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cc 1/Revenue

10 DOWNING STREET

From the Private Secretary

8 October 1984

Partnership Taxation: Basis of
Assessment

The Prime Minister has seen the Chancellor's minute of 28 September and has expressed concerns about the course he is proposing, in particular the decision not to pursue the introduction of a current year basis of assessment.

Andrew Turnbull

cst

David Peretz Esq
HM Treasury.

file

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cc 1/Revenue

5 October 1984

This is just to record that the Prime Minister has seen the Chancellor's minute of 28 September about the basis of assessment of partnership taxation. She is grateful to be kept informed of progress.

Timothy Flesher

Miss Margaret O'Mara,
H.M. Treasury.

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PRIME MINISTER

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Of 2/10

PARTNERSHIP TAXATION: BASIS OF ASSESSMENT

In 1977-78 and again in 1979-80 the Public Accounts Committee were very critical of the ease with which partnerships could avoid income tax. The main way in which they can do this is by arranging for their profits to fluctuate from year to year and by then making partnership changes (which effectively wind up one business and start another) at appropriate times. Because of the rules of assessment for the opening and closing years of a business, years with low profits can then form the basis of assessment two or three times, while years with high profits are never assessed.

2. When I was Financial Secretary to the Treasury I announced in the course of one of the annual debates on the PAC reports that a consultative document on this matter would be issued. Subsequently, however, Geoffrey Howe decided that the issue should be considered, and a consultative document should be prepared, in the context of wider changes in the handling of Schedule D generally, including the possibility of introducing a current year basis of assessment. Because of the difficulties, particularly the political difficulties in that wider course, I have now decided to consider these further aspects on a longer timescale and to limit the document to its original purpose.

... 3. I thought that you would wish to be aware of the progress being made and I attach a copy of the document. Just before the recess John Moore announced that it would be published around now and the news did not attract a great deal of comment in the professional press. I believe that even those who benefit



from the avoidance recognise the present position cannot be justified.

XL.

N.L.
28 September 1984

PARTNERSHIP TAXATION: BASIS OF ASSESSMENT

INTRODUCTION

1. In answer to a Parliamentary Question on 25 July 1984 the Financial Secretary to the Treasury, Mr John Moore MP, said that he had authorised the Inland Revenue to issue a consultative document on the avoidance of tax by partnerships (Hansard, 25 July 1984 Col 637, Written Answers).

2. As Mr Moore said, attention was drawn to this form of tax avoidance by the Public Accounts Committee in two reports (Sixth Report in Session 1977-78 and Eighth Report in Session 1979-80). The Committee said that many partnership changes were arranged to secure the maximum tax advantage. The process was repeated at regular intervals, with the result that part of the profits earned over the life of the business was normally excluded from assessment to tax. In their view an equitable tax system required that all the profits should be assessed; and they hoped that every effort would be made to find a way of giving effect to that principle, either by the adoption of a current year basis of assessment or, as an interim measure, by some other means. This paper considers some of the ways in which effect might be given to their recommendations.

3. The views of interested parties and of others would be welcomed on these possibilities. Comments should be sent to Inland Revenue, Policy Division, Room 125, New Wing, Somerset House, London WC2R 1LB by the middle of November.

BACKGROUND

Partnerships

4. There are about half a million partnerships in the United Kingdom. Almost any form of business activity may be undertaken by them and they form an important part of the business sector. They range from two member trading partnerships operating in a local environment to large international firms commonly found in the professions. In general the maximum number of partners allowed in any firm is 20, but since 1967 this limit has not applied to accountants, solicitors and members of the Stock Exchange, and some firms now have over 200 partners. The latest analysis available [1981] of the number of partners in each firm is:

Total			457,221
of which	3 or more partners		86,639
"	4	"	30,276
"	5	"	9,175
"	10	"	951
"	20	"	189

5. Partnership is defined in Section 1(1) of the Partnership Act 1890 as "the relation which subsists between persons carrying on a business in common with a view of profit". Carrying on a business in partnership imposes particular obligations on partners as regards their liabilities to their fellow partners and others. Under English law a partnership is not a separate legal entity and the business is carried on not by the partnership but by the partners jointly. Under the different rules of Scottish law a partnership is a legal "person". In practical terms there is no distinction between Scottish and other partnerships in the matters considered by this document. But under both

systems each combination of members is in law a separate partnership and any change in its members brings it to an end.

Basis of assessment to tax

6. The profits of a business carried on by a partnership of individuals are computed under the normal rules of Cases I and II of Schedule D. The tax on those profits is charged in one sum in a joint assessment in the name of the partnership and not by way of separate assessments on each partner. The tax is calculated by allocating the assessable profit among the partners according to their respective rights to share in the profits of the year of assessment (not in the year used as the basis for that assessment) and the partners bear joint liability for the tax so charged.

7. Each time that there is a change in the partners carrying on a business, and whether or not the business continues more or less as before, its profits are computed as if it had been permanently discontinued and a new business set up and commenced. However where at least one individual is carrying on the business both immediately before and after the change and if all the partners in both the old and the new partnerships agree, the partnerships are assessed as if the business were continuing and the special rules for the opening and closing years of an unincorporated business are not applied.

The commencement/cessation cycle

8. Under the normal rules of Case I and II of Schedule D unincorporated businesses (both sole traders and partnerships) are assessed to income tax in any year on the profits of the 12 months period of account ending in the previous tax year. This rule is modified in the opening and closing years of business. The assessment for the tax year in which a business starts is based on the actual profits

arising in that year; for the second tax year it is based on the profits of the first 12 months of the trade or profession; and for the third year (and subsequent years) it is based on the profits of the 12 months account ending in the previous year. In the closing year (and in the two previous years if the profits are higher than on the preceding year basis) the assessment is on the profits actually made. The result is that in the normal way the profits of the first year form the basis of up to three years of assessment, while on a cessation the profits of a corresponding period of up to two years fall out of assessment altogether.

9. These rules almost always result in a mismatch between the profits earned over the lifetime of a business and the profits assessed to tax. In general the benefit lies with the taxpayer since the profits assessed more than once at the beginning of the business will usually, but not always, be less than the profits not assessed at all at the end, even setting on one side the effects of inflation. However in the ordinary way the commencement and cessation rules will apply only once over the lifetime of a business.

10. When applied to partnerships however these rules on the opening and closing of a business may operate more than once and can give rise to substantially greater reductions in tax liabilities. This is because, as explained above, on each occasion when a new partner is admitted or a partner retires, the partnership has the opportunity, quite legitimately, to choose between treating its business as ceasing (and hence as a new business commencing) and electing to regard it as continuing. In a big firm there will inevitably be partnership changes every year, while a small firm can often arrange to have a partnership change when it is most advantageous.

11. In the large firms a commencement/cessation cycle can be arranged every five or six years; and within that period the profits for some years will be taxed two or three times while for other years the profits will not be taxed at all. A firm with frequent partnership changes can arrange, quite simply, that a change before a year of abnormally low profit will be treated as the occasion for a cessation for tax purposes. With a little more sophistication, involving, for example, the transfer of work in progress, the profits of the year which is to be taxed more than once can be substantially reduced to below the normal figure and the profits which fall out of the tax charge will be very much greater.

12. Example A firm with a continuing business and partnership changes every year starts a new partnership for tax purposes in 1980 and closes it in 1985. In the intervening years the partners elect for the partnership to continue. The firm makes up its accounts to 5 May. Its actual profits and work in progress are running at the same level each year but by transferring the work in progress from the old firm to the new firm at a figure considerably in excess of cost, (in this example for £1,080,000 more than the normal valuation) it ensures that its accounts show an abnormally low profit for the first year of the new partnership.

Profits				Income tax		
<u>Year to 5 May</u>	<u>Amount</u>	<u>Year of</u>				<u>Amount</u>
	<u>shown</u>	<u>asses-</u>	<u>Basis</u>	<u>Basis period</u>		<u>assessed</u>
	<u>(000s)</u>	<u>ment</u>				<u>(000s)</u>
1981	120	1980-81	Actual	6 May 1980 -5 April 1981		110
1982	1200	1981-82	First 12 months	6 May 1980 -5 May 1981		120
1983	1200	1982-83	*PY	6 May 1980 -5 May 1981		120
1984	1200	1983-84	/PY	6 May 1981-5 May 1982		1200
1985	1200	1984-85	/PY	6 May 1982-5 May 1983		1200
		1985-86	Actual	6 April 1985-5 May 1985		100
	4920					2850
Assessed on old partnership	1080					1080
Actual profits	<u>6000</u>			Amount assessed		<u>3,930</u>

*The partners do not elect for the actual profits to be assessed.

/ No cessation adjustment is necessary for these two years since the actual profits are the same as the profits on the preceding year basis.

Taking the figures for the new partnership in isolation, 42 per cent of the profits have not been taxed. However, as a result of the disposal of the work in progress, there will be an increase in the profits of the final year assessed on the old partnership. To that extent the amount unassessed will be lower than shown. Nevertheless there

will still be a considerable shortfall of 34.5 per cent in the amount taxed, $6000 - (2850 + 1080)$, and this process could be repeated at five-yearly intervals.

13. At the time of their enquiry, the Public Accounts Committee found that in a selection of 13 partnerships some £m12 or 23 per cent of the actual profits had escaped assessment with the individual amounts ranging up to more than £m2 and up to 35 per cent of the profits in some cases. Very many partnerships pay tax on the full amount of their earnings; but the latest estimates suggest that the amount of tax being ~~avoided~~ by other partnerships could be of the order of £m30 which, allowing for changes in earnings and tax rates, remains very much in line with these earlier figures. In addition in some cases substantial accumulated profits have not been charged to income tax because of the use of a basis for computing profits other than a full earnings basis (see paragraph 35 below).

14. The next section of this paper is concerned with possible ways in which the opportunities for partnerships to take advantage of the opening and closing rules for businesses could be eliminated or at least reduced. In considering the various possibilities outlined, the Government will wish to be satisfied that the effects on the firms and their partners are not unduly onerous; and that the administrative costs on the Inland Revenue and the compliance burden on firms are acceptable.

POSSIBLE CHANGES TO THE PRESENT RULES

Current year basis of assessment

15. As the Public Accounts Committee pointed out, the use of a current year basis of assessment for unincorporated businesses generally would ensure that the profits assessed always equalled the profits earned over the lifetime of a business. A current year basis would therefore

automatically eliminate the present loss of tax from partnerships simply because there would be no opportunity for profits to escape assessment.

16. The introduction of a current year basis of assessment however would raise questions which go very much wider than partnerships. The paper is solely concerned with measures which could be taken within a system in which assessments are made generally on the profits of the previous year.

Individual assessment of partners

17. One possibility would be to assess each partner individually on his share of the partnership profits as if he were carrying on a business which started when he joined the partnership and ended when he left it. But this would bring the complication that for any year of assessment some partners might be assessable on a previous year basis and others on a current year basis. There would also be difficult technical problems such as, for example, in allocating capital allowances. Up to 400 additional Revenue staff would be required because of the extra work arising from assessing and collecting tax from all partners separately, and by the same token there would be more work in total for partners and their advisers.

18. One of the possibilities suggested by the Public Accounts Committee was that the benefit of the commencement and cessation provisions should be denied to the continuing members of a partnership but allowed to departing or new members. This would give rise to the same sort of difficulties as with individual assessments, but the application of the provision and hence the frequency with

which the technical problems would arise would be less: accordingly the administrative consequences would be less serious. Nonetheless at first sight an approach along these lines would appear to have considerable disadvantages.

Mandatory continuation

19. A second possible approach would be to provide that, although each successive partnership should be assessed separately, the profits of a firm carrying on a continuing business should be assessed on the previous year basis; the commencement and cessation rules would apply only when a business actually began or ended. This would more closely reflect reality for large partnerships where a change in the members usually has no appreciable effect on either the business or its profitability.

20. One question which the Government will wish to consider is whether continuation treatment throughout the life of a business might cause hardship to new partners. First, a partnership change may in some instances fundamentally reduce the size and profitability of the business - for example on the retirement of a senior partner in a small firm - leaving the remaining partners liable to tax on the higher profits of the old partnership; and second, while a change in partners may not affect the ongoing level of business profits, an in-coming partner may find himself liable to pay tax on more profits than he is entitled to receive.

21. On the other hand, continuation elections are often made following a partnership change and a new partner may frequently find himself in this position. In particular, for partnerships taxed on a conventional basis (see paragraph 35 below), a continuation election is usually essential: if it is not made, the consequences will often be a substantial tax charge for the reason given in paragraph 39. When there is a change in the partnership

arrangements the old and new partners often have to settle a great many matters besides tax and it might not be unreasonable to assume that the taxation consequences of continuation could be left as a domestic matter for the partners in reaching a new partnership agreement.

22. Alternatively, mandatory continuation might not apply to all partnership changes. It might be possible, for example, for continuation to apply automatically only where there was a substantial common interest (eg 75 per cent) between the old and new firms. However there could be an additional measure of complexity in ensuring that this operated satisfactorily.

23. Mandatory continuation would be administratively simpler for both the Revenue and for taxpayers than the present system. Even though each partnership would still need to be assessed separately, it would no longer be necessary to adjust the assessments for previous years following a change.

Greater use of the current year basis

24. A third possible approach would be to apply the current year basis to partnerships generally, even though the present rules (set out in paragraph 8 above) were being maintained for sole traders - the difference in treatment would then be justified on the grounds that the scope for manipulation of the opening and closing rules by sole traders was very considerably less than the Public Accounts Committee had found was being practised by partnerships. If it were felt however that to apply the current year basis to all partnerships would be carrying the logic of this argument too far, then the previous year basis might be retained but the extent of its use restricted.

25. Mandatory Cessation. Under one variant of this approach each change in the members of a partnership would be treated for tax purposes as a cessation of the business. Mandatory cessation would effectively result in large firms with frequent changes in composition being permanently taxed on a current year basis, but small firms with less frequent changes of partner would remain relatively unaffected.

26. Although (as with mandatory continuation) there would be no possibility of a new partner being required to pay tax on the profits earned before he joined the firm, mandatory cessation could also pose difficulties for firms. Given the tendency for profits to rise, the effect of the closing rules is normally to require an adjustment to the assessments for the two years prior to a cessation. As a result there could be further and possibly unexpected bills for some partners. There would also be problems for partnerships now assessed on a conventional basis for the reasons discussed in paragraph 39 below.

27. The additional work involved in reviewing the assessments and making adjustments would add both to the administrative costs of the Inland Revenue and to the compliance costs of firms. Moreover mandatory cessation could also have an adverse effect on the cash flow to the Exchequer. At present in the year of a partnership change, tax is paid on a provisional basis on the normal due dates until the necessary continuation elections are made. Mandatory cessation might delay the payment of tax until at least 12 months after the commencement of the new partnership and there could be considerable delay in settling the individual partners' liabilities.

28. One way of cutting down the use of the preceding year basis, which would at least reduce the difficulties suggested above, would be to apply the current year basis permanently where continuation could have, but had not, been claimed even though there was a substantial common interest

between the partnerships. On this approach, following a comparatively minor change in the interests in a partnership, the partners would be able to choose between electing for the continuation treatment or having the cessation provisions applied to the old partnership and the permanent adoption of the current year basis for the new (and any subsequent) partnership.

29. Extension of existing commencement and cessation rules.

An alternative way of getting round the difficulties seen under this head would be to retain the present election for the continuation basis, but to provide that, on the cessation of a partnership and on the commencement of a new partnership, the current year basis should be used for a longer period - for, say, the last four years of the old partnership and/or the first four years of the new partnership. This would ensure that a large firm which elected for continuation regardless of partnership changes was unaffected, but at the same time it would reduce, although not eliminate, the opportunities for avoidance. The minimum length of the commencement/cessation cycle described above would be increased from five to nine years.

30. The advantage of this approach would be that it would be simple and require little change from the existing rules: in practice its existence would probably have the indirect effect of ensuring that many firms remained permanently on a previous year basis. The administrative burden for the Revenue and the compliance costs for firms would be broadly unchanged.

31. On the other hand, this approach would entail different rules for partnerships from those for other unincorporated businesses and it might be thought to impose an undue burden in cases where the mismatching of profits arose from the normal operation of the rules rather than from the contrived arrangements which the Public Accounts Committee sought to prevent. The latter objection could itself be met by

extending the use of the current year basis only in those cases where the profits of the opening year of a new partnership were abnormally low compared with the previous and succeeding years: however clearly the simplicity of this approach would then be lost in the detailed rules needed to determine what were abnormally low profits.

Balancing adjustments

32. A fourth approach would be that suggested by the Public Accounts Committee. The present election arrangements would be left as they are, but the mismatching between profits earned and profits assessed over the life of a partnership would be overcome by a balancing charge or credit in the final year of assessment when there was a cessation for tax purposes.

33. A difficulty in this approach is that many larger partnerships elect for the continuation basis to be applied on a change of partner so that they would not therefore be affected for very many years. When in due course they were - and if the records were then available - the partners in the business at that time would have to bear the liabilities which had accrued many years before. To alleviate this problem the pattern of earnings and assessments could be reviewed at regular intervals - say every five or ten years - with balancing charges or credits made accordingly. Nonetheless it might still be argued that new partners could find themselves bearing liabilities which had properly accrued to their predecessors, but that they had had no means of indemnifying themselves against these liabilities at the time that they entered the partnership. Similarly they might effectively receive repayments of tax actually paid by their predecessors.

34. It could also be argued that this solution would go further than was strictly necessary since it would deal with the mismatch between profits earned and taxable profits which may apply to all businesses and not simply to partnerships. On this argument, if the possibility of a balancing charge or allowance is to be pursued, it should apply to all businesses and not just to partnerships. In any event there would be a substantial administrative burden both for the Inland Revenue and for the firms themselves.

A CONVENTIONAL BASIS OF ASSESSMENT

Use of a conventional basis

35. So far this document has been concerned only with partnerships which take advantage of the commencement/cessation cycle to reduce their taxable profits, either by arrangement or in the natural course of events. Some partnerships, however - in particular medium size and big professional firms - remain permanently on a preceding year basis. While in these cases there will be no mismatching the full amount of earnings made by the firms may not be brought within the tax charge. This is because professional firms not infrequently draw up their accounts on what is known as a conventional basis. Perhaps one in four or one in five of the larger firms do so; so that when account is also taken of firms who use the commencement/cessation cycle less than one firm in two is assessed on the full measure of its profits.

36. The most usual reason why a firm on a conventional basis may not be assessed on a full earnings basis is that professional work in progress will be left out of account. The result is that any increase in its value year by year is not brought into the tax charge nor is a deduction given for any reduction in it. Before the introduction of modern accounting techniques it was more difficult to value work in progress and it may often have been simpler for both the

firm and the Revenue if work in progress were ignored: before the war or even in the 1950s the expectation was that, for an established business, taking one year with another, such a conventional basis would produce broadly the same tax results as the full earnings basis. It was therefore a useful measure of simplification. In practice however the result has generally been to favour the taxpayer so that by now there is a shortfall, running into seven figures in some of the largest cases, in the accumulated profits which have been charged.

37. Although a conventional basis of computing profits may be used by all professional businesses, whether partnerships or sole practitioners, in practice it is mainly in the large partnerships that the difference between profits on a conventional and on an earnings basis is most marked. Moreover the use of this basis is more objectionable in the case of partnerships, since it is inevitable that a business run by a sole practitioner will one day come to an end and (leaving on one side questions of cash flow as well as the mismatch to which reference has already been made) any amounts which have not previously been assessed will then be brought into charge. This is not the case with partnerships where the accumulated profits unassessed may never in practice be brought into the tax charge unless mandatory cessation (see paragraph 25 above) were to be introduced.

Withdrawing the use of a conventional basis

38. There is then a case for discontinuing the use of conventional bases of computing profits for professional partnerships at the time that the commencement/cessation cycle is tackled. Firms which are no longer able to benefit from that cycle may otherwise look to a conventional basis as an alternative means of reducing the charge below that on

their full earnings; while those firms which have paid tax on the full measure of their partnership earnings over the years may consider that the time is ripe for all firms to be assessed on the same basis.

39. There would be no difficulty in requiring that all new partnerships should use the earnings basis. Indeed for some time the Revenue has required that the profits of a profession for its first three years should be computed for tax on a full earnings basis. At the same time a conventional basis could be discontinued for future years for partnerships which are already using it. The question which arises however is whether special provision is needed to deal with the transition since the effect of so doing would not merely be to put these businesses onto the full earnings basis, in future. It could also give rise to a substantial charge in the year of change as the opening work in progress now brought into account would immediately become subject to tax under Case VI of Schedule D.

40. This would seem to require some alleviation, particularly since, if the full earnings of these firms had been assessed in the last ten years, stock relief would have been available to cover that part of any increase in the value of work in progress attributable to changing prices. Moreover the partners who would now have to meet the tax charge would not necessarily be the same as those who had previously enjoyed the benefit of the use of a conventional basis. And there may very well be no means by which the new partners could obtain recompense from the old ones. On the other hand there will be many other cases in which the existing partners will be the same as those who enjoyed the benefits of a conventional basis and it is by no means clear why they should be enabled to retain the benefit while partners in other firms have paid tax on the full amount of their earnings.

41. There are a number of ways in which some means of tempering the change could be found. For example, the charge might be limited to any increase in the value of work in progress over say the last six years, possibly after taking into account the stock relief which would have been due - in this way the extent to which new partners would effectively be called upon to pay the liability of the old partners would be reduced. An alternative would be to spread the liability, and thus also the payment, for the additional amount over the following six years. It might be suggested that the amount falling due should be put into cold storage until such time as the business ceased. However, in particular in the case of large established partnerships, this last course could in practice be tantamount to exemption and this would seem to be going too far.

Sole Practitioners

42. It was suggested in paragraph 37 above that the case for withdrawing the conventional basis from partnerships was greater than it was in the case of sole practitioners. Nonetheless if it were to be withdrawn from partnerships, it would be for consideration whether it should be withdrawn from unincorporated businesses generally. The problem arises very largely with partnerships, but where there are sole practitioners on a conventional basis there would be less difficulty in bringing its use to an end; for example, there would be no conflict between the interests of different partners. On the other hand any business run by a sole practitioner will inevitably come to an end in due course so that the matter is of less importance than it is in the case of partnerships.

43. In any event barristers provide a special case. There have always been special rules for members of the Bar which flow from their inability to sue for their fees. Subject to any consideration of the way in which the transition on the ending of a conventional basis is dealt with generally, there may be a case for leaving their tax treatment as it is.

SUMMARY AND QUESTIONS FOR CONSIDERATION

44. During the 1970s the Public Accounts Committee twice drew attention to the extent to which some partnerships were avoiding tax through the use of the commencement/cessation cycle and recommended that action should be taken to bring it to an end. The question arises therefore how this use of the present rules might best be brought to an end, bearing in mind the clear need for partners to be able to carry on their ordinary work without unreasonable burdens being placed on them.

45. There is also a good case for bringing to an end at the same time the use of a conventional basis of computing profits for tax. As a result of its use some professional partnerships have accumulated substantial amounts of income which have not borne tax and which are in practice unlikely to do so under the present rules.

46. The questions for consideration on which comments are sought are whether the commencement/cessation cycle should be brought to an end by:

- a. individual assessment of partners (paragraphs 17 and 18);
- b. mandatory continuation (paragraphs 19 to 21);

c. mandatory continuation where there is substantial common interest between the old and new partnerships (paragraph 22);

d. mandatory cessation (paragraphs 25 to 27);

e. the use of the current year basis where continuation treatment could have, but had not been, claimed (paragraph 28);

f. extending the application of the current year basis within the existing commencement/cessation rules (paragraphs 29 to 31); or

g. the use of balancing adjustments in the last year of a business or at regular intervals (paragraphs 32 to 34)?

47. Should the use of a conventional basis of computing profits for tax be brought to an end at the same time:

a. for all partnerships (paragraph 39);

b. subject, for existing partnerships, to one of the transitional provisions discussed (paragraph 41); or

c. for sole practitioners as well (paragraph 42)?

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