SLAUGHTER AND MAY/

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BACK TO BASICS: PARTNERSHIPS AND SP D12

SP D12 is a useful guide as to how the CGT rules should be expected to apply to partnerships and it fills in important gaps in the legislation. However, in practice it can lead to some surprising results and its non-statutory footing can cause uncertainty for taxpayers and advisers. SP D12 treats partners as holding a share in the partnership's property, with some flexibility as to how this share would be determined. Tax charges can arise on distributions, contributions and changes to profit-sharing ratios. The application of certain reliefs is explicitly addressed; on others, SP D12 is silent, but their application is generally accepted. Practitioners should approach SP D12 with care.

The tax transparency of partnerships and LLPs for CGT purposes has its statutory basis in TCGA 1992 s 59 (for partnerships generally) and s 59A (for LLPs specifically). The broad effect of these sections is that:

- tax in respect of chargeable gains on a disposal of partnership assets is charged separately on each of the partners, and
- partnership 'dealings' are treated as 'dealings' by the partners and not by the partnership as such.

This is the extent of statutory guidance on partnerships and CGT and so taxpayers and HMRC have had to fill in the gaps. An area of particular difficulty is transactions between partners and the partnership and transactions at the partner level: the two bullets above address transactions at the partnership level but have very little (if anything) to say about partner transactions.

Since 1975, these issues have been addressed by Statement of Practice D12 (SP D12). SP D12 has been updated several times, but remains fundamentally the same as when it was first published.

How authoritative is SP D12?

Like any other statement of practice issued by HMRC, SP D12 is no more than HMRC's view of, in this case, how TCGA 1992 ss 59 and 59A apply in practice. It does, however, have more force than standard HMRC guidance and HMRC would be expected to adhere to SP D12 in dealings with taxpayers and in any appeal (see HMRC's *Admin Law Manual* at ADML5100). Nonetheless, in an appeal to a court or tribunal, although SP D12 might be a helpful starting point for a judge, the decision would be made on the basis of the underlying statute.

This issue was considered by the Office of Tax Simplification (OTS) in 2014/15 as part of its general review of the taxation of partnerships. The OTS explored whether SP D12 should be given a statutory footing, but found that '[n]either HMRC nor practitioners seem enthusiastic about this possibility, and the statement would be extremely complicated to legislate'. It also commented that the majority of partnerships were small with few capital assets and larger partnerships had in practice managed to resolve disputes by negotiation with HMRC. As a result, the OTS recommended that SP D12 should remain a statement of practice, but be updated to clarify some issues and to reflect changes in business practice (which was subsequently done).

At present, there are no plans to reform SP D12. Practitioners must continue to use SP D12 to fill the gaps left by the legislation, but in the knowledge that it is only HMRC's view and not necessarily the law. Practitioners may, for the same reason, take positions that are not addressed in SP D12, but produce a sensible, pragmatic result – we consider this further in relation to changes in profit shares below.

What does SP D12 say?

SP D12 can be split into three broad parts:

- paras 1 and 2 address the fundamental question of what each partner's share in the partnership is;
- paras 3 to 8 cover transactions between the partners and the partnership and transactions at the partner level (changes in profit sharing ratios); and
- paras 9 to 14 address some specific issues relating to partnerships and chargeable gains.

This article focuses on the first two bullets and touches only briefly on the third.

How does SP D12 approach each partner's profit share?

A key feature of SP D12 is that each partner in a partnership is treated for CGT purposes as holding a share of each of the underlying assets of the partnership.

In HMRC's *Capital Gains Manual* at CG27220, HMRC address how to determine this: one starts with any specific agreement about the allocation of capital assets or capital profits and, failing that, looks for each partner's share of income profits. Otherwise, Partnership Act 1890 s 24(1) treats each partner as having an equal share in the partnership.

As such, there is a significant amount of flexibility in the allocation of capital rights between partners, provided that the allocation is clearly recorded. It can be completely different from the allocation of income rights and can even give the rights to the proceeds of specific capital assets to specific partners. This can be a very useful feature of SP D12, particularly in more complex partnership structures.

Let's look at what that means in a simple scenario. If a partnership has ten partners who share capital assets equally and the partnership owns 100 shares in a company, each partner will therefore be treated as holding 10% of each individual share, rather than each partner holding ten shares. This is a straightforward principle, but whether a holding is treated as comprised of ten individual shares or 100 fractional interests in shares can be important both within the scheme of partnership taxation (see further under '*Distributions*') and beyond.

How are the partners taxed if the partnership disposes of an asset?

Paragraph 2 of SP D12 provides that the proceeds of sale are allocated between the partners, as are the acquisition costs of the partnership in respect of the asset. The effect of this is that the gain is calculated at partner level, taking account of the partnership's basis in the asset. So far, so good: this is the scenario that seems to be directly envisaged by TCGA 1992 s 59.

How are distributions and contributions treated?

It may be tempting to think that transactions between partners and the partnership can be ignored for tax purposes on the grounds that the partnership is 'transparent', but that is not the case.

Distributions of assets from the partnership to a partner (and contributions in the other direction) follow similar principles to the disposal (or acquisition) of assets by the partnership, but the difficulty here is that the partner involved in the distribution (or contribution) retains an interest in the asset.

Distributions

In the case of a distribution, the partnership has clearly disposed of the relevant asset: it is no longer an asset of the partnership. According to para 3 of SP D12, this will be treated as a market value disposal by the partnership, presumably on the basis that a distribution is almost by definition not an arm's length transaction and TCGA 1992 s 17 therefore applies to treat the disposal as being for the market value of the asset.

Any partners not involved in the distribution are treated as disposing of their fractional share of the asset that is distributed, which may give rise to a gain that is chargeable immediately.

For the partner receiving the asset, however, the notional gain in respect of that partner's fractional share of the asset is treated as reducing the base cost that the partner obtains in the asset (which would otherwise be market value) and so there is no immediately chargeable gain. The rationale for this is that the partner retains their fractional share of the asset post-distribution and so there is no disposal of that fractional share: the effect of reducing the partner's basis by the notional gain is that the partner inherits the base cost of the partnership in their fractional share of the asset, but obtains full market value basis for the newly acquired portion of the asset.

This can result in some (arguably) unexpected outcomes.

Take the scenario from our discussion about each partner's interest in the partnership where a partnership has ten partners who share capital assets equally and holds 100 shares in a company, but this time together with some other assets. The shares have increased in value such that a market value disposal would result in a gain and the partners now want to hold the shares directly rather than in partnership – the partnership therefore distributes ten shares to each partner, but the partnership otherwise continues in existence and the partners' profit shares do not change. Economically, each partner is in the same position before the distribution (10% interest in 100 shares) and thereafter (holding ten shares) but on the basis of para 3, each partner would be allocated a chargeable gain in respect of their fractional share in the 90 shares that are distributed to the other partners.

There may be ways to mitigate this – for example, one could consider amending the profit-sharing rights in such a way that does not give rise to an immediate gain (see below) and gives each partner a share in the asset surpluses related to particular shares – or one could argue that SP D12 should not be strictly applied here. But this illustrates the difficulties that can arise on transactions between partners and the partnership.

Contributions

Contributions to the partnership operate on a similar basis (para 5 of SP D12). The contributing partner is treated as making a part disposal of the asset to the extent of the fractional shares of the asset to be allocated to the other partners – either on a market value basis or on the basis of consideration actually received, which can include a sum being credited to the partner's capital account.

What happens on a change in profit sharing ratios?

The answer can be found in para 4 of SP D12. This addresses a change in how existing partners share profits, but also what happens when profit sharing ratios change because a partner enters or leaves the partnership – including through the sale of their partnership interest to a third party.

Sale of one's partnership interest

It may seem counter-intuitive that a partner's exit from the partnership through selling their interest to a third party is treated as a change in profit sharing ratios.

A tempting conclusion might seem to be that TCGA 1992 s 59 does not apply to such a transaction because a partnership interest can be an asset in its own right and TCGA 1992 should apply to it as to any other asset, i.e. the partner's gain on the disposal of the partnership interest is the cash consideration minus the partner's basis in the partnership interest.

But the issue with this analysis is the potential for double taxation. If the partnership had itself previously disposed of an asset, any chargeable gain would have been allocated between the partners but would not have increased the partner's basis in the partnership interest, so that gain would effectively be taxed again when the partnership interest is disposed of (unless the disposal proceeds had previously been fully distributed to the partners). SP D12 therefore approaches changes in partnership interests as changes in each partner's share of the underlying partnership assets as being implicit in TCGA 1992 s 59. However, this gives rise to its own problems.

Paragraph 4 of SP D12 and its problems

Any change in partnership sharing ratios is a disposal under para 4 of SP D12. This includes not only obvious examples, such as where a partner leaves the partnership, but perhaps less obvious ones like a new partner entering the partnership, which is a disposal by the other partners of a fractional share of partnership assets to the new partner.

This then raises further questions. What is the disposal consideration? Is it limited to consideration actually received by the partner on the change in profit shares? If so, how is the consideration allocated to different partnership assets (which may or may not be within the scope of CGT)?

SP D12 only partially addresses these questions, and not always satisfactorily. Taking paras 4, 6, 7 and 8 of SP D12 together, the disposal consideration is broadly calculated as follows:

- Paragraph 6 of SP D12 treats the disposal consideration as including the balance sheet value of partnership assets, so if a partnership asset has been revalued in the partnership accounts, this will likely give rise to a gain on a change in profit shares.
- There should be added to this any consideration received directly by the partner. SP D12 assumes that such payments will normally be made for goodwill that is not included in the balance sheet (see para 7 of SP D12).
- If the transaction is not at arm's length or a genuine commercial transaction, the market value rule will apply instead and the consideration for the disposal is the partner's fractional share of the market value of the partnership assets (see para 8 of SP D12).

As such, there should usually be no gain on a change in profit shares if: (i) the transaction is arm's length; (ii) no assets have been revalued in the partnership accounts; and (iii) no payment has been made in respect of the change in profit shares.

However, this can result in unfair outcomes. For example, a partner might retire from a partnership and simply receive back their initial capital contribution to the partnership. Economically, one would not expect that to give rise to a gain, but there will be one under SP D12 if there happens to have been a revaluation of partnership assets in the partnership accounts.

Similarly, there is likely to be some overlap between the balance sheet value of partnership assets and any payment for the disposal of a partnership interest: the statement in para 7 that such payments are usually for goodwill is surely an oversimplification in most cases. Paragraph 7 acknowledges that the payment may sometimes clearly be for a share in other partnership assets, in which case the partner may be entitled to deduct their share of the partnership acquisition cost, but that might still leave some double counting where the asset has been revalued.

In scenarios like these, practitioners may have to take a pragmatic view to ensure that SP D12 reaches a sensible result.

What other issues are covered by SP D12?

Two examples of specific issues addressed in paras 9 to 14 are mergers and restructuring reliefs.

Mergers

Mergers (and demergers) of partnerships follow the principles applicable to changes in profit sharing ratios.

For example, if Partners A and B have a 50:50 share in two partnerships and those partnerships are merged, with Partners A and B retaining their 50:50 share, Partners A and B will not be treated as having disposed of or acquired any partnership assets, despite the fact that the original partnerships may no longer exist. Their underlying share of the partnership assets remains the same at all times.

If, however, profit shares do change and a partner effectively exchanges a share in one trading partnership for another, para 10 of SP D12 helpfully confirms that it may be possible for a partner to make a claim for business asset roll-over relief under TCGA 1992 s 152; for mergers or demergers of trading partnerships, this can be a useful way of mitigating some of the issues with SP D12.

Restructuring reliefs

Paragraph 14 of SP D12 confirms that various restructuring reliefs that do not, at first glance, obviously apply in the case of partnerships do in fact apply. These include incorporation relief under TCGA 1992 s 162 where a partnership's business is incorporated and hold-over relief for gifts of business assets under TCGA 1992 s 165. However, the conditions for these reliefs require careful consideration in each individual case: they are not drafted with partnerships in mind and so inevitably give rise to difficulties.

Conspicuously absent from para 14 are reliefs for share-for-share exchanges and schemes of reconstruction under TCGA 1992 s 135 and s 136. Nonetheless, it is generally accepted that these reliefs may be available where a partnership holds shares or debentures that fall within these provisions, although difficulties can arise where, for example, it is proposed that shares are issued to the partners rather than the partnership; as with other restructuring reliefs, partnerships do not fit perfectly into these provisions.

Conclusion

SP D12 is by no means perfect, nor does it provide a complete answer in all circumstances. But it is useful guidance on the application of the general legislative principles in TCGA 1992 ss 59 and 59A, and at the very least a good starting point for most partnership transactions.

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