Armstrong Watson's Response to the Consultation Document of 20 May 2013

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Introduction

- Our comments relate to the proposals made regarding 'mixed partnerships' and the allocation of profits but we make some additional comments which we believe could provide a better way forward for the taxation of different business entities. Other parts of the original consultation document would be affected by our suggestion if adopted.
- In the first instance we acknowledge that company members of partnerships pay tax at a lower rate than individual members and that, where excessive advantage has been taken of this differential, then it is reasonable for HMRC to look at ways in which the practice can be limited.
- Having said that, we are pleased to see that HMRC recognises (paragraph 3.9) that mixed partnerships can be legitimate structures and do not necessarily exist in order solely to obtain a tax advantage

HMRC Proposals

2.1 The proposals in paragraphs 3.33 to 3.37 include two difficult subjective judgements.

2.2 Firstly, there is the tax motive stipulated in paragraph 3.33 which may in some cases be difficult to sustain. Clearly there will be plenty of grey areas here as the differential in tax rates makes it difficult to deny that a tax benefit does usually accrue. It would, however, be disappointing if the mere existence of a tax benefit were considered sufficient reason to trigger the counteraction provisions.

2.3 In practice, the majority of these mixed partnerships will be small businesses where the nature of the business structure is certainly a decision usually taken with tax in mind although it is not necessarily the only or the most important factor. Despite the attractions of mixed partnerships, the commonest structure for reliably profitable businesses is full incorporation which provides the attraction of avoiding higher rates of income tax on retained profits. Where tax is the main driver, it seems likely that any substantial moves against mixed partnerships will result in more full incorporations effected purely for tax purposes. If the intention is to create a level playing field between different business structures, then it will not be successful; it will merely disadvantage those wishing to use a mixed partnership. It is not clear to us that there is any public policy benefit in full incorporations done for tax purposes over mixed partnerships done for the same reason.

2.4 The second judgement made relates to the counteraction which, it is proposed, should be on a fair and reasonable basis. This is likely to be a very difficult area in practice. Those partnerships where profits are not split equally often have complicated and internally contentious methods of profit allocation. There is certainly no easy answer to this or objective test that can be used to determine fair and reasonable profit allocations. It is likely that the introduction of such a subjective test for profit allocation will simply increase the number of protracted enquiries into these businesses. HMRC Inspectors will have little alternative and entrepreneurs will be diverted from focusing on their businesses at a time when the country is actively encouraging growth through tax reliefs and lower taxes.

2.5 Corporate partners where proper business functions do not exist might well not 'deserve' a profit share – other than interest on partnership capital or some similar arrangement. Such moneybox companies could be relatively easy to judge. In practice, however, many corporate partners will perform a real business function; it has certainly always been our view as a firm that they should. The real difficulty will come with the valuation of this role unless it is intended that the proposals should be limited to extreme cases only although one can see obvious difficulties in defining such extreme cases and making the proposed legislation effective in such circumstances. It might also be reasonably anticipated that, in such cases where there had been little or no role in the past, then one would probably be created or enhanced in future to minimise the impact of the proposals. It also seems very likely that these proposals will be cumbersome and difficult to implement in practice because of the lack of an objective test mentioned above.

2.6 If profits are reallocated from a corporate partner to an individual partner for tax purposes, then a further issue arises. The profits may have been moved for tax purposes but, in reality, they still belong to the company. In the absence of further provisions, there would be the possibility of some sort of a tax charge if those profits were subsequently distributed by the company or paid out as remuneration. This would obviously create an effective double charge to tax which would create its own unfairness.

2.7 Furthermore, it seems only reasonable that if this area of perceived unfairness is to be reviewed then, so should other areas of the tax code which discriminate against those legitimately trading through a mixed partnership. One area of concern is the restriction of 100% capital allowances for mixed partnerships. These tax reliefs are meant to encourage investment and drive growth.

A more fundamental approach

3.1 HMRC has correctly identified that, where what we have described as moneybox companies exist, then there is a justifiable cause for concern on behalf of the taxpayer. Nevertheless, the proposed remedy does we would suggest provide real concerns about the practicality of its operation as well as introducing a new difficulty for which a solution would have to be found.

3.2 We would suggest that the real problem here is that outwardly similar businesses which have different legal structures have completely different tax profiles. This means that tax is often an important driver for the decision on the most appropriate business structure. This cannot be ideal from a public policy point of view. Indeed the issues raised here go much further than mixed partnerships. The different methods used to tax different structures create a substantial market distortion.

3.3 Where a business is owned by a relatively small number of people then in an ideal world it and its owners should pay much the same sort of tax whether it is constructed as a limited (or unlimited) company or a partnership (or LLP). The structure would then be determined for commercial reasons alone and small business would be the more efficient for it.

3.4 We acknowledge that the creation of a tax level playing field is not easy but we believe that the proposed counteraction is probably unworkable. We recommend that the proposals regarding profit reallocation for tax purposes be withdrawn and a working party be set up to examine the whole basis of small business taxation with a view to producing consensus recommendations early in the next parliamentary session.