Analysis

Holding shares through partnerships: some observations

Speed read

The chargeable gains rules, and other tax legislation, do not deal with partnerships very clearly. In examining partnership transactions it can be helpful first to consider the attributes of a partnership under the general law. This is especially the case where transactions involve interests in partnerships, or the introduction of partnerships to corporate group structures. This general law starting point can assist advisers in applying tax legislation more accurately – including where the rules appear to distinguish between holding an 'interest in shares' and holding shares outright – and to evaluate HMRC's guidance on such transactions more critically.

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Readers of this journal will frequently encounter partnerships when looking at business organisations and transactions. They may occur to facilitate commercial objectives, such as tax neutral fund vehicles, commercial co-ownership, and carry/incentive vehicles for managers; or for the purposes of non-UK tax planning, as well as for any UK tax attributes which the introduction of a partnership might confer. It is well known that partnerships are 'transparent' for the purposes of UK corporation tax on income and gains (see HMRC's *Partnership Manual* at PM10700, for example); it is equally obvious that UK tax legislation does not deal with partnerships very comprehensively or satisfactorily.

In this article – which for the most part focuses on the taxation of gains rather than income – we suggest that a more helpful starting point is to set aside the concept of 'transparency' for a moment, and begin with the position under the general law. Getting to grips with the strict legal position, even though this may itself be abstract and problematic, can shed insight on the technical and practical implications for analysing certain familiar transactions and legislative expressions, including that of an 'interest in shares', which are discussed below.

It should of course be borne in mind that the default legal position may well be affected by the contractual terms of any particular partnership agreement; and, where overseas partnerships are involved, by the salient aspects of relevant non-UK law.

What is a partnership?

The Partnership Act (PA) 1890 tells us that a partnership is a relationship: 'the relation which subsists between persons carrying on a business with a view to profit' (but excluding the relationship which subsists between shareholders in a company). An English partnership is not itself a legal person.

However, the prevailing view, including that of HMRC (see HMRC's *Business Income Manual* at BIM82001, and INTM412060), is that a partnership is also a 'body of persons'; and therefore (unless the context otherwise requires) is a 'person' under the Sch 1 of the Interpretation Act 1978 (which applies generally through the Taxes Acts). A partnership will also be a 'person' for the purposes of double taxation agreements, where an appropriate definition (similar to that in the Interpretation Act) is included (see *IRC v Padmore* [1989] STC 493).

Some confusion may be caused by the fact that ITA 2007 s 989 and CTA 2010 s 1119 contain their own definition of 'body of persons' which is generally thought not to include partnerships. The point is that special rules are required to provide that partnerships are not assessable as separate entities for income tax and corporation tax purposes (ITTOIA 2005 s 848, CTA 2009 s 1258) and for tax on chargeable gains (TCGA 1992 s 59). It is perhaps useful to bear this in mind to counteract a preconception that a partnership is, of its nature, a 'nothing' for tax purposes.

Partnership property and partnership interests

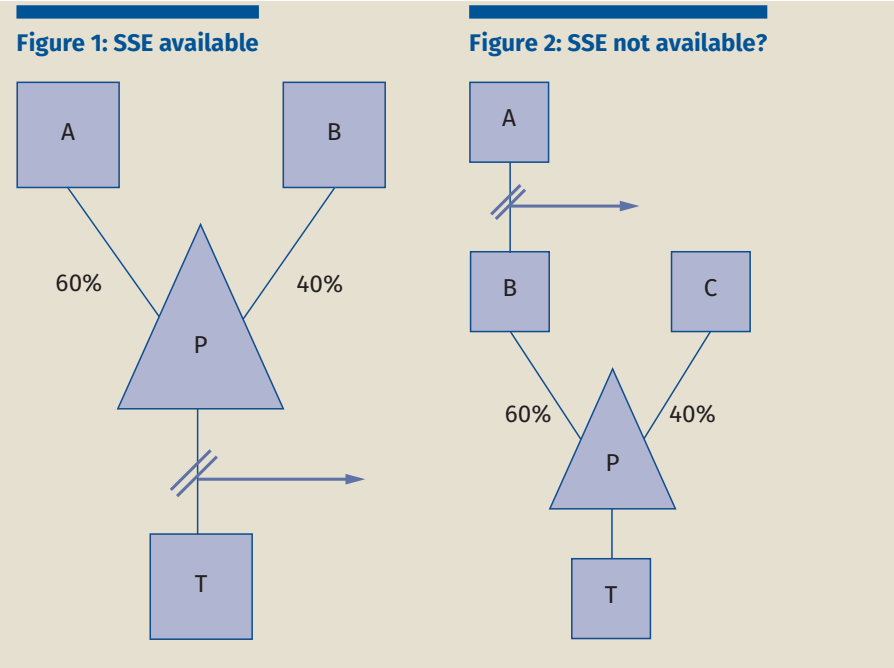
The general law distinguishes between:

a) the property held by a partnership as partnership property (for example, shares legal title to which is registered in the name of one of the partners); and
b) a partner's interest in the partnership.

While the legal nature of (b) is not easily defined, from a non-tax perspective there is probably some measure of consensus that it should be viewed as the bundle of rights which the partner holds under the Partnership Act and the partnership deed. Generally speaking, the essence of these will be:

- a right for the partnership property to be used for the purposes of the partnership business while the partnership carries on;
- a right to a share of profits;
- *on dissolution of the partnership*, a right for the partnership property to be applied to discharge the partnership's creditors (see PA 1890 s 39, for example); and
- *on dissolution of the partnership*, a right for the partnership property to be realised and to receive a return of capital and a share in any surplus (see PA 1890 s 44, for example).

It will be seen that, as respects the partnership property, the partner's rights are generally contingent rights to certain monetary sums. Thus, *Lindley & Banks on Partnership*, while describing a partner's interest as a proprietary or beneficial interest in the partnership property, describes this interest as essentially a *future* interest in the *net proceeds of sale* of the partnership assets, taking effect on dissolution of the partnership after all the



firm's debts and liabilities have been paid or provided for (see 9th ed., ch 19). This analysis of a partnership interest was effectively endorsed by the Court of Appeal in the non-tax case of *Gill v Sandhu* [2005] EWCA Civ 1297.

What is much less clear is how this bundle of rights should be treated for the purposes of tax on chargeable gains. The answer to this depends on whether – as a matter of general law or as a result of TCGA 1992 s 59 – the rights should be treated as a beneficial interest in the partnership assets for the time being.

On a traditional analysis, the starting point from a CGT perspective is that a partner's interest in a partnership is a chose in action, which is an asset distinct from the partnership assets for the time being. Given the general law position summarised above, there is much to be said for this from a technical point of view (and it is a view supported in a number of the leading textbooks). On this view, s 59 overrides the general law by treating 'partnership dealings' – i.e. acquisitions and disposals of partnership assets – as dealings by the partners: so that a disposal by the partnership is a taxable event for the partners, being (per Statement of Practice D12) a disposal of a fractional share of the relevant partnership assets (notwithstanding that the partner has not disposed of his chose in action as such).

An alternative analysis is that an interest in a partnership *does* constitute a beneficial interest (albeit of a somewhat nebulous kind) in the assets of the partnership for the time being. The tendency of the more recent case law, on the whole, is to speak of a partner's interest as being a beneficial interest in the partnership assets (see, for example, *IRC v Gray* [1994] STC 360; *Hadlee v IRC* [1993] AC 524; *Memec plc v IRC* [1998] STC 754; and see also BIM82058). On this view, s 59 (and SP D12 para 2) would be broadly consistent with the general law position.

So far, perhaps, so academic; but the difference in approach becomes more stark when transactions in partnership interests are considered (e.g. a change in profit sharing ratios). On the 'chose in action' analysis, this transaction is simply outside s 59: it is not obviously a 'partnership dealing'. Furthermore, the exception from market value treatment for transactions between partners at s 286(4) only applies to 'acquisitions and disposals of partnership assets'. Accordingly, it may technically be open to a partner to argue (contra SP D12 para 4) that the base cost inherited by the partner increasing his share is in fact the market value of that increased share, as a connected persons transaction. The scope for such 'enhanced base cost shift' planning in an investment management context has of course been curtailed by the 2015 changes TCGA 1992 Part 3 Ch 5, but there may be other contexts where taking such a view may be advantageous. Equally, there may be situations – for example, on dissolution of a partnership – where the 'chose in action' analysis could be highly problematic (e.g. where a partner has no base cost in the partnership interest chose in action as such, despite having some attributable basis in the partnership property).

An exhaustive discussion of this area is beyond the scope of this article (no doubt further alternative analyses are also possible). For most practical purposes, the practice set out in SP D12 of treating the partner as holding a fractional share in the partnership property for the time being will give rise to sensible and manageable results. We refer below, however, to some areas where difficulties arise where shares are held by partnerships. It will be seen that HMRC's approach to this is somewhat schizophrenic.

Substantial shareholding exemption and grouping

The substantial shareholding exemption (SSE) exempts gains arising on a disposal of 'interests in shares', as well as disposals of shares themselves (Sch 7AC para 1). 'Interests in shares' may also be taken into account in satisfying the substantial shareholding test (para 7) and certain other rules. This is a defined term in the SSE rules, capturing 'an interest as a co-owner of shares' (para 29). It is implicit in HMRC's 2016 consultation document on reforming the SSE (and explicit in SP D12) that, in HMRC's view, a partner holding shares through a partnership holds an 'interest in shares' for these purposes (see para 6.4 of that document).

So, in figure 1 – following that approach – A and B should in principle benefit from the SSE on the disposal by the partnership of the shares in T, on the basis that they have disposed of an 'interest in shares'. Arguably there is an alternative approach: the shares themselves have in fact been disposed of (by the partnership collectively); and given that this is manifestly a partnership dealing, s 59 treats it as a disposal by the partners. There is not obviously any need to rely on the 'interests in shares' limb at all. What about a disposal by A of its partnership interest? Here, it seems that HMRC ought to accept that the SSE applies, it being a disposal of an 'interest in shares'.

The consultation document also set out HMRC's view that, because the grouping tests for the SSE refer to (beneficial) ownership of ordinary share capital – and *not* to interests in ordinary share capital – a partnership interposed between a holding company and the trading subsidiary would cause the SSE not to be available. On this view, in figure 2, A would not be entitled to the SSE on a disposal of B (notwithstanding that B would be entitled to the SSE on a disposal by the partnership of shares in T, as we have just seen).

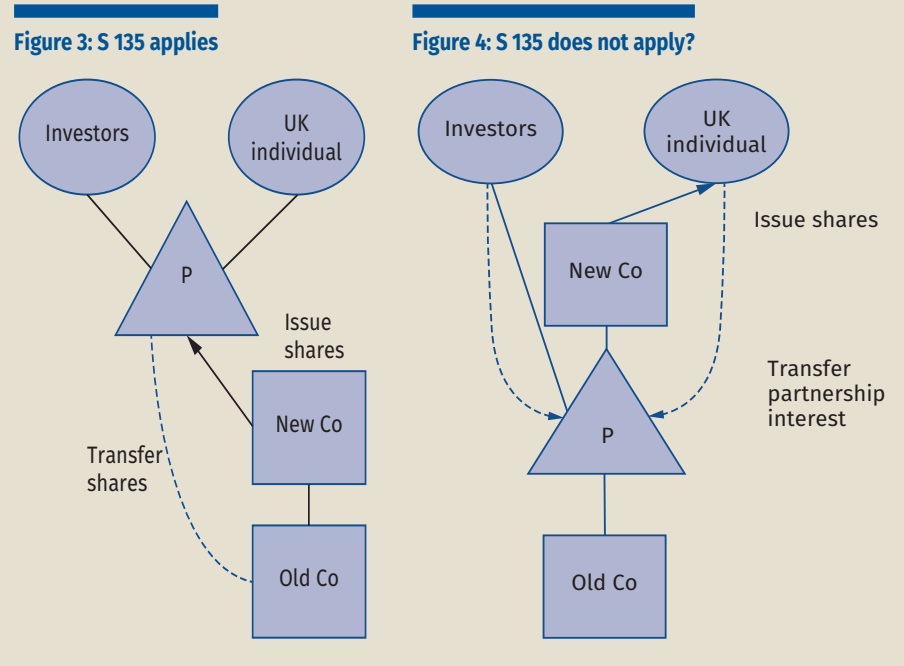


Figure 3: S 135 applies

Figure 4: S 135 does not apply?

neutrally under TCGA 1992 s 135 for a UK resident partner where Newco issues shares to the partnership (see figure 3).

It looks decidedly less clear, however, that HMRC would accept that s 135 is satisfied where the Newco is introduced above the partnership, as in figure 4. As a technical matter, it appears that here what Newco receives is (at most) an interest in shares, rather than the shares as such (and note that s 135(5) will not assist here). HMRC's guidance at CG45772 – while admittedly not focusing on precisely this fact pattern – indeed suggests that s 135 can *never* apply on an exchange involving interests in a transparent entity.

Quite why HMRC does not consider that s 59 could operate broadly enough to treat an acquisition by the partnership of the ordinary share capital of T as an acquisition by the partners of their share of it is not clear. It is furthermore inconsistent with HMRC's (more practical) guidance, and examples, set out in its *Company Taxation Manual* at CTM80152 in the context of corporation tax group relief, and its guidance on stamp duty group relief. (This guidance avoids the somewhat unreal conclusion that a corporate partner Company A with, say, a 75% interest in a partnership holding 100% of the shares in Company B, does not own 75% of Company B's ordinary share *either* directly *or* indirectly for the purposes of CTA 2010 s 1154.) Rightly or wrongly, however, it was felt that this point needed to be catered for explicitly in the extension of the SSE for qualifying institutional investors (but not otherwise): see Sch 7AC para 3B(6).

Anti-enveloping rules

The chargeable gains legislation distinguishes in many places between disposing of a particular asset itself, and disposing of an interest in that asset. Generally this is to ensure that a particular set of rules applies sensibly for transactions which are economically equivalent to a disposal of the underlying asset (see, for example, the wasting assets rules).

The draft Finance Bill legislation extending capital gains tax to non-residents for disposals of assets consisting of a 'right or an interest in a company' deriving 75% of its value from UK land is an example of this (Sch 1A para 2): a disposal of an interest in a partnership which holds such a company may well therefore be caught. Interestingly, the non-resident charge on disposals of shares deriving their value from North Sea assets (TCGA 1992 s 276) is drafted more narrowly.

Share for share exchanges

Groups seeking to IPO will frequently look to introduce a new holding company on top of the existing structure. The better view seems to be that this can be done tax

Stamp duty and SDRT

'Interests in shares' are chargeable securities for stamp duty reserve tax (SDRT) purposes (FA 1986 s 99(3)(b)). Does a transfer of an interest in a partnership which holds UK shares therefore attract SDRT? The 'chose in action' analysis referred to above provides a respectable technical argument to support what probably is the general practice that SDRT is not paid on such transactions (see also HMRC's *Stamp Taxes on Shares Manual* at STSM091040). The strength of this analysis may to some extent of course be impacted by whether the partnership has legal personality. On the basis that any documents effecting such transfers will rarely be presented for stamping or adjudication (see further the Office of Tax Simplification's review of stamp duty last year), there is however seemingly some residual risk of unfranked SDRT charges on these transactions.

Conclusions

Treating an interest in a partnership as an interest in the underlying shares will often be the right approach under the TCGA 1992 in practice. However, it is important to identify conceptually whether the transaction in question relates to partnership interests or the underlying shares.

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Care should be taken around the implications of introducing a partnership into group structures. Advisers should treat HMRC's guidance on such transactions critically and should be mindful that it does not exist to give taxpayers a less favourable outcome than may be available under the strict law. In the right circumstances, a more 'legalistic' analysis of partnership transactions may better serve their clients' interests – provided it is adopted consistently. ■