

HMRC has now published its long awaited consultation document on the taxation of partnerships and LLPs. It covers two aspects. Firstly there is the whole basis of taxation of LLP members whose terms resemble those of employees. Secondly there is the question of profit allocation where the partnership includes at least one corporate partner as well as individuals. The intention is to legislate on changes to take effect from April 2014.

LLP members

The first of these is the more straightforward. In a conventional partnership HMRC takes the view that fixed share or salaried partners are employees and that their income should be taxed as such (through PAYE with full National Insurance Contributions). It is only when certain factors such as profit sharing and risk are present that partners are treated as self-employed.

For LLPs the position has always been different with even salaried members being treated as self-employed by statute. In theory HMRC are consulting on this but it is pretty clear that the position will change from April 2014. LLP members will no longer have special treatment.

We have experience in protecting the status of individuals in professional and other partnerships and would be happy to talk to LLP firms who may be adversely affected by any change and wish to review their position.

Profit Allocation

HMRC has realised that having a corporate partner gives firms the potential to benefit from lower corporate tax rates whilst continuing to have the flexibility of the partnership or LLP structure. HMRC is seeking to limit this and to discourage those situations where it feels the benefits are being exploited unfairly.

That much is clear but what is much less clear is how this could be done and how far it will go.

Interestingly, HMRC quite specifically recognises that there are certain circumstances where it might be appropriate to have a corporate partner for what the taxman would consider legitimate reasons. This might include finance raising and dealing with succession issues.

The key to the perceived evils identified in the consultation document, however, is that the company is somehow receiving an excessive profit share for what it does. Sometimes the company is thought by HMRC to be making little or no contribution at all.

Whilst such 'moneybox' companies are perhaps a legitimate target for HMRC the unanswered question is how and where HMRC will draw the line. That is the difficult question to which HMRC is hoping to find the answer in the consultation exercise.

At Armstrong Watson we have always believed that such corporate partners should have a proper role and it would seem that there could well be a grey area of situations where any changes could catch more innocent arrangements.

It would seem that it is envisaged that there will somehow be determined what is a 'just and reasonable' profit share for a corporate partner's role. It has to be said that this is not an exact science and that many partners could themselves testify to the difficulty of determining the value of a particular partner in any given year. If HMRC try to go down that road we can expect no end of arguments.

This potential legislation clearly has some way to go before we know exactly where we are going to end up. It is difficult to see how HMRC are going to be able to introduce this without some kind of judgement call. A previous attempt to impose a similar sort of judgement in a different area (income shifting) collapsed embarrassingly a few years ago and maybe this will too.

Nevertheless, one has to assume that HMRC has learned from previous mistakes and will find a way to catch at least some of the areas identified in the document. We will be following this closely and will participate in the consultation.

So what should clients do who may be caught by these possible changes?

Firstly, the changes are not intended to take effect until next April and so existing arrangements will not be affected this year. There is absolutely no need to take precipitate action.

Secondly, the role of the corporate partner is clearly going to come under the microscope if the proposed changes are made and it would be useful to consider whether or not it does in fact perform a significant function – or could be changed to do so.

Thirdly, some further consideration of future business structure might be appropriate as matters develop. Obvious options include continuation of the same structure but with a lower profit share, reversion to a partnership or LLP of individuals or even full incorporation. Partnerships made up entirely of corporate entities are not affected by these proposals and may also be appropriate in some cases. Fundamental changes to business structures will take some time to put in place (particularly for law firms) and continuation of the existing structure with a lower profit share may be appropriate as an interim response if insufficient time is left after the outcome of the consultation becomes clearer.

Fourthly, some firms will be considering whether or not they should establish a corporate partner. I think it is clear that they should proceed only if the savings in the current year are likely to exceed the cost of the exercise.

The consultation proceeds until early August. Watch this space for updates.