Partnerships: A Review of Two Aspects of the Tax Rules Consultation Response by the Farming Group

The Farming Group

The Farming Group is an inter-disciplinary group of representative bodies from, and professional bodies connected with, the agricultural industry. The majority of the members of this group were previously members of HMRC's Agricultural Industry stakeholder group.

Each of the bodies within this group is involved in accounting and tax matters relevant to our respective memberships. As a result we are able to provide a wide range of representative views from our industry including those of farmers, landowners and their professional advisers.

The members of the Farming Group are:

-National Farmers Union
-NFU Scotland
-Ulster Farmers Union
-The Central Association Of Agricultural Valuers
-Country Land & Business Association
-Scottish Land & Estates
-Tenant Farmers Association
-Agricultural Law Association
-Institute of Chartered Accountants of Scotland
-Farming and Rural Business Group of the Institute of Chartered Accountants in England and Wales

Introduction

The Farming Group has previously met with HMRC's partnership consultation team. We have also provided HMRC with examples of where mixed partnerships are used within the agricultural industry for commercial reasons and as a result of regulatory restrictions. In this submission we are seeking jointly to provide a formal response to the Consultation document on Partnerships: A Review of Two Aspects of the Tax Rules, on behalf of all of the respective members of our individual bodies.

Executive Summary

This group is not seeking to comment on the proposed disguised employment rules, as these are not typically encountered in farming situations, as general partnerships are commonly used rather than limited liability partnerships.

The proposals in respect of partnerships with mixed membership will be retroactive and will adversely affect many long established small partnerships, including farmers who have entered into mixed membership partnerships for commercial reasons.

Our primary concern is that the proposals for mixed membership partnerships will impact on genuine commercial arrangements and so damage business activity. Whilst we can accept that hybrid structures involving companies and LLPs may have been used for tax avoidance motives, mixed membership partnerships are commonly used in the commercial structuring of farming businesses.

The fundamental issues are if, and to what extent, the proposed legislation will be applied to mixed partnerships which exist for commercial reasons but which obtain a tax benefit as a consequence of the business structure used. It is also essential that the legislation does not affect the profits or losses of any activities undertaken solely by the corporate partner.

We question the merit of applying the proposed legislation to all mixed partnerships regardless of size when the stated objective is to counter tax avoidance schemes which seek to manipulate profit and loss shares to gain a tax advantage. We would suggest there should be a de minimis for applying the legislation, for example a company profit share of less than £300k being the threshold for the small profits rate of corporation tax. Below this level it is hard to see how the differential in tax rates would be sufficient to justify the potential costs for both HMRC and the mixed partnership, particularly where profits are retained and reinvested in the business.

Background

The agricultural industry forms the foundation stone of an agri-food sector, which in 2011 contributed £95 billion to the economy, around 7 per cent of the national gross value added. The agricultural industry is however dominated by unincorporated business with in excess of 90% of farm businesses operating as unincorporated businesses in England for example.

Partnerships are a particularly suitable business structure for intergenerational family businesses being both simple to operate and providing long term flexibility in fairly rewarding different generations within the business for the changing contributions that they make to the business over their careers. As a result they are seen as the business structure for farms, which in general take a very long term approach to their businesses. Research conducted by Exeter University for example found that in England 31% of farms have been in the same family since 1900 and 84% of farms are farmed by the 2nd generation of the family.

Although many farms may have been held within the same family for decades they compete in a modern business environment where they are increasingly exposed to external risk and the need for economic efficiencies. As a result farm partnerships, particularly those with larger agricultural businesses, are increasingly including a corporate partner within their business structure to meet commercial, risk protection or industry specific needs.

Our group is particularly concerned that any legislation resulting from this consultation does not adversely affect mixed partnerships which are not the stated target of this proposed anti-avoidance legislation. In addition we wish to ensure that these businesses are not subject to uncertainty over their tax treatment, as all businesses, regardless of their structure, should be entitled to certainty. Unfortunately we believe that the proposed tests are extremely subjective and as a result are not well targeted. Indeed they could be interpreted in a way as applying to any mixed partnerships with a corporate partner where an incidental tax saving is made. In addition they could then be applied in a way which automatically cancels out any tax saving regardless of whether this is actually a true and fair result.

The issue of unfairness in the tax system

The consultation document implies that it is unfair that mixed partnerships are able to access the corporate tax rate. It recognises that there may be wholly unrelated reasons for using this form of business structure, but considers that this access to a lower rate of tax overrides these reasons and that legislation is needed to counter any tax advantage gained.

Whilst the Farming Group does not condone aggressive tax avoidance arrangements with the sole purpose of achieving a tax reduction we question if the proposed solutions in the consultation document are sufficiently well targeted.

In considering the issue of unfairness in the tax system we also question why the government believes it is fair to apply a significantly lower rate of tax to corporate entities compared to equivalent businesses operating as partnerships. We would suggest that the significant reductions in the rates of Corporation Tax over the last five years have largely been achieved at the cost of abolishing industrial and agricultural buildings allowances and reducing the rates of capital allowances for both partnerships and corporate entities. The resulting increase in the effective rate of income tax for partnerships which invest significant amounts of their profits in primary production buildings and equipment is in our opinion inherently unfair and inhibits investment and growth.

We are also disappointed that the consultation document completely ignores the tax disadvantages of operating as a mixed partnership. We would suggest it is essential to recognise that trading through a mixed partnership also carries a significant tax disadvantage for businesses which invest heavily in equipment, given that S38A(3) CAA 2001 denies the Annual Investment Allowances for mixed member partnerships. This gives rise to a deferral of the tax relief on qualifying capital expenditure, and might be argued to compensate the Exchequer for the deferral of the payment of tax on profits retained within the company at lower Corporation Tax rates. In addition for the purposes of transfers of land into and out of a partnership, a company is not regarded as a connected person for the purposes of calculating the Sum of the Lower Proportions. This gives rise to SDLT charges which would not arise in a farming partnership of connected family members.

In our experience if a mixed farm partnership structure is being used to try to obtain a tax advantage it is this need to reinvest profits which is most likely to be the key driver rather than trying to extract profits at a lower rate of tax. Any tax advantage gained is therefore likely to be mainly a timing difference and given that the corporate member will almost certainly be a close company, potential savings will often be countered by a charge under Section 455 CTA 2010 applying to loans back to the partnership. We would also suggest that it is unlikely that any profit share received by the company would be extracted by the individual partners using the sort of complex arrangements outlined in the consultation document as any potential savings for a business of this size would be relatively small. It would seem to us that the suggested methods of extraction at much lower or nil rates of tax would be limited to those participating in a large marketed tax avoidance schemes or large businesses.

Drivers for corporate partnerships

The group identified a number of areas where mixed partnerships exist within the agricultural industry for both industry specific and commercial reasons rather than to gain a tax advantage and we have set out further details and examples below:

Industry specific reasons for mixed partnerships

As the group highlighted, full incorporation is not an option open to the majority of tenant farmers, as land tenure arrangements place severe limitations on their ability to fully incorporate their businesses. Given that in excess of a third of land in England & Wales is farmed under some form of tenancy this is a significant barrier for a large section of our industry.

We believe that a landlord of agricultural land would generally wish to avoid granting a Farm Business Tenancy to an unconnected limited company. The landlord and tenant relationship necessarily involves a level of trust between the parties and landlords choose their tenants very carefully. Letting land to a limited company would remove a landlord's ability to control who their tenants is, given that the ownership of the limited company could easily be transferred.

However the main issues which prevent a tenant farmer from full incorporation relate to the provisions of Agricultural Holdings Act 1986 tenancies. As a result a tenant under this form of tenancy is extremely unlikely to either enjoy the protection that a full incorporation may afford their business or access the corporate rate of tax. As a result they may have no other option than to trade through a mixed partnership which includes a limited company.

The existence of a lifetime tenancy under the Agricultural Holdings Act 1986 would prevent full incorporation as the tenancy must be maintained in the name of the specified tenant. There is general comment on agricultural tenancies at:
http://www.hmrc.gov.uk/manuals/ihtmanual/ihtm24211.htm
and
https://www.gov.uk/agricultural-tenancies.

It should be noted that an Agricultural Holdings Act 1986 tenancy can have significant value and must be retained as they exist for the lifetime of the named tenant(s) and are, in general, not transferrable. In addition they generally allow for two successions to the tenancy and as a result it is extremely important for a family farm business holding such a tenancy to do everything in its power to ensure that the availability of the two successive tenancies are retained and utilised.

If the terms of the tenancy are breached, for example by parting with possession to a limited company, then the named tenant's lifetime security of tenure can be lost by forfeiture of the tenancy by the landlord.

Two examples are:

-Tenant – sharing possession allowed – partnership with company obvious solution

In many cases an individual is the tenant of a holding under an Agricultural Holdings Act 1986 tenancy. He may be entitled to share (e.g. by a partnership) but not part with possession (e.g. to

a company). The tenancy is valuable and must be retained. If either limited protection or access to corporate tax rates is wanted a mixed partnership is the obvious solution, as a full incorporation could result in the landlord terminating the tenancy.

-Full agricultural tenancies – succession – company for income from off the holding.

Where farming partnerships are founded on a traditional Agricultural Holdings Act 1986 tenancy, significant income from sources other than the tenanted landholding can prevent the next generation succeeding to the tenancy. In many cases loss of succession will have severe repercussions for the viability of the farming business. To address this risk, a farm contracting business (that draws income from off the holding) is separated into a limited company. The current tenant holds shares in the company and receives part of his income from that side of the business. The potential successor to the tenancy will then draw *his* income from the farming partnership that works the tenanted holding, rather than from the company that does the outside contracting.

In some instances however, a family company may have existed for many years and hold a valuable tenancy granted many years ago. An example of this is:

-Tenancies assigned to company – company in farming partnership – avoids parting with possession

Many farming companies, established for landlord/tenant reasons, have been in place for many years. Valuable traditional tenancies may have been granted or assigned to those companies. Alongside the company there may well be a farming partnership that carries on the farming trade, with the only asset in the company being the tenancy.

The tenancy agreement will generally prohibit any parting with possession, ruling out the grant of a sub-tenancy to the farming partnership. If, however, the company becomes a partner in the farming partnership it makes its tenancy interest available to the partnership without parting with possession. Indeed, if a tenant assigns his tenancy to a company and that company does not carry on any of the farming trade then the arrangement is liable to be set aside as a sham, see *Gisborne and Another v Burton [1988] 3 ALL ER 760*. So, to make sure this valuable asset is retained in the company, the company has no choice but to enter into partnership to prevent the sham argument. (It could, of course, farm the land itself using the partnership as a contractor but the company-in-partnership is a more natural vehicle.)

Commercial reasons for mixed partnerships

There are a number of commercial reasons why a mixed partnership used by farmers and rural businesses may include a limited company as a partner. Common scenarios include:

-Where a company has commercial activities of its own and subsequently come into partnership.

A company may have been formed by the previous generation and own farmland, the company shareholdings may now be fragmented between farming and non-farming members of

the family and to farm in an economic fashion the farming members of the family wish to farm land owned personally and land owned by the company in a single business.

Alternatively a company may have originally been formed specifically to mitigate against commercial risks when trading with external businesses, such as when contract farming operations are undertaken. This is done in order to protect valuable assets used by the farming partnership. However the company may also supply the same services, including the supply of its machinery and labour, to the farm partnership and the relationship may be more accurately reflected as a partnership. The limited status of the company does however remain essential to protect against risk when performing contracting operations externally.

An example is:

A farm partnership farms a large arable acreage, a mix of tenanted and contract farming arrangements. A few years ago, the contract farming arrangements, together with arable machinery etc were hived off into a new contracting limited company, leaving the home farm in the original partnership.

The limited company carries out arable contracting on a variety of arrangements from stubble to stubble contracting to full management on a variety of profit sharing formulae. That company also serves as a partner in the home farming partnership and takes a share of profits from that home farming partnership on top of its contract charge on a basis similar to what it would do for its other third party agreement. The commercial basis for arriving at the profit share allocated to the limited company is very important in this case as they have a member of staff being brought into the limited company with succession planning in mind (who is not a family member).

The key driver for the incorporation originally was to ring-fence liabilities associated with the substantial farm contracting work and asset protection is very important to this tenant farmer. The potential risks involved in providing contract farming are significant where it is not unknown for a claim to be made against the contractor for several years of lost profits where errors are made.

Whilst there may appear to be an incidental annual tax advantage in terms of the level of income tax payable under this hybrid structure, this must be considered against the alternative structure of the limited company standing alone and making a charge to the partnership.

-Fragmented ownership

Farming partnerships often include family trustees in order to ensure that the land remains available for future generations to farm. However if trustees are partners, the partnership cannot make use of the Annual Investment Allowance (AIA) in relation to plant & machinery costs because of S38A(3) CAA 2001. The potential impact of this in a farming context cannot be overlooked given the high level of capital investment in plant & machinery, for example tractors and combines.

This provision puts mixed partnerships at a significant tax disadvantage compared to both a limited company and an ordinary partnership consisting solely of individuals. Indeed with the current level of the Annual Investment Allowance a mixed partnership could increase the

partnership's tax liability by £100k compared to a partnership consisting solely of individuals, with this cost only being recovered over the life of the plant & machinery. This needs to be borne in mind when considering if "it is reasonable to assume the main purpose, or one of the main purposes, of the profit sharing allocation is to recognise profits at lower tax rates."

We do however appreciate that if a limited company is included in the partnership the limited company itself would be entitled to an Annual Investment Allowance. However this would only be useable where the company makes profits and owns plant & machinery.

Two examples are:

-A family trust owns the land and trustees want to get some of the beneficiaries involved in the farming. Whilst a partnership is the obvious route to do this, the trustees may wish to limit the risk to the trust assets and will interpose a company into the partnership to achieve this. The protection of the trust assets is the driver as the assets are also held for the benefit of non-farming beneficiaries and future generations.

-Pension scheme legislation (particularly Small Self Administered Schemes) has previously provided favourable tax rules for limited companies. As a result some farming families were encouraged to establish companies. Those companies generated profits and purchased land (often with loans back from the SSAS). These companies may not have enough land to trade independently, so resources are shared between the farming partnership and farming company. Again, charges flow between the two perfectly legitimately, and many may have chosen to admit the company to the partnership more truthfully to reflect the arrangements between them.

-Separate farming operations conducted by different family members but with some operations undertaken jointly

Farming has over the years become more specialised and certain operations may be conducted by specific members of the family. However from a business and economic perspective it will often be necessary for some operations to be undertaken jointly.

For example:

A farm has been owned by three brothers for many years. To best capitalise on their individual skills the livestock operation is carried on through a general partnership consisting of two of the brothers, whilst the dairy operation is carried on through a limited company by the third brother and his son. All three brothers also work together in an arable operation which is conducted through an LLP of which both the limited company and the individual partners are members. The business structures work well giving the various members autonomy in their particular area of operations as well as affording protection where needed. Whilst the profits may accurately reflect the contribution made by each of the two businesses they will still it seems suffer from the uncertainty of whether or not HMRC will seek to apply the legislation to the mixed partnership and if it does the costs involved in defending the allocation of profits.

-Preventing a reduction in the value of assets used in the business

The use of a corporate vehicle to hold land can dramatically erode the asset value of the property owner. Land within a corporate is subject to double taxation (Corporation Tax on disposal within the company and tax on extraction from the company), but held by individuals or a partnership it is not. A purchaser who wishes to acquire the farmland will as a result require a significant discount if the land is held within a company, particularly one which has a trading history. If the proposed legislation on mixed partnerships is enacted this would result in an unincorporated purchaser having to trade as a mixed partnership and creates uncertainty and risk. As a result it is likely further to reduce the value of land held within a company.

-Privacy

A general partnership provides greater privacy for its unincorporated partners in terms of public access to their financial accounts. Farmers operate in a food supply chain which is dominated by a limited number of large retailers and food processers who hold significant negotiating power. As a consequence if a farm partnership were fully to incorporate its business it would risk weakening its already limited negotiating position if its customer is able to access commercially sensitive information on its full financial position.

Analysis of Government policy

It is acknowledged that the Government wants a fair tax regime, that is non-discriminatory to all sectors and fundamentally investment in farming is key from a strategic perspective. Defra states we need to increase food production while improving the environment: In the natural environment white paper, we said we would find ways to increase food production while also improving the environment.

To do this, we set up the Green Food Project, working with the food, farming and environmental industries. This is a major study into how Britain's food system needs to change. We published the project's initial conclusions in July 2012. We'll use these conclusions and on-going work and discussions from the Green Food Project to inform policy in the future.

Investment was a key conclusion in the Green Food Project's initial conclusions. Surely retaining capital for investment allows this to happen. Companies in partnership are already discriminated against by not being permitted access to the Annual Investment Allowance – this in itself is discriminatory when standalone corporate and non-mixed partnership can.

The following two quotes speak for themselves:

29 March 2012 Letter from George Osborne to Lin Homer on her recent appointment:
"Tax policy and the policy partnership: I attach great importance to the role that HMRC plays in designing and delivering tax policy changes. Budget 2012 announced a significant package of tax reforms that HMRC will need to implement in the year ahead. I am grateful to the Department for their advice in the run up to Budget 2012. Over the course of the next 12 months, I ask that you continue to work with policy partners in HM Treasury (and the Office of Tax Simplification, where appropriate) to identify further policy reforms that support my ambition to have the most competitive tax system in the G20, reduce complexity, improve fairness and

reduce the scope for evasion and avoidance."

2011 Autumn Statement: Growth

the Chancellor of the Exchequer, George Osborne, said:

"We are committed to making Britain the best place to start, finance and grow a business. The measures I am announcing today will help us to achieve this by creating an environment in which businesses are easy to set up, have access to credit when they need it and are able to grow without being held back by red tape. This action supports our deficit reduction plan and the Government's monetary activism as we build a balanced economy."

Summary

There is no doubt that companies in partnership exist for legitimate, commercial reasons. Where this is the case we question the fairness of the proposed legislation.

If business profits are made available to the proprietor, be it sole trader, partner or shareholder, for non-business use it is accepted that the fair and proper rate of tax should be paid. However, where profits are retained within a business for expansion, it is inappropriate for the taxation system to discriminate in favour of one type of legal entity.

We therefore question if the Government is contending that if a business is unable wholly to incorporate, or chooses to have a corporate partner to meet commercial needs and protect against risk it should automatically be penalised and unable to access a lower Corporation Tax rate?

HMRC already has protection from abuse where the corporate partner is a close company by use of the section 455 CTA 2010 charge. This issue has been completely ignored in the consultation document yet legislation is being introduced (Schedule 28 Finance Bill 2013) to apply the s455 charge to any loans made to participators via partnerships.

HMRC should accept that, as long as profit sharing is fair and reasonable, taking into account the fact no goodwill exists for farming businesses (IHTM25082) and the partnership would be considered 'close', then no counteraction notice should be issued.

Whilst we would not therefore expect the proposed legislation to apply in many of the examples we have highlighted, if it is enacted without exceptions or a de minimis limit, the existence of a mixed partnership which includes a limited company will always create uncertainty. This is because the proposals could be read in a way that whether or not the business structure exists for sound commercial or industry specific reasons or if the company is reinvesting its profits in the business, the only consideration should be if "it is reasonable to assume the main purpose, or one of the main purposes, of the profit sharing allocation is to recognise profits at lower tax rates". Given that the existence of a limited company within a partnership will often result in a lower rate of tax being paid on some profits it is far from clear how the above test will be applied. We question if a clearance procedure should be available to mixed partnerships so that smaller businesses can obtain certainty on this point. We would also suggest a further test is required in assessing when losses should be restricted to ensure that this is not used unfairly.

Perhaps the most fundamental issue, if legislation is to be enacted, is how profits and losses should be fairly allocated, rather than the automatic cancellation of any tax reduction which may arise as a consequence of having a mixed partnership structure. We question how the proposed just and reasonable basis for any reallocation of profits will be arrived at by HMRC? We do not believe that this will be easy and would suggest that a thorough understanding of the business and the industry will be required in order to arrive at a fair result. For example in farming the rental value of land is often an area of dispute between landlords and tenants which results in formal arbitration. We would suggest that arriving at a "just and reasonable basis" for the apportionment of profits is likely to involve HMRC engaging third parties with specialised knowledge.

The government needs to be careful that the potential complexity of these proposals does not lead to the penalisation of businesses that are structured as mixed membership partnerships for commercial reasons.

Finally if legislation is to be bought forward it will be essential accurately to target the proposed legislation and avoid potential confusion and uncertainty. The Farming Group would like to offer our help, knowledge and assistance to the partnership consultation team during the informal consultation period in September and October 2013 when further consideration is to be given to any draft legislation and draft technical guidance.

Specific Question and Answer responses

Whilst we have considered all of the questions in the consultation, as this group is not seeking to comment on the proposed disguised employment rules for limited liability partnerships we have not responded to questions 1 to 5. We have answered the general questions 13 to 16 in some detail within the main body of our submission, and our responses to the specific questions 6 to 12 are shown below:

Question 6: HMRC would welcome views on this approach to counteraction, particularly what other specific indicators should be taken into account and possible alternative approaches that would counteract the tax advantages (including timing advantages).

Response 6: The proposed approach is much too broad. Where there are abuses these should be specifically counteracted, for example a commerciality test might be appropriate so that there is an obligation on the corporate partner to have satisfied itself that the transaction is on arm's length commercial terms which can be justified to the company's shareholders. Taxpayers should be free to choose a corporate, mixed partnership, general partnership or sole trader structure as is appropriate to their specific circumstances and the consultation flies in the face of that.

Question 7: Would the legislative approach set out above provide an effective deterrent and counter the schemes described?

Response 7: The proposed approach would probably provide an effective deterrent to the schemes described, but it will also penalise many innocent taxpayers and SMEs. Government

should be encouraging SMEs to develop their businesses.

Question 8: Would the proposed changes impact on situations that are not in line with the stated policy objectives? If so, HMRC would welcome detailed explanation of why you believe these situations fall outside the intended target areas.

Response 8: Yes. Family businesses seeking to retain profit for investment would be penalised. Given that there are few investment allowances for activities such as new buildings, reservoirs and so forth, a lower tax rate is essential to stimulate the economy. The proposed ambit is much too wide and, as stated, a commerciality test would be better.

Question 9: Do you consider that there are circumstances in which this rule would give rise to outcomes inconsistent with the policy objectives and, if so, in what circumstances and how might these situations be addressed?

Response 9: The proposals would create outcomes inconsistent with the policy objectives. Abusive arrangements should be more clearly targeted and it is suggested that commerciality might be the appropriate test. There should be a de minimis level, say £300,000 of corporate profit.

Question 10: As described above, it is proposed that the profit deferral arrangements will be tackled in the same way as the other mixed membership arrangements. HMRC would welcome views on whether relief could be given retrospectively in the event that a contingent profit awards does not ultimately vest. To prevent the risk of abuse, such relief would be confined to clearly defined circumstances and would also need to provide for additional tax charge to be imposed on other members in the event that those profits are re-allocated to other members.

Response 10: This would not appear to be an issue for farming mixed membership partnerships.

Question 11: A possible alternative to the approach suggested in question 10 would be to allow a member subject to a profit deferral arrangement to elect to be taxed as a salaried member, with the consequences then being as set out in paragraphs 2.24 and 2.25 above. Views on this proposal would be welcome.

Response 11: This would not appear to be an issue for farming mixed membership partnerships.

Question 12**:** Should there be any other exceptions to the proposed treatment? If so, please provide information why these cases should be excluded and suggestions on how these exclusions can be effected.

Response 12: This would not appear to be an issue for farming mixed membership partnerships.