

## Private Client Business

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### Inheritance tax and partnerships

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**\*P.C.B. 278** *This article introduces the concept of partnership and limited liability partnership (LLP) and outlines how inheritance tax (IHT) applies to partners of partnerships and to members of LLPs. The availability of business property relief (BPR) is also examined, with a particular focus on the availability of BPR where partnerships and LLPs are used in structures.*

The decision to operate a business as a partnership or through an LLP is often tax driven. Partnerships and LLPs are often described as being “tax transparent” because the income and gains generated by the business are taxed in the hands of the partners or members, rather than taxed both at “entity” level and then again in the hands of the individual owners (as would be the case for a company). Although increased income and capital gains tax (CGT) rates for individuals may now make tax transparency less attractive than in previous years, it may still have advantages in some circumstances. By using a partnership or LLP, there may also be significant employer’s National Insurance savings where the highly remunerated individuals are remunerated by way of profit share, rather than salary.

As well as considering the income tax and CGT position, it is important not to overlook the potential IHT implications of a structuring decision. BPR is a generous relief from IHT from which partners of partnerships and, more recently, members of LLPs have greatly benefitted and there is undoubtedly scope to use partnerships and LLPs efficiently to mitigate IHT. However, as will be seen, care is needed to ensure that the availability of BPR is not compromised when making structuring decisions.

### Key features of partnerships and LLPs

#### *Partnership*

A partnership is “the relation which subsists between persons carrying on a business in common with a view to profit”.<sup>1</sup> In England and Wales, a partnership is not a separate legal person, although the position is different in Scotland.

**\*P.C.B. 279** Every partner is an agent of the firm and his other partners.<sup>2</sup> This means that actions of any partner bind the firm unless the partner had no actual or ostensible authority to do so and it therefore follows that the partners are jointly and severally liable for the debts of the partnership.

Although there are a number of key differences, for the purposes of IHT and this article, limited partnerships and general partnerships are referred to as “partnerships” and are treated in the same way.

#### *Limited liability partnership*

Despite its name, an LLP is not in fact a partnership. It is a body corporate with legal personality separate from its members.<sup>3</sup> In order to be incorporated, “two or more persons associated for carrying on a lawful business must have subscribed their names to an incorporation document”.<sup>4</sup>

An LLP therefore contracts in its own name and is the legal owner of the assets used in its business. Every member of an LLP is the agent of the LLP.<sup>5</sup>

#### *Use of the term “partner”*

Members of an LLP are treated as if they are partners in a partnership for the purposes of IHT.<sup>6</sup> For the sake of simplicity, references in this article to partners and partnerships include members of LLPs and LLPs respectively, unless otherwise stated.

### ***What is a partner's share?***

The question of what constitutes a partner's share in a partnership is a complex subject, worthy of discussion in its own right. In summary, in most jurisdictions it is generally agreed that a partner's share is a bundle of rights and obligations, which might include the right to share in the partnership's profits, as well as a right to a proportion of the partnership's assets after payment of all of the partnership's debts and liabilities on dissolution of the partnership. There are default regimes governing the rights and obligations of partners in the Partnership Act 1890 s.24 and in the Limited Liability Partnerships Regulations 2001 reg.7, which provide, for example, for the equal sharing of capital and profits and the right for all partners or members to participate in the management of the business. However, the default regimes are subject to contrary agreement between the partners/members. There is therefore frequently a written agreement which sets out the rights and obligations of partners/members during the term of the partnership or the existence of the LLP as well as the entitlements of partners upon dissolution of the partnership or the winding up of the LLP.

### **IHT**

IHT is charged on "chargeable transfers", which are non-exempt transfers of value made by an individual.<sup>7</sup> There is a transfer of value if the value of the transferor's estate is diminished as a result of the transfer.

A transfer is not a transfer of value if it was not intended, and was not part of a transaction intended, to confer a gratuitous benefit and it was made at arm's length between unconnected persons or it was such as might be expected to be made in an arm's length transaction between unconnected persons.<sup>8</sup>

**\*P.C.B. 280** An individual is deemed to make a transfer of value of all of his property immediately before death for IHT purposes.

### ***What could constitute a transfer of value by a partner?***

A partnership share is an asset of the partner which has a value. If the partner transfers his partnership share during his lifetime and does not receive full consideration for the transfer, then he will have made a lifetime transfer which diminishes the value of his estate. Examples would be the transfer of a partnership share into a discretionary trust or, more usually in the context of a family partnership arrangement, the gift of all or part of his share to another partner.

Assuming that these transfers are not on arm's length terms, there would be a transfer of value by the transferor. Ignoring any possible application of BPR for the moment and any relevant exemptions, the transfer to trust would be a lifetime chargeable transfer and would attract an immediate charge to IHT of 20 per cent of any value in excess of the transferor's available nil rate band. Again ignoring BPR and any relevant exemptions, the transfer to another individual partner, such as a family member, will be a potentially exempt transfer under IHTA 1984 s.3A. This should escape a charge to IHT if the transferor survives the transfer by seven years or more,<sup>9</sup> provided that care is taken to ensure that the gift of the partnership interest entails the transfer of the capital together with the other rights attached to that interest, such as the profit sharing rights, so that there can be no suggestion that there has been a gift in which a benefit has been reserved.<sup>10</sup>

Depending on the terms of the partnership agreement, a transfer of value of a partnership share may also occur when a partner dies, because there will be a deemed transfer of value immediately before death.<sup>11</sup>

### **BPR and partnership interests**

BPR is available in respect of relevant business property. Relevant business property includes (but is not limited to) property consisting of a business or an interest in a business,<sup>12</sup> unless that business or interest in a business consists wholly or mainly of dealing in securities, stocks or shares, land or buildings or making or holding investments.<sup>13</sup>

The extent to which a business is that of making or holding investments has been the subject of much

litigation and a detailed discussion is beyond the scope of this article. In summary, this depends very much on the substance of the business itself, the services that it provides and:

“... regard will need to be had to its preponderant activities, assets, sources of income or gains at the time of transfer and over a reasonable period leading up to it.”<sup>14</sup>

In particular, the level of net profit is not to be considered as the principal test as the business should be looked at in the round.<sup>15</sup>

For the purposes of this article, it is assumed that the business of a partnership is not one of making or holding investments, but obviously in practice this is a crucial point that must be considered in detail.

**\*P.C.B. 281** Consideration should also be given to excepted assets which are not wholly or mainly used for the purposes of the business, which might include significant cash balances or shares in a service company, which would not attract BPR. Care is needed, for example, in fund management businesses as the business (which is typically run by an LLP) may attract BPR but underlying investments may impact on the availability of BPR.

An interest in a business attracts BPR at 100 per cent where the property has been owned by the transferor for the two years immediately preceding the transfer.<sup>16</sup> Helpfully, the treatment of LLPs as partnerships means that the transfer of a partnership's business to an LLP, commonly referred to as an LLP conversion, does not re-start the two year ownership period.<sup>17</sup>

Note, however, that where the partnership interest is subject to a binding contract for sale, BPR will be denied.<sup>18</sup> An example of this is where the partnership agreement provides that the deceased partner's personal representatives are obliged to sell the deceased's partnership share to the continuing partners. Where there is merely an option, rather than an obligation, to sell or buy, BPR will not be denied on this basis.<sup>19</sup>

Land or buildings and machinery or plant which are owned by the partner, rather than the partnership, and which are used wholly or mainly for the purposes of a business carried on by a partnership of which the transferor was a partner may qualify for 50 per cent relief. Although other taxes (such as stamp duty land tax) may be chargeable, partners often prefer to contribute this property to the partnership and take a larger partnership share as a result of the contribution, so that 100 per cent relief might instead be available.

### ***The holding company rules***

Unquoted shares in a company will also be relevant business property provided the company's business:

- does not consist wholly or mainly of dealing in securities, stocks or shares, land or buildings or making or holding investments; or
- consists wholly or mainly in being a holding company of one or more companies whose business would qualify as relevant business property.<sup>20</sup> This seeks to ensure that relief is not denied simply because shares are held through a holding company.

### **What is a holding company?**

“Holding company” and “subsidiary” are given the meanings used in Companies Act 2006.<sup>21</sup> A company (H) will be considered a holding company of its subsidiary (S) if:

- H holds a majority of the voting rights in S; or
- H is a member of S and has the right to appoint or remove a majority of S's board of directors; or
- H is a member of S and controls alone, pursuant to an agreement with other members, a majority of the voting rights in S.

H will also be considered a holding company of any subsidiary of S.

### **\*P.C.B. 282 What is wholly or mainly being a holding company?**

It is thought that the same “wholly or mainly” test which is used in the context of deciding whether a business is wholly or mainly one of holding investments (see above), would extend to the consideration of whether the business of a company consists wholly or mainly in being a holding company. If the holding company's only business is the investment in the subsidiary, then it seems fair to assume that the main activities of the business would be considered to be that of a holding company.

### **Sub-holding companies**

Is BPR still available where there is more than one holding company, or a string of holding companies? On a strict reading of IHTA 1984 s.4(b), possibly not, but it is understood that the Inland Revenue's Capital Taxes Office (as HMRC IHT then was) has previously indicated that it would look through the intermediate holding company to the underlying subsidiaries.<sup>22</sup>

### **The practical application of BPR and the holding company rules to structures featuring partnerships**

#### ***Would a partnership fall within the holding company rules?***

We have seen that a business or shares in a company whose business consists wholly or mainly of dealing in securities, stocks or shares, land or buildings or making or holding investments does not attract BPR (unless it is a holding company of a company which has a BPR-attracting business). In the case of a company, the Companies Act 2006 offers guidance as to how a company qualifies as a holding company.

IHTA 1984 s.104(b) refers specifically to “companies”. As noted above, a partnership is not a legal entity and the collection of individuals for which the short-hand term “partnership” is used, is not a company. Therefore, a partnership cannot be considered a “holding company” within these rules. Moreover, one of the key requirements for a partnership is the requirement that the partners carry on a business.<sup>23</sup> Joint ownership of property is insufficient of itself to constitute a partnership business<sup>24</sup> and so the use of a partnership is unlikely to be appropriate as a holding vehicle in any event.

#### ***Would a LLP fall within the holding company rules?***

Although the definition of “holding company” refers specifically to companies, the Companies Act 2006 definition goes on to clarify that “company” includes “anybody corporate”.<sup>25</sup> Because an LLP *is* a body corporate, it might therefore be considered arguable that an LLP could fall within the holding company rules.

However, HMRC guidance specifically says that, where an LLP invests in unquoted shares in trading companies, it would be inappropriate to allow BPR on the basis that the underlying assets constitute business property: HMRC consider the true position to be that the nature of the business of the LLP is that of an *investment* LLP with the result that no BPR would be available.<sup>26</sup>

On the other hand, the same HMRC guidance also asserts that:

**\*P.C.B. 283** “... an interest in a LLP is deemed to be an interest in each and every asset of the partnership, while an interest in a traditional partnership is a ‘chose in action’, valued by reference to the net underlying assets of the business.”<sup>27</sup>

In the authors' view, this is inconsistent with the position under IHTA 1984 s.267A, which provides that LLPs are to be treated in the same way as partnerships and with the subsequent paragraph in the IHT Manual referred to above, which provides that in determining whether the LLP is an investment business, the business underpinned by the assets, rather than the nature of the assets themselves should be considered. If one takes the (the authors suggest, incorrect) position that members should be treated as having an interest in each and every asset of the LLP, BPR might be available.

### **Partners with limited liability**

#### ***Corporate partners***

An individual partner with a partnership share which is relevant business property can benefit from BPR, but it is increasingly rare to see a direct investment by an individual into a business. In the context of a partnership, where unlimited liability for the partnership's debts may become the responsibility of any of the general partners, individuals often prefer to participate through a limited liability company.

In addition, individuals often participate in partnerships using a company as the partner in order to preserve confidentiality, particularly in the context of limited partnerships and LLPs where the partners' details are publicly available.

In such circumstances, it would be necessary to look at the business of the limited liability company to see if BPR is available in relation to the partnership participation. If the business of the company is (or is wholly or mainly) acting as a partner in a partnership, the business of which would itself qualify as relevant business property, then the shares in the company ought to qualify as relevant business property.

However, where the limited liability company conducts multiple activities, a preponderance of which would not be regarded as BPR-attracting businesses, it would not be possible to obtain BPR in relation to the partnership participation even if a direct interest in the partnership would be regarded as relevant business property.

### ***LLP as partner***

Some investment products which are marketed as attracting BPR are structured so that an LLP is one of the partners of a general partnership. The general partnership runs a non-investment business, and therefore (like the corporate partner described above) the business of the LLP is acting as a partner in a BPR-attracting business.

### ***Overseas LLP***

Some overseas LLPs are considered by HMRC to be companies for corporation tax or income tax purposes. There could therefore be scope for using an overseas LLP in structures. However, while LLPs may be treated as companies for the purposes of corporation tax or income tax, there is a risk that HMRC would not extend this to treat such overseas LLP as a company for the purposes of the holding company rules. If an overseas LLP is not treated as a company, it might be treated as a partnership or an LLP, neither of which falls within the holding company rules for BPR.

**\*P.C.B. 284** If the intention behind using an overseas LLP is that it will be treated as a company by HMRC for the purposes of the holding company rules for BPR, then greater certainty would arise from the use of an actual company.

### **The need to survive!**

In the context of a family limited partnership, partnership shares are often given from parents to children by altering the partnership shares over time. In this context, it is important that the partnership share comprises the income and capital rights to ensure that there is no gift with a reservation of benefit under the Finance Act 1986 provisions. If the partnership interest does not attract BPR, the lifetime transfer by the parent would become an exempt transfer if the parent survives the transfer by seven years. While it is impossible to predict the date of death, considering gifts sooner rather than later can increase the likelihood of surviving the gifts by seven years.

### **Foreign issues**

#### ***Domicile***

Inheritance tax applies to the worldwide estate of those domiciled or deemed domiciled in The UK.<sup>28</sup> It also applies to UK situs assets owned by individuals who are neither domiciled nor deemed domiciled in the UK at the time of their death.

#### ***Situs of a partnership share for IHT purposes***

It is important that individuals who are not domiciled (or deemed domiciled) in the UK are clear as to

whether they have any UK situs assets.

The situs of the partnership asset is determined by the jurisdiction of the partnership's place of business.<sup>29</sup> The principal place of business will be decided as a matter of fact in each case. There is some case law on the point, for example *Laidley v Lord Advocate*,<sup>30</sup> *Beaver v Master in Equity of the Supreme Court of Victoria*<sup>31</sup> and *Stamp Duties Commissioner v Salting*.<sup>32</sup> In essence, the principal place of business is where the overall management and direction of the business is exercised.

These cases are, however, of limited practical guidance in the authors' view as the case law is over a century old and, in this era of globalised businesses, the location of the principal place of business may not be clear in every case. Where an individual with links to the UK has an element of control over the business, the risk that the partnership's business might be determined as being situated in the UK could be mitigated by ensuring that the partnership's overall management and control is exercised outside the UK. It would appear from *Salting* that there may even be scope to achieve this by using non-UK resident agents, but this is not beyond doubt.

Could the proposed reform of limited partnerships law (which would see the introduction of a registered office for limited partnerships) impact on the basic position that the situs of a partnership interest is the partnership's principal place of business? Perhaps, although this seems unlikely in the authors' view, not least because it would be absurd if the approach for general partnerships can be distinguished from that applicable to limited partnerships.

### **\*P.C.B. 285 Conclusion**

The availability of 100 per cent BPR for interests in a business is a significant and useful relief from the charge to IHT. As such, there is scope to reduce significantly the potential charge to IHT on the death of an individual who is a partner. However, as has been seen, there are hurdles to overcome where partnerships and LLPs are used as part of larger, structured transactions.

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1. The Partnership Act 1890 s.1(1).
  2. The Partnership Act 1890 s.5.
  3. Limited Liability Partnerships Act 2000 s.1(2).
  4. Limited Liability Partnerships Act 2000 s.2(1)(a).
  5. Limited Liability Partnerships Act 2000 s.6(1).
  6. Limited Liability Partnerships Act 2000 s.11, inserting IHTA 1984 s.267A.
  7. IHTA 1984 ss.1 and 2(1).
  8. IHTA 1984 s.10.
  9. IHTA 1984 s.3A(4).
  10. The Finance Act 1986 s.102.
  11. IHTA 1984 s.4.
  12. IHTA 1984 s.105(1)(a).
  13. IHTA 1984 s.105(3).
  14. See HMRC's *Shares and Assets Valuation Manual*, para.SVM11150.
  15. See *Farmer v Inland Revenue Commissioners* [1999] S.T.C. (S.C.D.) 321.

- [16.](#) IHTA 1984 ss.104(1)(a) and 106.
- [17.](#) See HMRC's *IHT Manual*, para.IHTM25094.
- [18.](#) IHTA 1984 s.113.
- [19.](#) See HMRC's *Statement of Practice* 12/80 and "Business property relief: options and accruer clauses" [1997] P.C.B. 141.
- [20.](#) IHTA 1984 s.105(4)(b).
- [21.](#) IHTA 1984 s.103(2) and the Companies Act 2006 s.1159Sch.6.
- [22.](#) See, Legislative Comment, "Business property relief and subholding companies" [1996] P.C.B. 74.
- [23.](#) Partnership Act 1890 s.1(1).
- [24.](#) Partnership Act 1890 s.2(1).
- [25.](#) The Companies Act 2006 s.1159(4).
- [26.](#) See HMRC's *IHT Manual*, para.IHTM25094.
- [27.](#) See HMRC's *IHT Manual*, para.IHTM25094.
- [28.](#) IHTA 1984 ss.6(1) and 267.
- [29.](#) See R. l'Anson Banks, *Lindley & Banks on Partnership*, 18th edn, (London: Sweet & Maxwell, 2007) at para.36-66.
- [30.](#) *Laidley v Lord Advocate* (1890) 15 App. Cas. 468.
- [31.](#) *Beaver v Master in Equity of the Supreme Court of Victoria* [1895] A.C. 251 PC.
- [32.](#) *Stamp Duties Commissioner v Salting* [1907] A.C. 449 PC.

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