



NO TIME TO PANIC

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Solving the partnership structure problem calls for balanced review, not panic reactions, argues **Julie Butler**

Many tax advisers would argue that 2013 was the 'year of the partnership problems'. The reality is that 2014 will be the 'year of the partnership solutions' and that will include positive decision making around the tax legislation changes and implementing practical partnership strategy. Anti-avoidance provisions in the mixed membership partnership rules came into force from 5 December 2013. The other changes take effect from April 2014.

The HMRC consultation into partnerships concluded in August 2013, and during December 2013 the draft legislation was published. The government has confirmed it will move forward with the partnership consultation proposals which will (it hopes) prevent avoidance and remove the tax advantages set out in the consultation document. Tax advisers must focus on the main areas of apparent 'tax abuse' and combine this with a total overhaul of all partners'

tax affairs which HMRC has been trying to close down or at least radically change.

The government has aimed to increase its revenue by £9bn over the next five years by attacking tax avoidance, and the new partnership tax measures are part of that attack on what is deemed to be abusive tax planning.

CORPORATE PARTNERS

The 'corporate partner' is the jargon for a limited company partner acting as a partner in a partnership of individuals (a mixed member partnership). In recent years under such structures, profits have been diverted to the corporate entity to maximise the fiscal advantages available. Such a partnership arrangement takes advantage of lower corporate rates. Many would argue this structure is adopted with strong commercial emphasis to ensure profits are retained in order to secure the business' future and fund potential expansion.

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ACTION PLAN FOR ADVISERS

- Warn all clients of the changes and make sure they are aware of the impact
- Review all partnerships, including those without the problems of corporate partners and LLP status
- Where vulnerable existing arrangements will result in extra tax if no change is made, look to make existing arrangements more robust through capital, decision making, etc
- Where it is considered that the existing arrangements do not result in extra tax or change the tax status of members, make sure that the reasoning is well evidenced and such evidence is constantly reviewed
- Ensure that all clients and partnership members understand the concerns and risk assessments, and are very involved in all decision making
- Ensure that all reviews, proposed strategy, legal changes, decisions, risk assessments and, above all, client involvement are well documented
- Ensure updated partnership agreements and shareholders' agreements reflect the current trading operation and the required legal protection including succession planning
- Act now as there is not much time

have been enjoyed by the farming community. In recent years farming has enjoyed improved profitability and members of the farming partnership generally do not want to draw out all the profits created, they want to leave profits in the business. If the undrawn profits are left in the corporate entity, then the tax and national insurance contribution (NIC) savings, compared to paying full personal rates, can be significant.

LEGISLATION PUBLISHED

Legislation was published on 5 December 2013 relating to mixed member partnerships and takes immediate effect to counter what was considered the manipulation of profit and loss allocations which previously led to tax advantages. The complete package of draft legislation was published on 10 December 2013.

The profit share allocated to a corporate partner from 5 December will, under the legislation, need to be treated as being allocated to the individual members involved in the partnership as a whole rather than as a distribution to the limited company if it can be considered that the limited company share is excessive. The excess will be taxed as income for income tax and class 4 NIC purposes.

WHAT IS EXCESSIVE?

The allocation of profits is deemed excessive if the profit share exceeds what is regarded as a notional return on capital – a return by reference to the time value of money at a commercial rate of interest, taking account of all the circumstances less any return actually received in respect of the individual's capital contribution to the partnership that is not included in its profit share. Many consider that the legislation has wilfully disregarded the commercial environment in which many partnerships exist.

It is also argued that mixed member partnerships have been valuable tools to aid financial reconstruction and to promote a more conservative approach to profit distribution. If the corporate partner structure encourages retained earning then that is considered to be positive commercially, and this will have to be

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defended through a correct structure that meets the requirements of the legislation.

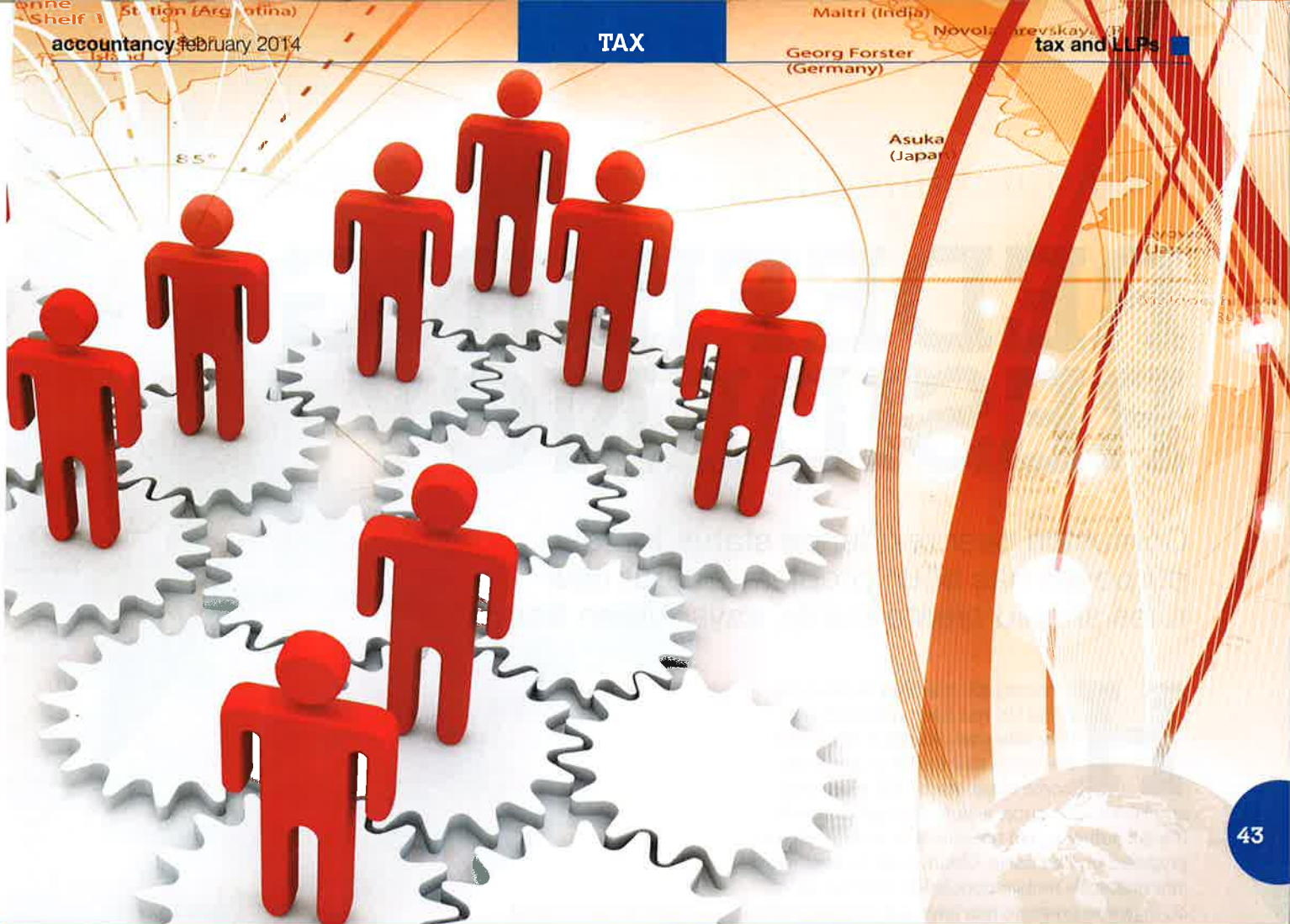
There are practical problems surrounding the implication of the legislation. For example, there is the reality that this will lead to material uncertainties as individuals must decide their own tax filing position. There may be challenges from HMRC as to decisions that have been made, eg, the calculation that allocations are not excessive will be reviewed by HMRC.

RETURN ON CAPITAL

The key point to defend the continued commercial use of the corporate partner must be the return on capital argument. If the corporate entity has high capital contribution by the partnership, there should be much evidence to support the high allocation of partnership profits as appropriate.

As an alternative to the profit share, there can be charges for services provided by the corporate entity within the business structure. These must be at an arms-length rate for services that the non-individual supplies to the partnership. Any excess of charge over market rate will be allocated to the individuals in the partnerships as taxable income at income tax rates.

A review of the profit allocation within all mixed member partnerships should therefore be undertaken as a matter of priority to consider whether the current arrangements are caught by the new rules that come into force from 6 April



2014, and that does not leave much time for planning. This should be undertaken as part of a whole strategy of a review of the partnership in the round.

ATTACK ON LLP SALARIED MEMBERS

The other significant area of focus by HMRC is the review of the employee status of limited liability partnership (LLP) members.

As mentioned, draft legislation was published on 10 December concerning individual members of a LLP who work for the LLP on terms that are tantamount to employment (salaried members) and LLPs that have salaried members.

The new rules seek to clarify the definition of LLP membership by determining whether fixed-share or salaried partners should be classified as employees for tax purposes. HMRC's new tests of employee status in a partnership include the level of partner's variable profit share, the influence that they have on partnership decisions and the amount of capital invested by the individual partners themselves.

The proposals are deliberately targeted towards those fixed-share members who are, in reality, disguised employees who have no commercial risk or variable reward within the business. Capital investment by such members can again be the solution to this problem, but unless introducing capital, sharing the risks and decision making is taking place, many will be caught by the new partnership rules.

RURAL IMPACT

In the farming community, it is a sad fact that there are few up-to-date partnership agreements. 2013 saw a legal case of *Ham v Ham [2013] EWCA Civ 1301* – a partnership dispute between father and son. The dispute was allowed to reach the courts because of the poorly worded partnership agreement. It is essential to review all partnerships in the early part of 2014 as part of the protection strategy.

It has been argued that the farming industry has been caught up in anti-avoidance measures that were aimed at much larger prey, eg, the large law firms and hedge fund operations, and many would argue that there was some abuse in these areas that needs to be addressed with more commercial focus. Another area of the rural industry that will be affected by this change is the riding school as the teaching of riding lessons by the proprietor is exempt for VAT purposes as these lessons count as a subject ordinarily taught in schools. Many riding schools have taken in teaching staff as LLP members in order to take advantage of this VAT ruling.

Clear, strong action must be taken, and fast.



JULIE BUTLER FCA
 Managing partner, Butler & Co,
 and specialist equine tax author
www.butler-co.co.uk