Office of Tax Simplification
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Consultation on Partnership taxation: proposals to clarify tax treatment

Response by the Office of Tax Simplification

1. Introduction and summary

1.1 The focus of the OTS is on simplification of the tax system. That encompasses two broad arms: technical simplification (simplifying the legislation and rules) and administrative simplifications (making the tax system easier to deal with). An important component of the latter is delivering certainty: a system that gives certain outcomes is easier to deal with. We therefore support the aim of this consultation in seeking to provide clarity and thus certainty in some areas of the partnership taxation system[1].

1.2 The consultation refers to the most recent of the OTS's three reports on partnerships taxation, published in January 2015. However, although we can broadly support the proposals, we do so with considerable disappointment that more ambitions reforms, likely to be of greater help to taxpayers, are not being taken forward.

1.3 We will be engaging with HMRC more widely on recommendations from our various reports that have not been taken forward or rejected for reasons we understand. Our partnerships proposals are among them and we look forward to a fuller discussion with those responsible for advising on partnership taxation in HMRC. We would like to think that one encouraging feature of the current consultation is that it signals a willingness by HMRC to look at how the tax system around partnerships can be made simpler and more efficient.

2. The Office of Tax Simplification

2.1 The OTS is an independent office of HM Treasury, established in 2010 to provide independent advice to Ministers on ways of simplifying the UK tax system. In developing our recommendations we carry out extensive evidence gathering from all those involved with the tax system – businesses large and small, individuals, representative bodies, advisers and HMRC. Our recommendations cover both technical and administrative aspects of the tax system.

2.2 The OTS is now established on a statutory basis by FA 2016 with an expanded remit. As well as researching specific areas of the tax system as requested by Ministers, our new remit now puts greater onus on the OTS to actively seek areas of complication and responding accordingly. And it is in that context that we comment on this consultation.

[1] In using the term 'partnership taxation system' we are well aware that partnerships are transparent for tax purposes and that it is the partners who are subject to income tax (and NICs). But we hope HMRC will accept it as a convenient shorthand.

3. Responses to the consultation questions

3.1 Clarification of who is the partner chargeable to tax

This seems a modest and sensible proposal. It is not an issue that we had raised as a concern so we do not see it as making any significant difference to partnerships. We wonder if it is more about protecting the exchequer.

3.2 Business structures that include partnerships as partners

As paragraph 3.1 in the consultation notes, this issue did come up in the OTS work. However, the conclusion we drew in framing our recommendation was that the use of partnerships in funding arrangements is evolving rapidly. Accordingly it seemed to us that the need was for there to be a liaison group involving groups such as BVCA with HMRC and HMT; the aim of the group would be to identify problems such as the issue highlighted in this section of the consultation and at the same time demystify the structures for HMRC.

At the time, our recommendation was rejected on the grounds that this could be dealt with by 'Working Together'. Given that Working Together is aimed at small practitioners and everyday administrative issues for individual and small business clients, we did not see the logic of this. In many ways the issue being addressed by this section of the consultation document demonstrates the need for the sort of group we suggested – which we think would be welcomed by the industry.

We accept Proposal 2 is a sensible way of taking this specific issue forward. However, this presupposes that the nominated partner in a partnership has the necessary power to obtain details of partners in a partnership that is a partner in the firm; we do wonder if there will be instances where this is not possible and whether HMRC will need to take further powers to address this which may add to complexity.

3.3 Investment income – tax administration

We noted a number of Investment income points, particularly around non-UK partners, in our reports; see in particular Chapter 4 of our Final report. The issue raised in section 4 of the consultation is one that was raised strongly with us in meetings. What follows is based on our research in 2013. It may be that the situation has changed since then: we have not gone back to those we spoke to test the situation. But if not, they are a good litmus paper against which to test the current proposals.

As the consultation document recognises, many partners in such scenarios have no exposure to UK tax. Those who do have no trading activity, and tend to prepare accounts on a cash basis, convert them into UK GAAP and then do tax computations for IT returns and CT returns.

It was suggested to us that the most onerous task is returning information on loan relationships, where separate and different computations are needed for individual and corporate members. The SA800 isn't geared up for a corporate member. In the end company items go into the white space. The HMRC online system did not at the time allow filing a mixed CT/IT partnership return so those we discussed the issue with filed a pdf of the CT return.

It is not clear there is a need for a partnership return in such situations at all.

- The corporate partner needs to declare a share of the profits, and the return does give HMRC assurance that their partnership share is correct.
- But an alternative might be to include the partnership accounts with the CT return, using a similar process to CT returns for UK branches of foreign companies – they fill in a CT return and send in accounts for the foreign company, with a linking tax computation. The costs of compiling and filing the partnership return is significant.
- Or there could be a targeted return, making parts optional or with a simple list of partners with a tick box to say X does not have any UK tax liability.

UTRs have been a problem for non-resident partners. Each partner gets a different UTR for each fund they invest in, so one investor could have 40 or 50 UTRs, which can be confusing for everyone.

Partners are treated as connected persons even in some cases where there is no business or family connection between them. This seems silly for funds where the only connection is that they happen to both be investing in the same fund.

3.4 Trading and property income – tax administration

We can see that the option in Proposal 4 for payment on account has some attractions but wonder whether it would really solve the underlying issue. How serious a matter is this for HMRC? We would be concerned if a change aimed at tackling a perceived abuse in limited situations added to complexity around payments on account for most ordinary partnerships.

We would note under this heading that our finding was that one of the most significant problems for partnerships in tax administration was complexities around basis periods and opening years. The response we received at the time from HMRC was that this was not just a partnerships issue (which we had spotted), with the implication that nothing much could be done. We are pleased to see that the Making Tax Digital proposals do seek to tackle this area and recommend that work should be extended to partnerships.

3.5 Allocation and calculation of partnership profit

We noted during our work that difficulties or uncertainties can arise over profit allocation, usually with regard to non-trading income or capital gains. Sometimes a partnership agreement specifies how trading profits are allocated but can be silent about capital gains; sometimes gains are treated as to be allocated in line with capital subscribed.

Our starting point would be that the partnership agreement should be followed in terms of profit sharing, whether for trading income, investment income or gains. That should include where the agreement has different allocations for the different types. That seems to us to give certainty and simplicity, so we agree with Proposal 5. The suggestion in para 6.4 seems uncontroversial, in the sense that to us it would be interpreted as a change (or decision) on the agreement.

At one level Proposal 6 seems uncontroversial, if the aim to prevent any changes in profit allocation formula between the 'raw' trading income and the trading income as adjusted for tax purposes. However, if Proposal 6 is an attempt to say that the allocation of investment income received by a partnership and capital gains made by the partnerships must be

allocated in the same way as trading income, then we cannot agree. There can be good grounds for differing allocations – trading income representing current work input, capital gains representing investment for example – for allowing differences. That is both commercial and simple.

3.6 Other matters

In response to question 9, we would reiterate our recommendation for partners to be able claim allowable business expenses that are personally incurred from their profit share, where the partnership agreement is set out on that basis. Our evidence showed that this would result in many cases in returns being completed sooner - and easier. This would not be a compulsory route as in many cases we heard that the partnership would prefer to keep all expenses claimed through the firm and systems are set up to achieve this.

HMRC's rejection of this proposal centred on two issues:

- The potential cost to the exchequer: although we understand HMRC's point that this route would result in claims for expenses that would otherwise not be made, the implication is that legitimate expenses are being denied relief by the current system. That cannot be right.
- The risk of double claiming of expenses: given the controls around expenses claims generally, we fail to see that this is a real issue.

We would urge that this be reconsidered. In this connection, we note that of the 29 recommendations in our interim report, at the time of our Final Partnership Report (January 2015) there were responses from HMRC of 6 'yes', 8 'no', 2 'partly' and 13 'under review'. We will be discussing these items and the recommendations in the final report with HMRC shortly as noted in para 1.3 above.

The Office of Tax Simplification
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