

Partnership taxation Proposals to clarify tax treatment

Consultation document

HMRC published a consultation document on partnership taxation on 9 August that covers five areas of partnership taxation and applies to all forms of partnership including foreign entities classified as partnerships under UK tax law. We expect many, if not all, professional practices structured as partnerships to be potentially affected by the current proposals to varying degrees.

Responses to the consultation document are required by 1 November and we encourage businesses to respond and / or discuss the potential implications with your usual Deloitte contact for consideration in our response.

A link to the consultation document can be found [here](#).

1. Clarification of who is the partner chargeable to tax

In late 2013, HMRC introduced some new wording into their Business Income Manual (BIM82005) addressing

the situation where a partner acts as nominee for other persons, and expressing their view that in such cases it is the actual partner who should be taxed on the relevant profit allocation. This was replicated for LLPs (BIM82110). The focus and application of this guidance was not clear.

In recent correspondence with HMRC we have become aware that the formulation/expression of this view had been triggered by a concern to protect their taxing rights over partnership profits in a particular case. It also became clear that the scope of their technical view, as expressed in the new guidance, could potentially extend to certain specific profit sharing arrangements adopted by some professional practices firms, although there has been no suggestion by HMRC that they consider such arrangements to be uncommercial or tax motivated in general terms.

HMRC now propose to act to remove uncertainty in this area, which implies an intended change to the tax legislation. Their proposal appears to place the onus on the partnership to represent to HMRC who the partners are, through their inclusion on the partnership return. HMRC would then accept that they are the correct persons on whom to tax the partnership profit. On the face of it, this would protect HMRC's taxing rights over the whole of the partnership profit, as it would be necessarily allocated in full among those persons. However, this proposal does raise a number of questions that will need to be addressed, for example:

- What is the basis on which firms will be required to determine who the partners are for the purposes of filing the partnership return?
- In the type of situation HMRC have identified, would this always be the nominee or the beneficiaries, or would some kind of test be required e.g. by reference to principles in case law?
- Presumably there will need to be clear criteria, and firms will not be able to identify whomever they choose e.g. family members, non-resident partners only etc.
- If the identification of partners on the partnership return for tax purposes may carry an implicit representation that they are partners as a matter of fact, how does that interact with the identification of partners for other purposes e.g. regulation?
- Would the same principles apply to the allocation of losses and associated tax reliefs?

- More fundamentally, is there actually a problem with the existing legislation that compromises HMRC's taxing rights? And if so, is there a better means to clarify who the taxable person is in this type of situation and thereby protect HMRC's position?

This gives a flavour for the types of questions that will be raised, and more will emerge through the consultation process. A key concern will be to attempt to clarify HMRC's proposal and the impact it will have on firms' filing positions.

2. Allocation and calculation of partnership profit

An important feature of partnerships as an operating vehicle is their acknowledged flexibility to address individual partners' performance, a partner's investment in the business and to ensure equity between partners and / or generations of partners along with a number of other commercial factors. HMRC have raised a concern that this flexibility may lead to uncertainty regarding the correct calculation of partners' tax adjusted profits or manipulation of profit allocations for tax purposes.

HMRC are proposing to introduce new legislation seeking to address their concerns by:

1. Requiring that the profit sharing arrangements in the partnership agreement are the determining factor in identifying the partners' profit shares.

In connection with this provision, HMRC are proposing that any deviation (written or otherwise) from the profit sharing arrangements as set out in the partnership agreement would need to be notified to HMRC.

The intention of this measure seems to be to remove any uncertainty arising where there may be a dispute between partners on the allocation of profit or the nature of a payment to a partner, for example, whether a payment is capital, compensation for damages etc.

There are a number of practical issues that need to be addressed through the consultation process, for example:

- The profit sharing mechanism for many professional firms lies largely outside the partnership agreement e.g. in side agreements and/or the delegated functions of a management committee. It is important that this wider framework is acknowledged in any new measure.
- If changes to the profit sharing arrangements (in the broader sense) need to be notified to HMRC, the timing of that notification will need to take into account commercial arrangements e.g. profit allocations are often determined, at the discretion of management, wholly or partly after the accounting year end.

The main objective here will be to adequately cater for the wide range of commercial ways in which professional partnerships allocate their profits in practice.

2. Providing that the basis of tax adjusted profit should be the same as the allocation of the accounting profit / loss between the partners.

Current tax legislation provides that a partner's profit allocation is determined, for tax purposes, in accordance with the firm's 'profit sharing arrangements', rather than specifically the allocation of the accounting profit or loss. In simple cases, where partners share in profits on an equal basis, one could expect them to share in tax adjustments in proportion to their allocation of accounting profit. However, in practice there may be departures from this correlation which may affect the allocation of tax adjustments e.g. to reflect arrangements for Fixed Share Partners. It is not clear whether these kinds of commercial arrangements would be affected.

Further, the consultation document refers to the manipulation of 'profit, loss and capital gains allocations for tax purposes. For example, by allocating specific allocations of income and expenditure to particular partners or classes of partner or by determining profit shares after the end of the accounting period'.

It is common for certain income to be allocated to a particular group of partners, often simply to reduce the complexity of every partner having entries in their tax returns to record interest, annuities, dividends etc. It is not clear if HMRC are intending to disturb such arrangements.

Finally, there is a reference to 'determining profit shares after the end of the accounting period' in the context of manipulating profit shares for tax purposes. Given that the practice of determining an element of profit shares after the accounting period end is common (particularly where firms have valve partners), clarity on HMRC's intention behind this statement will need to be sought through the consultation process.

The proposals at this stage seem general and wide-ranging and ordinary profit sharing arrangements existing to address normal commercial objectives could be impacted without adequate representation.

3. Business Structures that include partnerships as partners

Where structures involve tiered partnerships (i.e. one partnership is a member of another), HMRC are proposing that the return for the partnership generating a profit or loss should disclose the ultimate taxable persons. So to take a simple example, say Partnership A is a member of Partnership B, B's return would contain a partner page 7 for each of the partners of A.

In the context of professional practices, tiered partnership structures are relatively uncommon and in any event, this proposal should simply be an administrative change in the manner in which partnership returns are filed. However, the effect on basis periods for individuals may need to be considered where partnership accounting dates are not aligned.

4. Trading and Property Income – tax administration

Where a partnership is unable to establish the details of all the partners or obtain UTRs for them, HMRC wish to explore options for protecting the Exchequer e.g. by requiring the partnership to make a payment on account on behalf of the unidentified partners.

HMRC expect these cases to be rare and we do not believe that this proposal will be relevant to most in the sector. The measure seems to be designed to address e.g. some tiered partnership structures with overseas partners, whereas in most professional practices structures the filing requirements are usually addressed through composite arrangements.

5. Investment income – tax administration

This proposal applies to partnerships with only investment income and is unlikely to apply to professional practices. Further detail can be found in Section 4 of the consultation document, [here](#).

Summary

The consultation document is potentially far-reaching, impacting common structures and profit sharing arrangements in the professional practices sector. It raises a number of questions that professional firms will want to see addressed in a pragmatic manner, taking into account the commercial ways they are structured and manage the allocation of profits and losses.

We will be engaging with HMRC and preparing our own response to the proposals. As noted above, firms may feel they want to submit their own responses, but we would welcome input and discussion with you to assist you in considering the potential impact on your own business, and also to incorporate any views in our response to HMRC.

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