a share of the profits and is entitled to a share of surplus assets on a winding-up.
26. There is an element of subjectivity in the test as the economic risk in the first leg will be ignored if the risk is insignificant and "What is insignificant will be determined in the light of all the circumstances and by reference to the overall package of benefits derived from the partnership agreement". This will require detailed guidance as in many partnerships the capital is very low and so the loss of it may appear on first sight to be insignificant.

Q2: Is there a simpler alternative for delivering the same policy objectives, whilst reducing uncertainty and preventing avoidance?

27. The proposed tests do not give certainty. Removing the presumption of self-employment and using the well established tests for employment vs. self-employment which are familiar would avoid the introduction of a new layer of legislation, be less complicated and be no less uncertain.

Q3: 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?

28. See earlier comments.

Q4: 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?

29. We have no objection per se to a TAAR but it should be framed such that the presumption is that there is no tax motive for the arrangements unless proved otherwise. Partnership arrangements can be very quirky for many reasons, the individuality and flexibility of partnerships are two of the reasons they are preferred to limited companies and amendments will frequently be made with no reference to the tax consequences. We are concerned that changes could be made to an LLP agreement that result in a tax benefit although that was not the motive and it is very difficult to prove a negative.

Q5: 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.

30. The guidance should be issued well in advance of the start of the legislation particularly as many LLPs are already in a financial year that will be caught by the changes in legislation. It would be preferable to implement changes in accounting years starting after 5 April 2014.
31. The guidance should cover all areas where there is an element of subjectivity in the legislation, so examples of a significant profit share.
32. We would prefer all matters to be dealt with within the legislation rather than having to rely on guidance which does not give certainty to the taxpayer. That said we are happy to offer our help in preparing guidance.

PROFIT AND LOSS ALLOCATION

Mixed member partnership – profits

Q6: 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).

33. As noted above our view is that the proposals are indiscriminate and will impact on businesses that the consultation document says are not the intended target. We support measures to tackle abuse of the tax system and think that the measures should be more targeted. If the intention is to force those partnerships that can to incorporate the tax take will be reduced and the corporation tax element of it will be paid later.

Mixed member partnerships – profits and losses

Q7: Would the legislative approach set out above provide an effective deterrent and counter the schemes described?

34. The proposals would deter the schemes described but will also have a detrimental impact on ordinary trading businesses that have a mixed partnership.

Q8: 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.

35. Many family and other small businesses have a mixed partnership structure. The lower corporation tax rate on the profits allocated to the company allows them to invest and grow the business. Where profits allocated to a corporate partner are reinvested in the business that profit allocation should be classed as being just and reasonable.

Q9: 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?

36. Yes, see earlier comments.

Q10: 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.

37. It is unreasonable to collect tax on an income before it is received and it is more equitable to put in place a system that collects the tax when the profit is actually “earned” which is after the contingency has passed.

Q11: 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.

38. This does not appear to be a reasonable or workable solution, the partner would be an employee for income tax and National Insurance for a short period so there would be cessation and commencement rules to apply. What about other taxes such as capital gains tax and inheritance tax? If the partnership owned land and buildings what about SDLT charges on the change of membership of the partners?

Partnership members with differing tax attributes

Q12: 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.

- 39.** Any structures where tax was not the motive should be excluded from the proposed legislation even if there is in addition a tax advantage, for example where business structures have been put in place for commercial reasons, or where they are historical and cannot be changed.

General questions

Q13: 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?

- 40.** Our earlier comments list different reason why mixed partnerships exist where tax was not the motive for the structure. It would seem that the target of these proposals is the large organisations that have chosen to abuse the tax system. If a de minimis rule was included the intended targets would still be caught whilst many of the “innocent bystanders” would fall out of the proposals without any compliance costs on their part or on the part of HMRC.

Q14: 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?

- 41.** The Government objective of cutting the corporation tax rate whilst the income tax rates remain high is inherently unfair so it is not clear what “wider objectives of fairness” are being referred to. The flexibility of the partnership structure will be adversely affected if profit retained within the business for growth and expansion is taxed at the top rates of income tax rather than at the lower corporate tax rates.

Q15: Can interested parties offer views on any other likely costs that partnerships and their partners may incur in order to implement the changes?

- 42.** Mixed partnerships are likely to incur professional costs in reviewing their structures to see if they are affected by the changes. Where members are designated as employees moving forward there will be legal costs incurred in amending partnership deeds and drawing up contracts of employment. There could well be additional compliance costs in operating a payroll and RTI. Compensation may be payable to a member who becomes an employee. Individual may incur additional capital gains tax and inheritance tax costs if they are no longer a partner. SDLT charges may be incurred on a change in the partnership. Additional costs will be incurred in deciding what is a just and reasonable allocation of profit to a corporate partner which has, for example, provided finance or goodwill.

Q16: 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?

- 43.** In our view the proposals will impact on the arrangements outlined in Annex C. No consideration appears to have been given to partnerships comprised entirely of limited companies. A structure including a subsidiary company, one that is owned by the partners rather than it being a partner, is not considered in the consultation document.

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APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see icaew.com/en/technical/tax/tax-faculty/-/media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx)