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Economic Affairs Committee

2nd Report of Session 2013–14

# The Draft Finance Bill 2014

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See Appendix 1.
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Evidence is published online at http://www.parliament.uk/hlfinancebill and available for inspection at the Parliamentary Archives (020 7219 5314)

References in footnotes to the Report are as follows:
Q refers to a question in oral evidence.
Witness names without a question reference refer to written evidence.

## ABSTRACT

The Finance Bill Sub-Committee (FBSC) of the Economic Affairs Committee has met each year since 2003, except in 2010 and 2012, to examine selected aspects of the year's Finance Bill.

In December 2010, the Government introduced a "new approach" to tax policy-making which includes publishing a draft Finance Bill in December. This means that the Sub-Committee can now start its work earlier in the year and examine the draft Finance Bill. The FBSC began its inquiry into draft Finance Bill 2014 in January and chose to look at the measures which deal with the taxation of partnerships and at the extent to which they had been developed according to the principles of the new approach. It also considered how effectively the new process had been applied to the development of tax legislation since 2011 and whether the recommendations of our 2011 inquiry into the new approach had been acted upon.

**The measures affecting partnerships**

The Limited Liability Partnerships (LLP) Act 2000 introduced into UK law a new form of partnership in which each partner's liability for the partnership's debts is limited to his or her contribution to its capital. A feature of LLPs is that for tax purposes all members of a LLP are treated as partners, and so as self-employed, even if they would have been treated as employees in a traditional or general partnership. This provision appears to have been abused to minimise the income tax and NIC liabilities of LLP members and the NIC and employment law obligations of LLPs.

One of the measures in the draft Finance Bill seeks to counter this abuse by introducing legislative tests intended to place members of a LLP in the same tax position as partners in a general partnership. A LLP member would pay income tax and NICs as an employee if he failed these tests and the LLP would pay employer NICs.

Most of the evidence we received argued that the proposed legislative tests went too wide and would have the effect of classifying as employees some LLP members who would be treated as partners according to case law. Most of the evidence was in favour of using the case law test to determine whether a member of a LLP was a true partner or an employee, in the same way as for a general partnership.

Although we think it is still open to question which approach best achieves the Government's objectives, we agree that the measures in the draft Finance Bill are so different from the original proposals consulted on in the summer that more time is needed to settle that question and get the legislation right. We therefore recommend delaying the salaried members' provisions until April 2015. This would also enable businesses to adapt to any changes and the Government to consider whether the new rules should apply for the partnership's accounting year rather than for the tax year. We set out the likely Exchequer effects of such a delay.

The main other measure concerns those partnerships, including LLPs, with corporate members ('mixed membership partnerships'). It seeks to counter the practice of allocating disproportionate profit shares to corporate members, with the effect that the total amount of tax borne by the partnership's members is reduced or deferred. The measure gives HMRC the power, in certain circumstances, to reallocate profits on a 'just and reasonable' basis. Following consultation, special arrangements are being introduced for alternative investment fund managers who are obliged to defer bonuses to meet the requirements of an EU directive. The consultation also drew attention to the scale on which profit shifting was practised in the AIFM sector, causing estimates of yield from this measure to be revised very sharply upwards.

Most of our witnesses were concerned that, in attempting to counter the exploitation of structural differences in the tax system, as well as outright avoidance, the measures risked affecting long-established commercial practices, including the use of corporate members to reduce the tax liability on profits intended for reinvestment in the business. It is clear however that the Government intend the legislation to apply to such cases. We recommend that HMRC amend the provisions so that they are drafted more precisely and rely less on guidance.

We were concerned that HMRC appeared to have allowed the practice of profit shifting to become embedded as 'acceptable tax planning'. And we were also concerned at HMRC's unwillingness to explain and disaggregate their estimates of yield from the partnership measures.

**The new approach to tax policy-making**

We looked at the extent to which the development of the partnerships tax package was consistent with the new approach. We commend the Government on the conduct of the consultation between May and August 2013, but criticise its decision to launch significantly different proposals in the draft Finance Bill 2014 without allowing time for further consultation.

We also looked at the development of tax legislation since 2011 and conclude that, in the great majority of cases, the new approach to tax policy-making had been applied comprehensively. We commend the Government accordingly and recommend that it consider any lessons learned about best practice and take steps to apply them to achieve consistently good results.

We were pleased to hear that the tax policy partnership between HMRC and HMT appeared to be working more effectively. We were disappointed that a formal review of their partnership had not been carried out and that recommendations in our Report of 2013 had not been followed up. We reaffirm the substance of our recommendations about the policy partnership between HMRC and HMT, and about consultation on impact assessments and with smaller businesses and non-business stakeholders, post-implementation reviews and 'roadmaps' outlining the strategic context in which tax policy changes are being developed.

# The Draft Finance Bill 2014

## CHAPTER 1: INTRODUCTION

1. This is the tenth report in a series which began in 2003 when the House of Lords Select Committee on Economic Affairs first appointed a Sub-Committee to inquire into selected aspects of that year's Finance Bill. The Finance Bill Sub-Committee's inquiries address technical issues of tax administration, clarification and simplification rather than rates or incidence of tax.

2. In December 2010, the Government introduced a 'new approach' to tax policy-making which was examined in our report on Finance Bill 2011. It includes publishing a draft of the Finance Bill in December, some three months before it is laid before Parliament. Consequent on this, the House of Lords revised the terms of reference of the Sub-Committee so that it could start its work earlier in the tax year and examine the provisions in the draft Finance Bill. This enables our report to be available before the Budget and publication of the Finance Bill itself, so that it is ready for consideration at all stages of the Parliamentary process in the House of Commons.

3. The draft Finance Bill 2014 was published on 10 December 2013 and the Sub-Committee began its inquiry in January 2014. As in previous years the Sub-Committee has to be selective as to what it can include for close examination.

4. This year, the Sub-Committee chose to look at measures in the draft Finance Bill which deal with the taxation of partnerships: principally the salaried members of limited liability partnerships and the taxation of mixed membership partnerships The draft legislation was examined in the context of the taxation of partnerships generally and of an interim report, published by the Office of Tax Simplification (OTS) just as we were commencing our evidence sessions. This topic occupied most of the Sub-Committee's time.

5. In addition, the Sub-Committee looked at the new tax policy-making process: specifically at how the measures on the taxation of partnerships had been handled against the five stages of that process. Also the Sub-Committee considered how the new process had been developing more generally in the period since 2011 and whether the recommendations in our 2011 report were being acted upon.

6. As in previous years, the Sub-Committee conducted its inquiry by taking written and oral evidence from a wide range of witnesses and from HM Treasury (HMT) and HM Revenue and Customs (HMRC). A list of those who have contributed to the inquiry in this way is given in Appendix 2.Their evidence can be found on the Economic Affairs Finance Bill Sub-Committee website,[1] including those who responded to the general invitation to provide written evidence. The Sub-Committee would like to thank all those who have contributed to its work. Without their help this report could not have been written.

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1 See: http://www.parliament.uk/hlfinancebill

7. Chapter 2 contains a general introduction to the taxation of partnerships and a summary of the OTS report. Chapter 3 looks at the stages leading up to the draft legislation and what was published in the draft Finance Bill. Chapters 4 and 5 examine the draft legislation, the first looking at the salaried members of limited liability partnerships and the second the other elements of the package. Chapter 6 examines the new policy-making process, both as regards the partnership measures and more generally. The conclusions and recommendations are summarised in Chapter 7.

## CHAPTER 2: PARTNERSHIPS-GENERAL BACKGROUND

8. This chapter sets the scene for the next three chapters. It begins with a brief overview of the different types of partnership and of how the members of partnerships are taxed. And it goes on to outline the main findings and recommendations of the interim report of the OTS's Review of Partnerships.

### What is a Partnership?

9. The concept of a 'partnership' is one of the earliest forms of business organisation and its origins go back to the beginnings of commercial activity. The Partnership Act 1890, almost all of which remains in force today, consolidated existing law and defined partnership as "the relation which subsists between persons carrying on a business in common with a view of profit"[2].

10. Partners in a partnership may be either natural persons or legal entities such as companies, and a partnership may consist entirely of natural persons, entirely of legal entities or a combination of both (a 'mixed' partnership). There is no limit on the number of partners in a partnership. A partnership may exist between two or more persons whether or not they have a formal partnership agreement.

11. The 'business' carried on by a partnership can include "every trade, occupation, or profession"[3] and the profits or losses from that business may be shared between partners in any way they agree.

12. Some members of a partnership, often referred to as 'salaried partners', may be entitled to a fixed share of the profits prior to any allocation of profits to other partners. Whether such partners are 'true' partners, or in fact employees of the partnership, depends on the facts in question including whether, in all other respects, the nature of their involvement in the conduct of the partnership's business is that of a true partner. There is no specific formula to determine status but the decision is guided by case law.

### Types of Partnership

13. There are three types of partnership: general partnerships, limited partnerships and limited liability partnerships.

#### *General Partnerships*

14. 'General' partnerships, sometimes referred to as 'traditional' partnerships, are the sort of partnerships envisaged by the Partnership Act 1890. Each partner can act on behalf of the partnership in the conduct of its business with binding effect on the other partners, and all partners have unlimited liability for the debts of the partnership.

15. A general partnership is not a legal person in England, Wales and Northern Ireland although it is in Scotland.

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2 Partnership Act 1890, section 1(1).

3 *Ibid.*, section 45.

### *Limited Partnerships*

16. The concept of a 'limited partnership' was introduced by the Limited Partnerships Act 1907 and it allows a person to be a 'limited partner', whose liability for the partnership's debts is limited to his or her capital contribution to the partnership. A limited partnership must consist of at least one general partner, whose liability is unlimited, and one limited partner; limited partners must not be involved in the management of the partnership's business.

17. In most other respects limited partnerships are subject to the Partnership Act 1890 and, like general partnerships, are not legal persons, except in Scotland.

### *Limited Liability Partnerships*

18. Limited liability partnerships (LLPs) were established by the Limited Liability Partnerships Act 2000. They are 'bodies corporate' with legal personality separate from their members. They enable each partner to limit his liability for the partnership's debts to an amount (usually the capital they have invested in the LLP) agreed with the other members of the LLP.

19. Like general partnerships, LLPs can be formed by two or more (natural or legal) persons, including other LLPs, carrying on a business as defined above. LLPs therefore offer the limited liability benefits of the company combined with the organisational flexibility of general partnerships and have become a very popular way of organising business arrangements and transactions.

## Partnership Facts

20. In 2011–12 there were some 420,000 partnerships of one form or another, accounting for about 10 per cent of the total number of UK businesses. Partnerships are predominantly very small: 90 per cent had three or fewer partners and less than one per cent had more than 50. HMRC estimate that, of the partnerships operating in the UK, some 23,000 (about 5 per cent of all partnerships) had a corporate member. Of these just over half were mixed member partnerships and the remainder consisted of non-individual partners only.[4]

21. Partnerships cover a very wide range of commercial activities from small husband and wife businesses to international professional service businesses and City-based vehicles investing in property development or venture capital activities.

## Taxation of Partnerships

22. The title of this section is, in one sense, a misnomer in that partnerships are not liable to tax in their own right on the profits and capital gains generated by their business activities. UK tax rules 'look through' the partnership to the individual partners or members who are then taxed on their share of the partnership's profits and gains at their marginal tax rates and according to whether they are individuals or companies. This transparency applies even where the partnership is a separate legal entity, as is the case for Scottish partnerships and for LLPs.

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4 All figures from *Review of partnerships: interim report*, OTS, January 2014, Annex A.

23. This means that the total amount of tax and National Insurance Contributions (NICs) collected in respect of any given partnership's income and gains depends on the individual tax liability of each member and on the relative share of each in the profits, losses and capital gains of the partnership.

24. For non-corporate members of general partnerships and limited partnerships, tax liability is governed by whether they are 'true' partners or whether they are employees. However, for tax purposes all LLP members are treated as partners, and therefore as self-employed, even if they would be treated as employees in a general partnership.

25. The issue of employment status has significant tax consequences for both individual members and the partnership. A partner is deemed to carry on a personal trade or profession and his or her share of partnership profits or losses is calculated according to income tax rules. Profits are taxed at the partner's marginal rate of income tax—20, 40 or 45 percent—and NICs are payable at the self-employed rate of 9 per cent on profits up to £41,450[5] and 2 per cent thereafter. The partnership pays no employer NICs since the partner is not an employee.

26. An employee is liable to income tax on his or her earnings (with less generous expense deductions) at the same marginal income tax rates as the partner, but pays NICs at the employee rate of 12 per cent on earnings up to £41,450[6] and 2 per cent thereafter. The partnership pays employer NICs at 13.8 per cent on those earnings[7] and collects income tax and NICs from employees under PAYE. And employment status confers certain rights and obligations on both the employee and the partnership (as employer).

27. Tax liability on the share of the profits allocated to a corporate member of a partnership is calculated using corporation tax rules, including reliefs not available to individuals, and tax is payable at the corporation tax rate—23 per cent for 2013–14, but due to fall to 21 per cent next year and 20 per cent the year after.

28. As for capital gains, the rules provide that, where a business is carried on in partnership, capital gains tax (CGT) is charged on the partners separately. The same applies to corporation tax on chargeable gains for company members of a partnership.

29. These differences in tax treatment arise from the structure of the UK tax system and the current default assumption that every individual member of an LLP is a self-employed partner. They give rise to very substantial opportunities for minimising the tax and NIC liabilities of both partners and the partnership and for the partnership to reduce its employment law obligations. These tax arbitrage (and avoidance) opportunities lie at the heart of the changes proposed by the Government in the draft Finance Bill 2014.

30. Turning to tax administration, partners must report their profits from the partnership business on an income tax or corporation tax return as appropriate. And, although it is not liable to tax in its own right, the partnership (or rather a partner nominated to do so) must make a 'partnership tax return', using income tax rules to compute the share of profits allocated to

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5 Above a threshold amount.

6 *Ibid.*

7 *Ibid.*

individual partners and corporation tax rules to compute profits allocated to corporate members. Where chargeable capital gains are made they must be reported on the chargeable assets page of the partnership tax return.

### Review of Partnerships: Interim Report

31. Against this rather complex background, the Office of Tax Simplification (OTS) was commissioned in 2013 to carry out a comprehensive review of partnership taxation. The terms of reference of this review covered the range of taxes applying to partnerships and included the legislation itself, the administrative processes and the guidance provided by HMRC and complexities surrounding the different types of partnership.

32. The interim report of the OTS review was published on 22 January 2014 and we heard evidence from the Tax Director of the OTS at around the same time. Given its terms of reference, the report and its recommendations are necessarily quite detailed and technical.

33. The report was not based on a survey, but on interviews, meetings, seminars and the like carried out between September and November 2013, on written submissions and on intensive desk research in the OTS and on data analysis in HMRC. It paints a very interesting, and sometimes surprising, background picture of the scale on which the partnership form is used to organise business in the UK, of the size distribution of partnerships, and of the wide range of activities, from corner shop to multi-million pound property development, which partnerships of one kind or another undertake.

#### *Conclusions*

34. The main findings of the report were that:

- notwithstanding the size of their contribution to the UK economy, policymakers seem to pay scant regard to the effect on partnerships of tax policy changes. So, for example, the Government's strategy for developing a competitive UK business tax environment focuses entirely on corporate tax, sometimes at the expense of partnerships;
- although a case can be made for a separate tax code for partnerships, which perhaps distinguished between small and large partnerships, there appears to be no appetite for the disruption and uncertainty such a major reform would entail; and
- the most common concern among partnerships and their advisers was the absence of a mechanism, other than through a corporate partner, for retaining profits for commercial purposes, including the growth of the business.

35. The interim report concluded that "HMRC and the tax system generally needs to evolve a more supportive and constructive approach to partnerships"[8] and in particular that:

- the 'one size fits all' approach of partnership tax law and of tax administration leads to extra burdens and complexities for small partnerships as compared with sole traders carrying on businesses of a similar size;

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8 *Review of partnerships: interim report*, OTS, January 2014, page 6.

- the tax system needs to take a more strategic approach to partnerships rather than allowing their tax environment to develop merely as a consequence of policies and administrative arrangements designed for sole traders or companies;
- HMRC needs to coordinate more effectively its work with partnerships, including its support functions, such as guidance notes, which are not currently consolidated; and
- HMRC needs to take steps to change the widespread conviction that its view of partnerships is that they are primarily a vehicle for the reduction or avoidance of tax liabilities.

*Recommendations*

36. The Report's recommendations are divided into 'short term fixes', medium-term proposals and suggestions for longer-term investigation.

37. The short-term fixes are intended to provide "useful benefits, mainly for small firms, for modest effort on the part of (mainly) HMRC"[9] and include: republishing a model partnership agreement; producing a single consolidated manual with clearer, up-to-date guidance for partnerships; simplifying the SA and CTSA tax returns; and developing free tax return software for small partnerships.

38. The OTS's main recommendations for the medium term, which "should be taken forward, presumably through formal consultation, in the near future",[10] are that HMRC should:

- update the statements of practice for computing the capital gains made by partnerships;
- ensure that double taxation agreements deal properly with partnerships so that credit for foreign tax is not lost;
- simplify the rules for accounting for any non-trading income, such as interest, received by partnerships;
- review the penalties for late filing of partnership returns and for failures to notify changes of status for VAT purposes; and
- put in place arrangements for monitoring and responding to the development of new business structures involving partnerships.

39. The Report also suggests that there is significant scope for HMRC's digital programme to offer further simplification of administrative processes for partners and partnerships, including submitting tax returns and partners' expense claims.

40. Finally, the Report recommends that, in the longer term, further work should be done to investigate "areas where there is clearly a problem in need of simplification but where the solution is not clear-cut"[11] including:

- ways of further reducing the administrative burdens of smaller partnerships, perhaps including removing the requirement for them to file

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9 *Review of partnerships: interim report*, OTS, January 2014, page 6.

10 *Ibid.*, page 7.

11 *Ibid.*, pages 7 and 8.

a partnership return, and of improving their understanding of their tax obligations;

- how the 1890 Act partnership agreement, which applies in the absence of a formal agreement between partners, might be updated and publicised more widely;
- the scope for allowing partners to claim personal expenses outside the computation of partnership profits; and
- the scope for removing SDLT charges in partnership reorganisations where no cash changes hands and for reducing the complexities caused by adopting accounting periods that do not correspond to the tax year.

41. The OTS's Interim Report was published shortly after our inquiry had begun so that most of our witnesses had had little time to digest and take a view on its conclusions and recommendations. But it provided very useful background to our inquiry and witness comments about it were very positive.

## CHAPTER 3: THE CONSULTATION AND THE DRAFT LEGISLATION

42. This chapter sets out the background to the legislation which appears in the draft Finance Bill. It starts with a brief overview of the Limited Liability Partnerships Act 2000, then moves to the announcement in Budget 2013, followed by the consultation document published in May 2013. It describes the consultation responses and the Government's reactions as evident from the legislation in the draft Finance Bill. All four elements of the partnerships package are described, followed by a brief section on the estimated yield from the package. For the proposals concerning salaried members of limited liability partnerships, the chapter examines the evidence that the proposed legislation is radically different from what preceded it and offers conclusions.

### Limited Liability Partnerships

#### *The Limited Liability Partnerships Act 2000*

43. As discussed in Chapter 2, the Limited Liability Partnerships Act 2000 introduced into UK law limited liability partnerships with limited liability for their members. This was in response to concerns at the risks associated with large legal claims for professional firms set up as general partnerships.

44. When the LLP Act was introduced, the broad policy intention was that members of a LLP should be treated in the same way as partners in a general partnership; this was achieved by section 4(4) of the Act. The precise drafting of this sub-section has been criticised in various employment law cases where the point at issue has been whether the LLP member had been an employee of the partnership, with the rights and protections that go with that status.[12] However, the courts have been prepared to take a purposive approach to its interpretation by addressing the question of whether the member would have been treated as a partner or an employee if the LLP had been a general partnership.

45. It was also intended that there should be equivalence of treatment between LLPs and general partnerships for tax purposes. As HMRC put it in their consultation document of May 2013 "The original tax policy aim was to place members of LLPs in the same position for tax purposes as partners in a traditional partnership."[13] However, the provision which is now at section 863 Income Tax (Trading and Other Income) Act (ITTOIA) 2005, results in the tax legislation going further than the original intention by deeming an LLP member to be a partner for all the activities of the LLP. This is the legislative basis for treating LLP members as self-employed in all cases.

46. Many of our witnesses confirmed this understanding of both the intention and the outcome. For example, the Law Society of England and Wales (LSEW) wrote:

> "[The LLP Act] intended that the status of a person who is a partner in a general partnership and a person who (although he may purport to be

12 See for example *Tiffin v Lester Aldridge LLP* [2012] 2 All ER 1113.

13 *Partnerships: A review of two aspects of the tax rules, Consultation document,* HMRC, 20 May 2013, paragraph 2.8.

> a partner in a general partnership) is in law an employee of the partnership, should not change if the general partnership converts to an LLP … However, this policy misfired."[14]

47. The result is that the case law tests, based on court decisions which apply to determine whether a person is an employee of, or a partner in, a general partnership, do not apply for tax purposes to members of a LLP. Put simply, membership of a LLP is sufficient to produce the result that the member is self-employed with the attendant tax and national insurance savings. This presumption of self-employment has been increasingly exploited to disguise employees as self-employed partners. Mr John Whiting, OTS, told us "We were cited one so-called LLP partnership that had 20,000 partners in it … Equally, I was told by one practitioner of occasional fruit pickers being officially partners in an LLP."[15]

### *The Budget Announcement and the First Consultation*

48. Budget 2013 announced that "the Government will consult on measures to remove the presumption of self-employment for limited liability partnership (LLP) partners, to tackle the disguising of employment relationships through LLPs."[16]

49. The consultation document which followed in May 2013 stated that "The policy aim is to prevent a member of an LLP benefiting from the default partner status if the terms of his or her engagement with the LLP are tantamount to an employment."[17] Baker Tilly reminded us how the Exchequer Secretary had written in his foreword to the consultation document "Fundamentally, this consultation is about levelling the playing field. It will have no impact on those partnerships or LLP members that use partnership structures as Parliament originally intended."[18]

50. The consultation document set out how the Government was intending to achieve its policy aim. An individual LLP member who met either of two conditions would be classified as a "salaried member" and would be treated as an employee of the LLP. An employment status test would form the first condition and determine, by reference to the tests set out in HMRC's Employment Status Manual, whether the member would be treated as an employee if the LLP were a general partnership. The second condition would be an economic risks test which would treat the member as an employee if he did not meet the first condition but carried no economic risk, was not entitled a share of the profits and was not entitled to a share of any surplus assets on winding up the partnership.

### *The Response to the First Consultation and the Draft Legislation*

51. The consultation closed in early August and HMRC published a Summary of Responses on 10 December 2013 alongside the draft Finance Bill.

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14 LSEW, paragraphs 7 and 8.

15 Q 8.

16 *Budget 2013*, HMT, March 2013 (HC 1033) paragraph 1.209.

17 *Partnerships: A review of two aspects of the tax rules, Consultation Document*, HMRC, 20 May 2013, paragraph 2.12.

18 Baker Tilly, paragraph 10.

> "A large number of the respondents objected to the use of traditional employment status rules (the first of the two conditions proposed in the consultation document). They did not think that the self-employed and employee tests described in HMRC employment status manuals would be appropriate to determine the status of large professional LLP members."[19]

Those tests had been "devised to differentiate between self-employed consultants and employees rather than between partners and employees."[20]

52. The Government's response to these views was to withdraw the first condition (the employment status test) and rely instead on strengthening the second test (the economic risks test). The option that had been pressed by many respondents, of simply repealing the presumption of self-employment and relying on general case law, was rejected on the basis of general uncertainty over the meaning of the case law.

53. The revised second test is included in the draft legislation. A LLP member is to be treated as an employee if all three Conditions A to C are met:

    Condition A: the member is to perform services for the LLP in his or her capacity as a member, and is expected to be wholly or substantially wholly rewarded through a "disguised salary" that is fixed or, if varied, varied without reference to the profits or losses of the LLP;

    Condition B: the member does not have significant influence over the affairs of the partnership; and

    Condition C: the member's capital contribution to the LLP is less than 25% of the annual, disguised salary.

54. HMRC announced in its Summary of Responses document that "The original start date of 6 April 2014 will not be deferred given that there has been a long lead time for customers to prepare for these changes following the Budget 2013 announcement."[21]

55. In chapter 4, we discuss the evidence concerning the merits of adopting these legislative tests compared with the general partnership case law tests and the extent to which they deliver the policy objective of aligning the tax treatment of LLP members with partners in a general partnership. In this chapter we focus on the evidence as to whether the Conditions in the draft legislation are a natural development of the earlier round of consultation or whether they constitute a radically different approach.

### *Views on the Draft Legislation*

56. There is a widespread view that the legislative proposals are very different from those in the May consultation document. Baker Tilly thought that "the policy objective has changed significantly since the original consultation".[22]The view of the Confederation of British Industry (CBI) was that

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19 *Partnerships: A review of two aspects of the tax rules, Summary of Responses,* HMRC, 10 December 2013, paragraph 1.7.

20 *Ibid.*, paragraph 3.8.

21 *Ibid.*, paragraph 3.20.

22 Baker Tilly, paragraph 39.

> "The consultation process which took place between May and August 2013 sought responses to a much narrower set of proposals than those published on 10 December 2013. Had businesses known these parameters, many more may have responded and those that did respond may have responded differently."[23]

57. The LSEW were more strident in their criticism: "This is a fundamentally different approach from that set out in the May 2013 consultation … HMRC said that Conditions A to C were a strengthening of the second condition. We do not agree as we believe that they are a fundamentally different proposal."[24] The Association of Partnership Practitioners (APP) agreed.[25] Mr Frank Haskew, Institute of Chartered Accountants in England and Wales (ICAEW), thought that "Somewhere along the line, it seems as though that view was changed in favour of these totally different tests."[26] Mr Gary Richards, LSEW, described them as "radically different."[27] Herbert Smith Freehills[28] and Mazars[29] added their support.

58. In her evidence Ms Judith Knott (HMRC) stated that

> "the text in the draft legislation is different from that proposed in the original consultation, but that is because of the views we heard during the consultation. Views differed, as you heard in the hearings, but there was a strong view that a clear set of rules was required, which is what we have tried to provide in the draft legislation. We were persuaded that the case-law tests would not suffice and would not work well in the context of LLPs."[30]

59. **The failure of the Limited Liability Partnerships Act 2000 to achieve its policy objective of aligning the tax treatment of LLP members with that of partners in a general partnership is at the heart of the problems that have arisen with LLP members all being treated as self-employed.**

60. **We accept the evidence of our private sector witnesses on the provisions concerning salaried members of LLPs, and agree that the December proposals are significantly different from those proposed in the earlier consultation.**

61. **This change of direction in December has implications for the way in which this consultation should have been handled and the way in which consultations generally should be handled. We return to this in Chapter 6.**

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23 CBI, paragraph 4.

24 LSEW, paragraph 16.

25 APP, paragraph 4.2.

26 Q 44.

27 Q 71.

28 Herbert Smith Freehills, paragraph 3.

29 Mazars, paragraph 10.1.

30 Q 118.

## Mixed Membership Partnerships

### *The Budget Announcement and the First Consultation*

62. This is the second main element of the tax package proposed for partnerships in Budget 2013. The Budget announced that "the Government will consult on measures to counter the artificial allocation of profits to partners (in both LLPs and other partnerships) to achieve a tax advantage."[31]

63. The May 2013 consultation document explained what was intended here:

> "A partnership may involve different types of entity, for example, it may include both company and individual members … HMRC has seen an increasing number of arrangements involving such mixed structures where the profit-sharing ratios are calculated in such a way as to minimise the overall tax paid by the partners."[32]

64. The proposals in the May consultative document were that HMRC could reallocate to individual partners profits allocated to a corporate[33] partner where the partnership comprises individual(s) and company(ies), there is an economic connection between those partners, and it is reasonable to assume that the main purpose or one of the main purposes, of the partnership profit-sharing arrangements is to secure an income tax advantage for any person.

65. In such circumstances the profits could be reallocated on a just and reasonable basis, taking into account all the circumstances. The proposals would also target the situation where losses are allocated to individual partners where loss relief can be claimed at a higher effective rate of relief.

### *The Response to the First Consultation and the Draft Legislation*

66. Many respondents noted that the proposals were a departure from traditional anti-avoidance measures. Others argued that at least some of the arrangements targeted were commercial, for example, to enable working capital to be taxed at a lower rate. We return to this point in Chapter 5 and describe the very similar points that were put to us. Others thought that only a timing advantage was gained by allocating profits to a company; some considered this legislation an over-reaction.

67. In their Summary of Responses document, HMRC stated that their analysis showed that

> "arrangements involving partnerships with mixed members give rise to permanent tax loss, and that any later tax attributable to dividend income is significantly less than the tax lost at the point of allocation. The Government considers that blocking excessive allocations at the start is the only certain way to stop this tax loss".[34]

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31 *Budget 2013,* HMT, March 2013 (HC 1033) paragraph 1.209.

32 *Partnerships: A review of two aspects of the tax rules, Consultation document,* HMRC, 20 May 2013, paragraphs 3.9, 3.10.

33 Strictly a non-individual partner, but since this situation arises most frequently with a corporate partner, this report refers to a corporate partner from here on.

34 *Partnerships: A review of two aspects of the tax rules, Summary of Responses,* HMRC, 10 December 2013, paragraph 4.11.

As discussed in chapter 5, HMRC was unable to give us any further idea of how this permanent tax loss was achieved, when such arrangements were first introduced or the amount that had been foregone as a result of them.

68. However, the Government did make some changes to the proposals including replacing the main purpose test with a more objective test. The provisions included in the draft Finance Bill give HMRC the power to reallocate, on a just and reasonable basis, profit shares where a partnership or LLP makes a profit for tax purposes and a profit share is allocated to a corporate partner, and either

    (a) the company's profits represent the deferred profit of an individual member and in consequence the individual's profits and the overall tax liability are lower than they would otherwise be, or

    (b) an individual partner has the power to enjoy the company's profit share and it is reasonable to suppose that both the individual's profit share and the overall tax liability are lower that they would have been in the absence of that power to enjoy the company's profits.

69. HMRC's draft guidance issued on 10 December 2013, stressed the need for an economic interest between the individual partners and the non-individual partner: "The legislation does not apply to mixed membership partnerships in which the individual and non-individual partners are genuinely acting at arm's length."[35] And it applies only if it is reasonable to suppose that the profit allocated to the corporate partner is excessive and that allocated to the individual partner is correspondingly reduced.

70. The issue of profit deferral arrangements, which occur mainly in the banking and investment fund sectors, received most comment. These arrangements are where an amount

> "may be awarded to particular executives but during a deferral period be subject to forfeiture depending on the performance by the executive or a wider group over that time …The aim of these deferral arrangements is to align incentives with long-term performance and discourage the taking of risks which may yield short-term profits but long-term losses."[36]

71. It is clear that, with many partnerships, deferred profits are allocated to a corporate partner so that the tax immediately payable is correspondingly reduced and the individual partner does not have to pay tax on monies that he has not yet received. Generally, the Government's view remains that the allocation of the deferred profits of an individual partner to a corporate partner does not justify special treatment whatever the reason and that is why profit deferral arrangements have been included in the draft legislation. However, the Government was prepared to relax this stance in one situation which emerged during the consultation, the treatment of Alternative Investment Fund Managers (AIFM) partnerships.

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[35] *Partnerships: A review of two aspects of the tax rules, Technical Note and Guidance*, HMRC, 10 December 2013, paragraph 3.1.a).

[36] *Partnerships: A review of two aspects of the tax rules, Consultation document,* HMRC, 20 May 2013, paragraph 3.16.

### *Views on the Draft Legislation*

72. Whilst we have received much evidence on the scope and drafting of this legislation on mixed membership partnerships, no-one has contended that it is not a natural progression from what was proposed in the first consultation document, or that it should be delayed.

## AIFM Partnerships: Profit Deferral Arrangements

### *A New Mechanism to Tax Deferred Profits*

73. In the May consultation document, HMRC set out its "understanding that at present it is exceptional for partnerships to be subject to any regulatory requirement to operate either profit deferral or clawback, but that this may change in the future."[37] This turned out to be incorrect in one area, the AIFM sector which is subject to regulation under the AIFM EU Directive (AIFMD).[38] The aim of the AIFMD is to improve investor protection across Europe and promote efficiency and cross-border competition. It came into force on 22 July 2013 and was implemented in the UK through secondary legislation and FCA rules. It requires certain firms to defer 40–60% of the variable remuneration of key staff by 3 to 5 years and pay at least 50% of that variable remuneration in units or shares of the funds they manage, rather than cash. Full application of the AIFMD is subject to exceeding certain thresholds. These apply to the total net assets that the manager has under management across all funds, rather than the size of the individual funds that he manages.

74. The allocation of profits to corporate partners has been very prevalent in this sector and the mixed membership proposals would affect these partnerships very significantly as the individual partners would be required to pay tax on monies that could not, as a regulatory requirement, be paid to them. Accordingly, in discussions with representatives of the sector, HMT and HMRC developed proposals which would ease this difficulty by including a new mechanism for taxing the partnership (not its partners) at the additional rate of 45% on profits allocated to the partners but deferred in accord with the AIFMD. Under the mechanism, an election may be made to allocate certain restricted profits to the partnership, rather than any partners, and the partnership will pay the tax of 45%. When the profits are paid out subsequently, the individual partner pays tax and NIC at their marginal rates with a credit for the tax paid by the partnership.

## Transfers of Assets and Income Streams Through Partnerships

75. The proposals in the May consultation document and the resulting legislation cover schemes which seek to exploit the differing tax attributes of members of a partnership. The respondents to the consultation document were in favour of this being tackled and the draft legislation is as proposed in the May document.

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[37] *Partnerships: A review of two aspects of the tax rules, Consultation document,* HMRC, 20 May 2013, paragraph 3.18.

[38] 2011/61/EU.

## Estimated Yield From Draft Legislation

76. At the time of the Budget, the estimated yield from the package of measures was estimated at £1345 million for the 5 years from 2014–15. It turned out that this greatly under-estimated the yield from the AIFM sector. The discussions with the AIFM sector showed that the mixed membership proposals would have a much greater impact on that sector than had been anticipated. As a consequence it was announced in the Autumn Statement that the estimated yield was increased by £1920 million. In chapters 4 and 5 we return to discuss these yield figures in greater detail.

## CHAPTER 4: SALARIED MEMBERS OF LIMITED LIABILITY PARTNERSHIPS

77. This chapter examines the evidence on the proposed changes to the tax treatment of members of LLPs. It opens by considering the Government's proposals and an alternative that was pressed on us. It then examines the scope of the proposals: whether Conditions A to C achieve the policy intention and the business implications of applying those Conditions. There then follow some more detailed points on the draft legislation. Finally, the chapter examines the evidence on the difficulties in implementing the provisions with effect from 6 April 2014 and the consequences of delaying the introduction of this part of the legislative package. The chapter ends with an overall recommendation of the best way forward.

### The Draft Legislation

78. As has been seen in chapter 3, the proposals are designed to change the presumption in existing legislation that all LLP members are self-employed partners in the LLP. They seek to do this by incorporating into the existing legislation (Income Tax (Trading and Other Income) Act (ITTOIA) 2005) three new sections.

79. The first section (section 863A) directs that an individual LLP member is to be treated as an employee if Conditions A to C are met for that member. The detail of Conditions A to C is contained in section 863B. Section 863C contains an anti-avoidance provision. Where the proposals apply to make the LLP member an employee of that LLP, there are then supplementary consequential provisions.

### The Approach of the Legislation: Case Law or Legislative Tests?

80. The problems with salaried members of LLPs stem from the failure of the LLP Act 2000 to achieve its policy objective of aligning the tax treatment of LLP members with that of partners in a general partnership. As discussed in chapter 3, the provision which achieves this for general law purposes, particularly employment law, is considered not to apply for tax purposes, given the wording of the tax provisions.

#### *A Case Law Approach*

81. It might be thought therefore, that the most obvious way to rectify the situation is to amend the legislation so that it does directly align the tax treatment of LLP members with that of partners in a general partnership, and indeed, this was proposed in the May consultation document. This would be done by removing the presumption of self-employment from tax legislation thus allowing the case law that applies to general partnerships to apply to LLP members.

82. This approach was favoured by most of our witnesses. The ICAEW wrote "The existing rules for determining an individual's employment status could

be used for an LLP."[39] Mazars[40], the APP[41] and Deloitte[42] all agreed, as did Mr John Dixon, EY: "In our analysis we would agree with the Deloitte point of view."[43] Mr Kevin Nicholson, PwC, expressed his view that "You can see why you might think a mechanical test is a good one. Unfortunately this does not create certainty at all. It creates anything but certainty …"[44] He reinforced this later in his evidence "That is why, I am afraid, I would not try to come up with a mechanical test. I would go back to basics … because you will be sitting here in 14 years saying, 'Why did somebody not shout louder, and why did we just allow this to happen?'"[45] Mr Bill Dodwell, Deloitte, could see why "Bright line tests can be easy for administrators … but they do not hit the qualitative approach, which we think is the right answer for assessing partnerships."[46]

83. The British Private Equity and Venture Capital Association (BVCA) and the LSEW agreed and the latter commented that

> "the December 2013 technical note brushes aside the suggestion made by many respondents to the May 2013 consultation that the test in LLPA 2000 s.4(4) should be followed for tax purposes and instead proposes three new conditions. The Law Society is concerned by this lack of transparency…".[47]

This view is strongly echoed in the other oral evidence. For example, Mr Chris Sanger, Tax Professionals Forum (TPF), said "We do absolutely believe it would have been simpler to reinforce the [general partnership law] tests."[48] Mr Ashley Greenbank, LSEW, rejected the suggestion that the drafting difficulties with section 4(4) of the 2000 Act were sufficient to justify the alternative approach taken by the Government.[49]

### *The Legislative Tests*

84. Although there was a very considerable weight of evidence in favour of a case law test from the private sector witnesses, there was some understanding of HMRC's position and a willingness among some witnesses to try to make a legislative approach work. Mr Steven Whitaker, BVCA, was "realistic, in that it is unlikely that we can move to a case-law determination of what a partner is".[50] The LSEW too, notwithstanding their preference for a case law approach, did not object to the alternative approach "provided that in essence they replicate the case law test and respect the tax principle underlying the case law test."[51]

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39 ICAEW, paragraph 26.

40 Mazars, paragraph 7.

41 APP, paragraph 3.4.

42 Q 105.

43 Q 105.

44 Q 105.

45 Q 109.

46 Q 105.

47 LSEW, paragraph 20.

48 Q 25.

49 Q 70.

50 Q 87.

51 LSEW, paragraph 17.

85. In their evidence KPMG supported the policy objective and, while not necessarily preferring the approach taken in the legislation, were more comfortable with it, believing "that the three factors used in the draft legislation of profit sharing, management and capital are, on balance, those most prominently featured in previous case law."[52]

86. The apparent difference between the KPMG view and that of Deloitte, who favoured the case law approach, was discussed by Ms Jane McCormick, KPMG, and Mr Dodwell at one of our witness sessions. They agreed that there was not that much between them. It was common ground that with the legislative tests it was essential that they achieved an outcome equivalent to the case law approach.[53]

### *HMRC's View*

87. HMRC's reasons for rejecting the case law approach were set out in the Summary of Responses document: "The main concern here was that normal self-employed vs. employee tests as described in HMRC's employment status manuals would not be effective tests in this context."[54] Notwithstanding the fact that in the Overview of Legislation in Draft,[55] these measures are brigaded in a section entitled "Anti-Avoidance", Ms Knott told us that the partnership measures were not purely about anti-avoidance: "These are structural changes, designed to ensure that the taxation of partnerships and LLPs is fair and consistent and to prevent significant tax loss."[56]

88. Invited to explain why the Government did not restore the position to what was intended in 2000 by removing the presumption of self-employment Ms Knott outlined the answer given in the Responses document:

> "That was something that we considered. In the original consultation document that we published last year, one of the proposals was to rely on the case-law tests alongside another specific test. One of things that we learnt during the consultation was that the case-law tests do not necessarily work well in the context of an LLP … there could be a lack of clarity."[57]

### *Reconciling Views*

89. It is difficult to reconcile the views expressed by private sector witnesses with those expressed by HMRC. It appears to us that there may have been a misunderstanding about the nature of the objections submitted by respondents to the original consultation concerning the case law approach. They seem to have been objecting to the use of the tests in HMRC's Employment Status Manual, not to the use of the case law tests in general.

90. This point was put to us in evidence. The LSEW wrote:

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52 KPMG, Further evidence, paragraph 3.

53 Q 105.

54 *Partnerships: A review of two aspects of the tax rules, Summary of Responses*, HMRC, 10 December 2013, paragraph 3.7.

55 *Overview of Legislation in Draft,* HMRC and HMT, 10 December 2013.

56 Q 118.

57 Q 119.

> "Additionally, like others, the Society objected to the use of the inappropriate tests in the Employment Status Manual in applying the first condition [in the May 2013 consultation document]. ... The Employment Status Manual is not aimed at partnerships but at the wider question of whether, in relation to any kind of employer … , an individual is an employee of the employer or a self-employed independent contractor ..."[58]

Mr Greenbank summarised the position as "It was just applying the tests in the wrong context, and so it made it difficult to apply."[59] Others had the same thoughts.

91. It is not clear to us how significant this apparent misunderstanding might have been in HMRC's decision to reject the case law test. However, the Summary of Responses document, having acknowledged that many respondents wanted the case law test, went on to say:

> "The Government does not consider that its objective of legislative clarity would be achieved by simply repealing the presumption of self-employment. There is a general lack of agreement over the interpretation of case law in this area. Relying on this would, in practice, give rise to a greater administrative burden and would not provide the level of certainty that many respondents have demanded."[60]

92. **It is clear that there are alternative ways of achieving the policy outcome of aligning the tax treatment of LLP members with partners in a general partnership. One approach would be to remove the presumption of self-employment from the tax legislation and to rely on partnership case law to determine whether a LLP member is an employee or a self-employed partner. Another approach would be to adopt legislative tests designed to achieve the same outcome.**

93. **In our view, it is still open to question which is the better approach. We agree strongly with those who stressed that, if legislative tests are adopted, it is vital that they achieve the intended policy outcome of aligning the tax treatment of members of LLPs with that of partners in a general partnership.**

94. **If our recommendation on commencement of the provisions on salaried LLP members (paragraph 142 below) is accepted, it will provide time to enable a reassessment of both approaches and for HMT and HMRC to have further discussions with all interested parties.**

### Do the Three Conditions Achieve the Desired Policy Outcome?

95. In this section we examine the evidence concerning the legislative tests in Conditions A to C and particularly whether they achieve the policy outcome of aligning LLP members with partners in a general partnership. We also consider their business implications as the legislation is currently drafted.

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58 LSEW, paragraph 13.

59 Q 70.

60 *Partnerships: A review of two aspects of the tax rules, Summary of Responses,* HMRC, 10 December 2013, paragraph 3.14.

96. As discussed in Chapter 3, the draft legislation provides that a LLP member will be treated as an employee if all three Conditions A to C are satisfied:

Condition A: the member is to perform services for the LLP in his or her capacity as a member, and is expected to be wholly or substantially wholly rewarded through a "disguised salary" that is fixed or, if varied, varied without reference to the profits or losses of the LLP;

Condition B: the member does not have significant influence over the affairs of the partnership; and

Condition C: the member's capital contribution to the LLP is less than 25% of the annual, disguised salary.

We find the negative way in which the conditions have been drafted surprising. It sets out conditions which, if satisfied, would make the LLP member an employee for tax purposes. We would have expected the legislation to set positive hurdles which, if satisfied, would make the member a partner. If our recommendation for delay is accepted, this approach might be revisited.

### *The General Scope of the Conditions*

97. It will be clear from the preceding section that some of our private sector witnesses were more comfortable than others with the principle of having tests in the legislation. However, there was unanimity of view that the three Conditions as drafted failed to achieve the desired policy outcome. The widespread feeling was that the Conditions went further than desired, had the potential to affect many, if not most, partnerships and would reverse the present relatively advantageous position of LLPs compared with general partnerships. In this report it is possible to mention only a selection of the evidence we received on this point. Viewing the evidence directly will confirm the weight of opinion that we received.

98. Baker Tilly made their point in this way:

> "So if the new legislation has achieved its intended outcome, existing professional partnerships who are continuing to use a pre-LLP framework for their partnership agreement should be able to say 'we are using a partnership structure as Parliament intended: this legislation will have no impact on us'.
>
> *This is manifestly not the case*. It is our experience, based on very extensive discussions with our own clients, that the legislation will have an impact on virtually every professional partnership in the UK which operates as an LLP."[61] (their emphasis)

99. The City of London Law Society (CLLS) considered that "the current proposals demonstrably go further than treating as an employee for tax purposes an LLP member who would otherwise be an employee as a matter of general law and change the policy fundamentally in that they clearly and

[61] Baker Tilly, paragraphs 14 and 15.

explicitly place the LLP at a positive disadvantage."[62] Grant Thornton[63] agreed, as did Herbert Smith Freehills[64] and Mazars[65].

100. KPMG, after accepting the objectives of the legislative tests, wrote: "However, as currently drafted we do not believe that the legislation achieves its aim … In effect it does have the capacity to impact significant numbers of genuine equity partners."[66] The CBI "support the stated objectives but are not convinced that they are achieved by the proposed legislation."[67] The LSEW, concluded that "the objective tests set out in Conditions A to C completely fail both to replicate the case law tests and to respect the tax principle that they embody."[68] Others, including Mr Patrick Stevens,[69] Chartered Institute of Taxation (CIOT), Mr Magnus Spence,[70] New City Initiative (NCI), and Mr Louis Baker,[71] APP, made the same point, shaded to reflect the sectors that they represent.

101. Mr Richard Murphy, Tax Research, gave us his perspective on this:

> "If you look at what is happening ... particularly in the law profession … you will see a great many articles coming out suggesting that firms are having to review their partnership structures quite radically. They are quite concerned that a great many junior partners, who would have previously been on PAYE even though supposedly having partnership status, are now members of the LLP with a guaranteed income; that is clearly tax-motivated."[72]

However, Mr Murphy thought that "The ideas are pretty poorly structured inside the new legislation … We are creating new tests that are inappropriate."[73]

102. Having reviewed the evidence on the scope of the three conditions, which strongly suggests that they fall well wide of their target, we now examine in turn the objections that have been raised with regard to each of the conditions.

### *Objections to Condition A*

103. The main concern with Condition A was that, by focusing on the profits or losses of the whole LLP, it excludes those members who are remunerated by reference to the performance of part of the business, a division or a line of business. The Professional and Business Services Council (PBSC) wrote "In a large and complex business, it would not be unusual for a partner to be given a variable profit share over the profits of a single service line or

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62 CLLS, paragraph 17.

63 Grant Thornton, paragraph 1.3.

64 Herbert Smith Freehills, paragraph 9.

65 Mazars, paragraph 9.

66 KPMG, further evidence, paragraph 4.

67 CBI, paragraph 2.

68 LSEW, paragraph 17.

69 Q 71.

70 Q 84.

71 Q 85.

72 Q 33.

73 Q 35.

geographic location for which they have some responsibility."[74] This concern was supported by many others. Whilst the PBSC referred to large and complex businesses, we think this could equally be an issue with smaller LLPs.

104. The ICAEW had a slightly different slant on the same theme "The definition of disguised salary in new s 863B(2) will catch profit pools comprising bonuses that are to be allocated on different bases."[75] The LSEW had a slightly wider point: "Condition A does not address the correct question, namely, whether the individual's remuneration results from a division of the LLP's profits or represents an expense in arriving at those profits. It merely addresses the computational aspects of the payment."[76] The oral evidence that we heard supported the large amount of written evidence that we received on this aspect.

### *Objections to Condition B*

105. There was also much concern about the significant influence test in Condition B. Herbert Smith Freehills outlined the problem as they saw it:

> "HMRC guidance suggests that 'sufficient influence' would not exist merely because a member has voting rights or the ability to participate in the election of senior management. Instead, according to HMRC, actual participation in the management of the affairs of the LLP is required. The reference to affairs is being interpreted to mean all the affairs—or business as a whole—of the LLP, as opposed to some aspects or some business lines only. On this basis, in the case of many professional partnerships Condition B is unlikely to be satisfied other than in relation to senior management."[77]

106. Again many others agreed, and we heard the same complaints in the oral evidence. Mr Stephen Herring, Institute of Directors (IoD), thought there was a very significant misapprehension about how large professional firms are run.[78]

### *Objections to Condition C*

107. Our witnesses thought that Condition C would cause many partners to increase their capital contribution to the LLP to satisfy the 25% test when the partnership did not need the increased amount of capital. There was concern as to the capacity to arrange such funds on the requisite timescale. There was also concern as to how 'capital contribution' was defined in the legislation. HMRC's Technical Note and Guidance states that "it does not take into account undrawn profits unless by agreement they have been converted into capital."[79]

108. Mr Nicholson commented:

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74 PBSC, page 2.

75 ICAEW, paragraph 29.2.

76 LSEW, paragraph 18.

77 Herbert Smith Freehills, paragraph 12.

78 Q 85.

79 *Partnerships: A review of two aspects of the tax rules, Technical Note and Guidance*, HMRC, 10 December 2013, paragraph 2.4.5b.

> "A lot of partnerships and LLPs do not require a great deal of capital. Some do, but a lot do not. In order to make sure that they at least pass that which is probably the clearer of the three tests—'How do I make sure I have sufficient capital?'—there will be an awful lot of activity with banks, trying to make sure that they can get the level of capital they want, that they can talk to their partners about how that operates."[80]

109. Amongst others, Herbert Smith Freehills clarified the point about the definition of capital contributed: "while the definition of contribution for the purposes of Condition C is technical, and complex, it is broadly restricted to capital contributed to the LLP, so does not include retained or undistributed profits which many times fulfil the same purpose as capital, nor is it clear that loan accounts would constitute capital for these purposes."[81]

### *Business Implications of the Three Conditions*

110. Many of our witnesses commented on the business implications of applying Conditions A to C, making a number of different points. Most partnership agreements would have to be reviewed by 6 April and perhaps amended. Many were concerned about damaging UK competitiveness. The read across to foreign LLPs carrying on a business in the UK was a source of puzzlement. And there was concern about the potential absence of employment rights if LLP members were reclassified as employees for tax purposes.

111. The need to review partnership agreements and the attendant difficulties came from many witnesses. Professor Freedman commented

> "It is clear that they are all having to rethink their partnership agreements and before April as well, because they have set them up under certain rules and now they are all having to re-examine them. That will not necessarily be about avoidance; it is just about knowing how their people are going to be taxed."[82]

Mr Gammie agreed[83] as did Baker Tilly who wrote "This is not a one-off requirement. It will need to be done in respect of each individual member of the LLP every year and every time a new member joins or leaves the LLP."[84]

112. A number of our witnesses were concerned about the effect on UK competitiveness. Mr Greenbank identified some disadvantages: "It is the employer national insurance contribution that is the most direct cost. …Your tax reserves will have to be paid out effectively month after month, so you cannot use them to fund the working capital of the business, as most partnerships do. There is then general compliance."[85] The CBI's view was that "It appears that this economic impact may not have been fully assessed in advising the Ministers, perhaps underestimating the number of firms

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80 Q 106.

81 Herbert Smith Freehills, paragraph 13.

82 Q 27.

83 Q 27.

84 Baker Tilly, paragraph 16.

85 Q 76.

impacted if the test 'thresholds' are set as proposed."[86] The ICAEW were concerned about the "additional compliance cost for LLPs."[87]

113. The LSEW were particularly strong in their criticism: "what started as a moderate and sensible proposal to counteract obvious tax avoidance (e.g. potato pickers being corralled into LLPs) has become a widespread attack on a business model which is of central importance to the legal profession and an increasing number of other businesses."[88] Grant Thornton contested[89] the statement in the Tax Information and Impact Note that the measure will have a negligible impact on businesses.

114. Not only would UK general partnerships be outside the scope of this legislation and therefore be treated differently from UK-registered LLPs, but so would be LLPs which were formed outside the UK and carrying on a business in the UK. This was drawn to our attention by a number of witnesses. Mr Richards said "Which makes it interesting that HMRC is perfectly happy to accept the tax consequences of those foreign LLPs, as when someone is an employee or partner, but cannot accept those consequences when it comes to our own home-grown LLPs."[90] Others saw this as an anomaly.

115. One other consequence that was brought to our attention was that those LLP members who would be treated as employees for tax purposes under this legislation would not necessarily acquire employee rights under employment law. A number of our witnesses thought it wrong that the tax consequences should be altered without looking more widely. The ICAEW saw the resulting uncertainty as important "The increasing divide between employment law and tax law leads to more uncertainty, complexity and unfairness as individuals are taxed as employees, but without equivalent employment rights."[91] Others were also concerned at this difference. We explore this aspect in Chapter 6 where we examine evidence from our witnesses on the desirability of looking at tax changes in a wider, more holistic context. We note that these partnership measures are one example of this not happening.

### *Officials' Response*

116. We put all these points on scope and business implications of the proposed legislation to HMT and HMRC. Ms Knott argued that the three conditions achieved the same outcome as case law tests:

> "We have chosen these three tests because in essence we think that, with the three elements, they capture what it means to be in partnership. We think they are quite clear tests, so people should be clear about their application. Together, they should produce an appropriate outcome. Only if somebody fails … all three tests, will they be regarded as an employee. We think that collectively it is quite a good test. …

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86 CBI, Appendix A, paragraph 5.

87 ICAEW, paragraph 22.

88 LSEW, paragraph 20.

89 Grant Thornton, paragraph 3.1.1.

90 Q 76.

91 ICAEW, paragraph 13.

> I think it is important to recognise that there are the three different tests. Not every test will be appropriate to every partnership, but collectively we think the tests will work."[92]

117. Commenting specifically on the three Conditions, Ms Knott made the following points on Conditions A and B:

> "Coming back to your first point on the partnership share, the specific point about it relating to part of the business was raised during the consultation. This is draft legislation, so we are still in the process of tightening the test…
>
> I think the influence test is perhaps more difficult. But, as I say, we have the three tests."[93]

118. Responding to a question that additional capital might have to be contributed that might not be needed and that the test does not take into account undrawn profits, Ms Knott said:"Again, there will be different circumstances for different partnerships, but with the three tests we think that broadly it should be possible to apply it in all circumstances."[94]

119. Asked whether she agreed with the widespread view that LLPs would go from being in an advantageous position compared with general partnerships to being disadvantaged, Ms Knott responded "Again, we do not think that that is the case, because we do not think that the test is any tighter than the case-law test."[95]

120. Ms Knott was asked about claims that many partnership agreements would need to be reviewed. She said "We were certainly aware that certain reviews would take place. We would be surprised if all LLPs had to review their arrangements in that way, but we are certainly aware of some of that. It is quite common when tax laws are changed for people to review their structures in that sense."[96] Asked about concerns that the measures would have the effect of reducing working capital and "could sound the death knell for investment management partnerships",[97] she responded "Those statements are certainly quite concerning, but we have consulted widely on this measure and do not believe that the impacts will be as serious as suggested by those statements."[98]

121. Ms Knott was asked about the position of foreign LLPs and responded:

> "there may well be a case for looking again at overseas LLPs. One of the problems that we face, though, is that overseas structures can have quite a wide variety: there may be LLPs but there could be other overseas structures that are similar but not quite the same. It is certainly something that is worth looking at."[99]

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92 Q 120.

93 Q 120.

94 Q 120.

95 Q 120.

96 Q121.

97 NCI, introductory paragraph.

98 Q 121.

99 Q 120.

122. **Nearly all the evidence that we received supported the view that the proposed legislative tests to determine who is a partner for tax purposes do not achieve their policy objective. If the Government continues with the approach in the draft legislation, it is vital that they address all the points made and amend those tests so that they place members of LLPs in the same position as partners in a general partnership.**

123. **The Government should also consider the position of non-UK LLPs carrying on a business in the UK with a view to aligning their treatment with that of UK LLPs.**

### The Three Conditions: Other Points

124. In addition to the issues concerning the scope and business implications of the three conditions, various other important points were put to us which could be dealt with in revising the draft legislation

125. The first concerns the detailed wording of the provisions which some considered to be so subjective as to lead to significant uncertainty. The PBSC were concerned about the words 'reasonable to expect'.[100] Grant Thornton focused on 'significant influence' and 'wholly, or substantially wholly'.[101] KPMG were similarly concerned.[102]

126. Others were concerned at the length of the guidance and the function it was performing. KPMG wrote: "The guidance supporting the draft legislation is 56 pages long … we do not believe that the guidance as currently drafted performs its correct purpose. This should be to clarify the legislation rather than to extend it … Despite its length the guidance itself does not clarify certain key points."[103]

127. Another cause of complaint from a number of witnesses was that the three Conditions were based on the fiscal year, rather than the period over which the partnership draws up its accounts. Mr Dodwell explained this: "There is a huge practical problem that the Revenue has given everyone here, which is that instead of applying the test from the beginning of the partnership's accounting period, or the end, they are applying it from a tax year."[104]

128. Asked about these points, Ms Knott recognised

> "that it should not be the role of guidance to fill out the legislation to any great extent. The legislation that we published in December was draft legislation, so we have continued to take comments on that draft. Where we think we can make the legislation clearer we will do so in the legislation rather than relying on the guidance."[105]

129. **We expect that many points on the detailed drafting of the legislative tests will have been made to HMRC. It is essential that the drafting of the legislation is tightened so that, as far as possible, any subjectivity and resulting uncertainty is minimised. We recommend that this be**

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[100] PBSC, page 2.

[101] Grant Thornton, paragraphs 2.1.1 and 2.1.2.

[102] KPMG, further evidence, paragraph 4.

[103] KPMG, further evidence, paragraphs 15 and 16.

[104] Q 105.

[105] Q 122.

**done in close consultation with all interested parties so that, where possible, consensus is reached.**

130. **We recommend that the guidance should then be redrafted so that it performs its proper function of clarifying rather than extending the primary legislation.**

131. **We recommend that the Government consider with interested parties the case for changing the basis of the tests decided on so that they operate by reference to the accounting period of the partnership rather than over a fiscal year. This would avoid some administrative difficulties that would otherwise arise.**

## Salaried Members' Provisions: Commencement

132. Finally in this chapter we focus on the evidence we have received on the start date for these provisions. The Government's proposal is that they should operate from 6 April 2014. However, we have received much evidence that because the provisions announced on 10 December were so different from those that had been consulted on previously, it is unfair and impractical for that April timetable to be maintained.

133. The CLLS's first recommendation was "that the implementation of the proposals should be delayed until 2015."[106] They make a number of points in favour of this recommendation which others echo in their evidence: the proposals are detailed and still relatively undeveloped; they will not be finalised until Royal Assent; business needs time to consider properly how the provisions will apply to them; and, as we shall discuss further in chapter 6, the way the consultation has been handled.

134. Others would settle for a shorter delay. The ICAEW wrote "[6 April] is too short a period to make any necessary changes given that at that date many LLPs will be part way through an accounting period. … We believe any change should apply from the start of the first accounting period after 6 April 2014."[107] Deloitte took a similar view.[108]

135. We asked HMRC about the consequences of delay of a year in the introduction of the salaried members' provisions. Ms Knott focused on the Exchequer implications "it would cost the Exchequer a considerable amount of money because the measure raises a considerable amount."[109] When challenged that there had been significant changes in December, she said "we think the tests should be clear to operate, so people ought to be able to apply this from 6 April." [110] Challenged again that an April deadline does not give businesses very much time to get themselves organised, Ms Knott said

> "There are certain transactions that we have been told of where people are trying to get things in train. We have heard these representations. There might be some possibility as we get to 6 April that transactions

106 CLLS, heading to paragraph 19.

107 ICAEW, paragraphs 30, 31.

108 Deloitte, paragraph 5.4.

109 Q 130.

110 Q 130.

are in train but have not quite got there … that we could regard as qualifying under the law."[111]

136. **Given the change of approach to the provisions that took place in December, we conclude that there is too little time to settle all the outstanding issues, get the legislation right and enable businesses to adapt to that legislation in time for a 6 April start.**

### Exchequer Consequences of Delay

137. Ms Knott was asked whether she could make an estimate of the yield from the salaried members' provisions. She replied

> "I am not able to divide the yield that we have scored between the salaried members and the mixed member partnerships partly because the two measures are quite intertwined. I can say though that the £1.9 billion additional yield that was scored at the Autumn Statement all related to the other element of the measure, the mixed member partnerships, and all that yield related to the alternative investment sector."[112]

138. There is no doubt that, as Ms Knott contended, any delay would have an effect on the profile of the yield from these measures. The yield figures for these measures is estimated by HMRC to be as set out in the following table.[113]

**TABLE 1**

**Partnership Taxation Package: Estimated Yield**

| £m | 2014/15 | 2015/16 | 2016/17 | 2017/18 | 2018/19 |
|---|---|---|---|---|---|
| Budget | 125 | 365 | 300 | 285 | 270 |
| Autumn Statement Addition | nil | 680 | 430 | 410 | 400 |
| Total | 125 | 1045 | 730 | 695 | 670 |

As Ms Knott confirmed, none of the additional yield in the second line of the table is attributable to the salaried members' provisions so it would be unaffected by any delay in their introduction. The original (Budget) yield in the first line comes from a combination of these salaried members' provisions, the mixed members provisions as they apply to partnerships (which was known about at the time of the Budget) and the anti-avoidance provision preventing the transfers of assets and income streams through partnerships.

139. HMRC seems unable or unwilling to disaggregate the respective contributions of the three measures to the Budget estimates, but the yield from the salaried members' provisions must be a proportion of the figures in the first line of the table. That suggests that deferring the introduction of the salaried members provisions by a year would mean deferring the proportion of the first-year yield of £125m attributable to this measure to 2015/16, with

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[111] Q 131.

[112] Q 119.

[113] *Overview of Legislation in Draft*, HMRC and HMT, 10 December 2013, Annex A 127.

commensurate consequences for the rest of the Budget row. Even if all the yield estimated at the Budget were a result of the salaried members' measure, that would mean a loss, over the scorecard years, of £270m (the 2018/19 figure), or 8 per cent of the total yield of £3,265 billion from the whole package. But, of course, since the measure accounts for only some of the Budget yield, the loss would be smaller than 8 per cent. Precisely how much smaller we can know only when HMRC chooses to tell us; we have asked for these details and not received satisfactory answers. In any case, whatever the amount is when estimated more precisely, the Exchequer effects of a delay would have to be balanced by the benefits of achieving better targeting of the legislation and giving businesses time to adapt to the provisions.

140. As discussed earlier, some commentators argued for the provisions to commence from the beginning of the first accounting period of the partnership after 6 April. For some, those with a 30 April accounting date, this would not be a very significant delay, though such a change would bring the administrative benefits that we referred to earlier. The Exchequer yield would clearly be affected by less than for a delay of a whole year. This more limited delay would provide businesses with more time to adapt, particularly those with an accounting date later in the fiscal year. However, crucially in our view, it would not give any more time to get the legislation right. The legislation would still have to be included in the Finance Bill 2014.

141. **We recognise the importance to the Government of the tax yield from these measures. However, taking the time necessary to target these provisions more precisely would ensure that the resulting legislation was more robust and effective and that the new rules gained greater acceptability amongst taxpayers.**

142. **Accordingly, we recommend that the Government give urgent consideration to delaying these provisions until next year. That would give time for a reassessment of the alternative approaches to achieving the policy outcome and, if the present approach in the legislation prevailed, to target that legislation more accurately.**

143. **A delay would also give time to make a proper assessment of whether these provisions should apply for the accounting periods of partnerships rather than for the fiscal year in order to reduce the administrative burden on partnerships affected.**

## CHAPTER 5: THE OTHER ELEMENTS OF THE PARTNERSHIPS PACKAGE

144. This chapter examines the evidence we received on the other elements of the package of measures dealing with partnerships: mixed membership partnerships; AIFM partnerships; the anti-avoidance provisions against the disposals of assets and income streams through partnerships.

### Mixed Membership Partnerships

#### *Objectives and Presentation*

145. In their written evidence, HMRC explained that the Government's objective for this measure was to secure tax revenue and achieve fairer taxation by:

> "changing the long-standing structural flexibility of partnership profit and loss allocation rules to achieve tax advantages on the profit and losses allocations strand. The main focus has been on mixed membership partnerships where profits earned by individual members are allocated to a company that they control."[114]

They went on "This flexibility has been used to generate tax advantages. For example, profits may be allocated to a low tax entity, such as a company, while individual partners taxable at higher income tax rates ultimately receive the benefit of those profits in low-taxed or even non-taxable form."[115]

146. HMRC's evidence also emphasised that "The mixed membership proposals will not be relevant to traditional partnerships consisting wholly of individuals (or wholly of corporates), nor where profit and loss allocations are made on a basis that properly reflects the contribution made to the partnership by the relevant members."[116]

147. In her evidence, Ms Knott underlined that these changes were not purely about tackling avoidance "These are structural changes, designed to ensure that the taxation of partnerships and LLPs is fair and consistent and to prevent significant tax loss."[117]

#### *Draft Legislation*

148. The provisions in the draft Finance Bill 2014 aim to achieve those objectives. As outlined in Chapter 3, they give HMRC the power to reallocate, on a just and reasonable basis, profit shares where a partnership or LLP makes a profit for tax purposes and a profit share is allocated to a corporate partner, and either

    (a) the company's profits represent the deferred profit of an individual member and in consequence the individual's profits and the overall tax liability are lower than they would otherwise be, or

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114 *Taxation of Partnerships,* HMRC, paragraph 8.

115 *Ibid.*, paragraph 10.

116 *Ibid.*, paragraph 16.

117 Q 117.

(b) an individual partner has the power to enjoy the company's profit share and it is reasonable to suppose that both the individual's profit share and the overall tax liability are lower that they would have been in the absence of that power to enjoy the company's profits

*General Reactions to the Provisions*

149. A number of witnesses commented on the presentation of these provisions. Some thought that they should not have been portrayed as tackling avoidance. It is not clear whether HMRC has changed its stance in this regard, but its present view is that the provisions are about more than avoidance. Mr Whiting, commenting on evidence on HMRC's attitude to mixed membership partnerships gathered during the OTS review, concluded "Everybody [including HMRC] recognises that there can be perfectly valid commercial reasons for having a corporate partner."[118]

150. Mr Haskew commented on the incentives created by differing tax rates

> "We have a large disparity between income tax rates and particularly marginal income tax rates, … potentially 62%. That compares to a corporation tax rate that will be 20%. So there are huge distortions within the tax system."[119] Professor Freedman agreed "that the ideal should be to reduce the differences as much as possible between the different types of taxation".[120]

151. Professor Freedman also thought that you could not allow mixing and matching: "There are benefits of having a partnership and there are benefits of having a corporation. At the moment, that is the way it is, and you cannot let people pick and mix the bits that they want, because that again will just give rise to avoidance opportunities."[121] Mr Herring[122] agreed, as did Mr Murphy:

> "You either choose to be a corporate entity and therefore to be able to shield your retained profits from tax, or you should choose the advantages of an LLP and accept the consequences of the structure. What has quite clearly happened is that a number of lawyers and accountants have decided to do that mixing and matching. I think that is inappropriate."[123]

152. NCI adopted a pragmatic position "the practice of using corporate partners to avoid or defer paying income tax on partnership profits, although a longstanding and accepted feature of partnership taxation, may not chime well with the need for everyone to pay their dues to help repair the UK's financial position."[124]

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[118] Q 11.

[119] Q 46.

[120] Q 19.

[121] Q 20.

[122] Q 89.

[123] Q 36.

[124] NCI, paragraph 1.

### *Scope: Which Existing Arrangements are Affected by these Provisions?*

153. Having established that, as well as possible avoidance, the reason for the tax-motivated allocation of profits is the underlying difference in tax rates, we heard evidence on the extent to which existing arrangements are affected and how common these arrangements are.

154. KPMG's view was that the introduction of these rules

> "is anticipated to cause difficulties for many mixed partnerships because the legislation is intentionally aimed at taxing commercial arrangements, as well as structures specifically designed for tax avoidance. Examples of commercial arrangements caught by the new rules include allocations of profits to corporates for working capital purposes, investments, or deferred profit arrangements."[125]

The Association of Chartered Certified Accountants (ACCA) were also concerned about the restriction imposed by the proposals on "accruing reserves at the same [tax] rates as other limited liability trading vehicles."[126] This was a common theme in the evidence.

155. ICAS pressed the point that "The HMRC proposals would impact on legitimate commercial structures, particularly with family businesses and farming businesses."[127] Ms Charlotte Barbour, ICAS, emphasised this in relation to rural and multi-generation businesses.[128] The ICAEW were concerned that "The proposals fail to accommodate the commercial and historic reasons why some businesses have a mixed partnership structure. For example, many businesses hold land within a corporate partner or use such a member to build up working capital requirements."[129]

156. The CBI accepted the "policy objective of preventing unfairness and market distortion by ensuring that inappropriate, uncommercial and tax-motivated partnership allocations to a company or similar vehicle do not create tax advantages."[130] However they later commented that "The mixed partnership proposals are very broad, and are likely to affect many legitimate structures, in addition to those that are specifically targeted."[131]

157. Mr Murphy had a different perspective on the issue of targeting:

> "A number of anti-avoidance measures would have come to me before these ones. For example, requiring the withholding of tax at source on payment of profits to a corporate entity …The other one would be to say, 'No, you cannot have a corporate entity as a member and most certainly you cannot have a corporate entity not tax resident in the UK as a member', but that is the problem we have."[132]

158. Mr Michael Parker, National Farmers Union (NFU), told us that

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125 KPMG, further evidence, paragraph 11.

126 ACCA, paragraph 13.

127 ICAS, paragraph 12a.

128 Q 46.

129 ICAEW paragraphs 34.

130 CBI, paragraph 3.

131 CBI, Appendix A, paragraph 7.

132 Q 36.

> "It is primarily the mixed-partnership legislation that could have an impact [on the agricultural sector] … We have gone from original proposals, which seemed to have a motive test that one of the main reasons for the business structure was tax avoidance, to something which is more around whether it is reasonable to assume that a tax advantage has been arrived at."[133]

159. Mr Stevens said

> "All the examples of allocations given in the original consultation were to do with avoidance carried on by a relatively small number of partnerships … It is my view that counteracting that is wholly appropriate …The difficulty I have is that the proposed legislation goes very much further than is needed in order to counteract this form of avoidance."[134]

Mr Greenbank[135] and Mr Herring[136] agreed with the thrust of this and added their own gloss.

160. Mr Spence was concerned that these provisions would encourage incorporation, potentially scoring an "own goal"[137] for the Government. Mr Nicholson was concerned with general competiveness: "My concern in that area … is how this fits with the government White Paper of March last year … it seems counter to the policy about retaining and attracting asset management business."[138] The BVCA also were concerned about the effects on UK competitiveness and the implications for the strategy announced last March.[139] NCI agreed, writing "HM Treasury needs to be very careful that they don't throw the baby out with the bath water."[140]

161. A "potential tax avoidance"[141] issue was put to us by War on Want and Change to Win. It concerned the use of LLPs holding UK property for large multinational groups; the partners in the LLPs appear to be companies, some of which are non-UK resident. This evidence arrived very late in our inquiry and we were unable to follow it up with any of our witnesses. It is available in the usual way for anyone to peruse. HMRC will have seen this evidence and will need to consider whether it merits further investigation.

162. Responding to the points concerning the arrangements affected by these provisions, Ms Knott stated that "This is targeted on the tax planning we have seen. It is not necessarily tax avoidance … That is why we have adopted a wider approach."[142] And later that

> "The Government certainly accepts that there can be legitimate business reasons for the use of corporate members in partnerships. This measure seeks to address the flexibility that has allowed for tax planning … This

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133 Q 57.

134 Q 77.

135 Q 77.

136 Q 90.

137 Q 86.

138 Q 101.

139 BVCA, page 3.

140 NCI, paragraph 9.

141 War on Want and Change to Win, paragraph 2.

142 Q 125.

> is not designed as any kind of attack on those mixed member partnerships; it is simply designed to get a fair and consistent tax outcome."[143]

163. Asked if she thought the proposals could jeopardise the UK's competitive position she said "We would hope that is not the case."[144] When asked whether she thought these proposals might tip the balance in favour of incorporation Ms Knott replied "We think it could lead to some mixed member partnerships incorporating. I do not agree that it will tip the balance against mixed member partnerships, but there may be some who will wish to incorporate. If that were to happen, that is factored into our costings."[145]

164. It seems clear from evidence from our private sector witnesses that corporate member tax planning has been an accepted part of business life for many years. Many see the practice as a natural and rational reaction to the differences between the taxation of corporates and individuals, and not as avoidance. Whenever a practice is not challenged over a protracted period, it becomes part of accepted commercial practice and the longer it is allowed to continue the greater the likely outcry when the law is changed to reverse it.

165. It seems equally clear from the HMRC evidence that the Government's intention is that the proposed legislation should encompass situations which the private sector would regard as normal commercial arrangements—for example, the allocation to a corporate partner of profits which are for reinvestment in the business and would be taxed at corporate rates. As HMRC put it in its Summary of Responses document:

> "The tax rules will not affect … commercial uses as they will merely be an overlay that, in certain circumstances and for tax purposes only, will result in part of the partnership profits being reallocated to the individual member simply to remove the tax advantage that results from such use."[146]

### *The Legislation: Specific Issues*

166. In addition to the evidence around the general scope of the provisions, we heard evidence on more specific issues. Most of these centred on the apparent subjectivity in, and therefore the uncertainty of, the draft legislation. KPMG thought that

> "the legislation has been drafted with anti-avoidance mainly in mind … This style of drafting is appropriate for tax avoidance legislation, where a degree of flexibility is required. However, where the legislation has a purpose of raising additional tax from commercial arrangements it is not appropriate to have such subjective tests. Such subjective concepts give rise to a high level of uncertainty as to how the legislation applies to a commercial situation. We believe that these should be removed as they do not make good legislation."[147]

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143 Q 125.

144 Q 125.

145 Q 126.

146 *Partnerships: A review of two aspects of the tax rules, Summary of Responses*, HMRC, 10 December 2013, paragraph 4.34.

147 KPMG, paragraphs 12 and 13.

Others made similar points, including ICAS who thought that "it is nevertheless an unwelcome move to have legislation that is drafted in such a manner that guidance is required in order to know how it will be applied."[148]

167. Mr Whiting thought that "one of the difficulties will be judging when you have gone beyond what is reasonable into what is excessive."[149] Mr Parker was concerned about justifying the corporate partner's role in the partnership.[150] One issue for Mr Greenbank was that the legislation was "too narrow"[151] to encompass equity-type investments held by the corporate partner.

168. HMRC was asked about the allegation that these provisions are too subjective. Ms Knott responded

> "we do not think that the legislative tests on mixed members are subjective … There are objective criteria that will come into play. We also think that in practice it would be pretty clear. If you have a situation where a corporate member is connected to an individual member and the corporate member is disproportionately remunerated, we think that will be pretty clear in most circumstances. We do not think that the tests will be too difficult to apply in practice."[152]

169. **We acknowledge that it is open to the Government to make structural changes of the kind proposed for mixed partnerships to prevent or reduce tax loss, although it should state its objectives clearly at the outset.**

170. **We are concerned, however, at the apparent disconnect that can develop between business and HMRC over what is acceptable for tax purposes. Had HMRC been aware of the scale of the practice of profit shifting earlier and dealt with it then, there might have been less resistance to the proposed changes. We are also concerned by the loss of tax that can arise if potentially unacceptable practices are not addressed as early as possible.**

171. **We are sure that all the points that have been made to us on the drafting of the legislation will have been made directly to HMRC. We strongly recommend that HMT and HMRC consider them all very carefully with a view to tightening the legislation so that it is drafted as precisely as possible and the reliance on guidance is reduced.**

172. **If this can achieved in the time available, we see no reason why the mixed membership proposals should not go ahead with effect from 6 April, thus retaining most of the yield from the partnership package.**

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148 ICAS, paragraph 14.

149 Q 11.

150 Q 57.

151 Q 78.

152 Q 126.

## AIFM Partnerships

### *The AIFM Legislation*

173. During the consultation in summer 2013, it became clear to HMT and HMRC that profit deferral using corporate members of LLPs was very prevalent in the AIFM sector. The mixed membership proposals would have a profound effect on this sector. As a result, the Autumn Statement announced that the yield from that part of the legislative package was increased by £1,920 million over the years 2015/16 to 2018/19.

174. Mr Paul Hale, Alternative Investment Management Association (AIMA), and Mr Jiří Król (AIMA) gave us some useful background on the AIMA and the AIFM sector.[153] Mr Hale told us that

> "The AIFMD[154] is in the process of coming into effect but many managers are already operating similar deferment regimes for business reasons, not least because there are investor pressures. Even if the managers are not required under the rules in the directive to operate this deferral regime, because they pass a series of proportionality tests, they may fall into other regimes under other directives or under voluntary arrangements, which will require them to operate these deferral arrangements."[155]

175. Mr Hale said that his organisation had been much involved in discussions with HMT and HMRC following their becoming aware of the issues. "It should not have been a surprise … because the very point had been identified in submissions made to the FCA … [and] made in liaison meetings with HMT and HMRC, and I am afraid to say that the right channels of communication, quite clearly, had not been present."[156] However, once they realised the position, Mr Hale told us that HMT and HMRC were very receptive to the need to find a solution. Otherwise managers would have to pay tax on monies that they might not, and could not, receive for a long deferral period.[157]

176. Mr Hale confirmed that the provisions in the draft Finance Bill which relate to AIFM business are "an easement—it is not a tax-raising provision at all—and is being developed with a considerable amount of input from our organisation to provide a solution to a problem that arises because of the AIFMD deferral regime."[158] The essence of the arrangements that had been agreed for AIFM partnerships and were built into the draft legislation were explained to us by Mr Hale, who concluded "everybody, give or take the vagaries of life, is happy."[159]

177. We asked HMRC what they had learned from the consultation. With one exception, Ms Knott's response focused on the AIFM sector. She said:

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153 Q 60.

154 Alternative Investment Fund Managers Directive—see chapter 3.

155 Q 60.

156 Q 61.

157 Q 61.

158 Q 60.

159 Q 61.

> "We learnt a number of things. As I mentioned earlier, we learnt about the application of the case-law tests to LLPs. In this context, we learnt a lot about the extent of use of these structures and the amounts of money involved in the alternative investment fund sector. We also learnt a really important point on alternative investment funds, which is that they were having to change their behaviour because of the alternative investment fund managers' directive. We actually put a specific mechanism into the legislation to enable alternative investment funds to comply with the directive, but in a way that had the correct tax outcome."[160]

### *The Additional Yield*

178. We asked Mr Hale and Mr Król about the additional yield of £1.92 billion from the AIFM sector over the period 2015/16 to 2018/19 and whether they could help us in identifying where that came from. Mr Hale told us

> "You will have to ask HMRC how they arrive at those figures. I would also point out that, although we are the Alternative Investment Management Association—we represent hedge funds—there are other industries in the alternative investment management sector, such as private equity firms, infrastructure businesses and real estate firms which could be included in the alternative investment sector, as referred to in the budget estimates that were put out. The Revenue will have their reason for believing that there is that money there. It seems a lot from our point of view."[161]

179. Mr Hale did accept that

> "there are or have been arrangements out there for the avoidance of tax using corporate members. That is why the profit-shifting rules have been brought in. They are capable of being used by businesses across a wide range … Hedge fund businesses have made money; therefore, the opportunity to look at using these schemes would be there. However, what the likely take would be if the rules are implemented and are effective, I have no way of assessing."[162]

180. We asked most of our other witnesses whether they could help us with identifying where the figure of £1.92 billion came from. None could help. We asked HMT and HMRC about the costings. Ms Morgan gave us a general explanation of how costings were arrived at but told us that she could not "go into the detail of the exact nature of the assumptions made in that costing".[163] Ms Knott explained to us that with partnerships "because the structure is so flexible, it is possible for profits to pass to the individual member. They may be allocated initially to the corporate member, but there are ways in which they can pass to the individual without tax being paid. So it is not just a deferral; it can be a permanent loss of tax."[164] However, she did not explain how.

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[160] Q 129.

[161] Q 62.

[162] Q 62.

[163] Q 127.

[164] Q 127.

181. Ms Knott explained the timing factors that meant that the additional £680 million in 2015/16 was more than one year's tax, but did not further enlighten us as to how the yield had been computed. She did tell us, in response to a specific question, that the large yield was a combination of the scale of the funds involved and the number of partnerships. We asked for notes to clarify the derivation of the £1.92 billion. Two were produced, but with the exception of providing a figure of 1,000 for the number of partnerships involved, they did not offer any other information to assist our quest for a better understanding of how this additional yield had been calculated.

182. We asked HMRC whether they had made any estimate of the taxes lost in previous years through the allocation of profits to corporate partners. Ms Knott told us "We have not done that. As I said earlier, this is not an avoidance measure so the tax is not lost to avoidance in that sense. We keep the tax system under review and Ministers make decisions as to when to introduce measures."[165]

183. **We fail to understand why HMRC has been so unwilling to provide more detail on how it has arrived at the figures for the additional yield of £1.92 billion scored in the 2013 Autumn Statement. Of course, we wholly accept that HMRC is prevented from doing so if that would identify individual taxpayers, or even smaller groups of taxpayers. But we think that is unlikely to be the issue here.**

184. **We recommend that, within the normal constraints of taxpayer confidentiality, HMRC should be more open about how figures for yield from structural changes to the tax system have been computed.**

185. **We are concerned that the additional yield from the AIFM sector clearly came as a surprise to HMRC and that it was not aware of the extent to which profit deferral using corporate members was happening in the sector.**

186. **We recommend that HMRC should take additional steps to become even more aware of developments in the businesses from which it collects tax and particularly of practices to which it might object. This would not only help prevent such practices becoming embedded but, as seems to be the case with the Alternative Investment Fund Management sector, may also prevent the loss of a very large amount of tax.**

### Transfers of Assets and Income Streams through Partnerships

187. HMRC's Technical Note and Guidance explains this measure: "A number of avoidance schemes have sought to manipulate the flexibility of partnerships to reduce tax by exploiting the differing tax attributes of the members. These 'tax attribute' schemes involve the transfer of assets or income streams through or by partnerships."[166]

188. We received little written evidence on this measure. Those witnesses who commented on it in their oral evidence thought that this type of situation was clearly avoidance and should be stopped.

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[165] Q 127.

[166] *Partnerships: A review of two aspects of the tax rules: Technical Note and Guidance*, HMRC, 10 December 2013, paragraph 5.1.

189. There was some discussion on whether tackling this avoidance should have relied on the General Anti-Abuse rule (GAAR). Mr Roy-Chowdhury thought not: "one of my concerns about GAAR is that we need to keep it at the extreme, abusive end. I would probably counsel against that".[167] Mr Richards commented "Ministers and others are understandably reluctant to say, 'I am going to rely on the GAAR'. You have the uncertainty of the courts."[168] Mr Stevens said "I do understand Ministers wanting to be sure that they are stopping something that ought to be stopped."[169]

190. **We agree with our witnesses that it is entirely appropriate for the Government to introduce a targeted anti-avoidance rule to stop avoidance by means of tax-motivated transfers of assets and income streams through partnerships.**

[167] Q 51.

[168] Q 79.

[169] Q 79.

## CHAPTER 6: THE NEW APPROACH TO TAX POLICY-MAKING SINCE 2011

191. This chapter begins by setting out the five-stage consultation approach to tax policy-making adopted by the Government in 2011 and the main conclusions and recommendations of this Committee's inquiry[170] into this new approach. It then goes on to assess the process of developing tax legislation since 2011, including the current partnership tax proposals, against the benchmark set by the new approach and the recommendations in our 2011 Report.

### The Tax Consultation Framework

192. The Government's new approach to tax policymaking is intended to help bring about a clearer, more stable and predictable tax system with better tax legislation and more effective scrutiny of proposed tax changes. It consists of a formal commitment to full and open consultation, except in exceptional circumstances, at every stage in the development and implementation of a new tax policy proposal.

193. The approach the Government intended to follow in developing future tax changes was outlined in June 2010 and finalised on Budget Day 2011 in the Tax Consultation Framework.[171] This sets out five stages in the policy-making cycle at each of which full and open consultation should take place as a matter of course:

(1) setting out policy objectives and identifying options;

(2) determining the best option and developing a framework for implementation, including detailed policy design;

(3) drafting legislation to effect the proposed change;

(4) implementing and monitoring the change; and

(5) reviewing and evaluating the change after its implementation.

194. The main exceptions to this process, apart from changes to tax rates, allowances and thresholds, are measures to protect tax revenues or where there is a significant risk of forestalling. By way of clarification, the Government published a protocol[172] in March 2011 outlining the conventions it would seek to abide by in announcing tax changes outside the Budget.

195. The new approach means that, in practice, most tax legislation should be published in draft for consultation at least three months before the relevant Finance Bill is laid before Parliament, with consultation on the first two stages of the process having taken place in the preceding months.

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[170] Select Committee on Economic Affairs, *The Finance Bill 2011* (4th Report, Session 2010–12, HL Paper 158).

[171] *The Government's Tax Consultation Framework: Summary of Responses and finalised Framework*, HMT and HMRC, March 2011.

[172] *Tackling tax avoidance*, HMT and HMRC, March 2011, Chapter 4: Protocol on unscheduled announcements of changes to tax law.

196. The Framework also established a 'Tax Professionals Forum' (TPF) to consider and report on the Government's performance against these principles, including the protocol, and to identify and prioritise improvements to the way in which tax policy is made. The TPF's role also includes monitoring progress towards the goal of simplifying the UK's tax code.

### Report on Finance Bill 2011: Recommendations on New Approach

197. This Committee's inquiry into the 2011 Finance Bill found widespread support for the new framework which was seen as building on the good practices of previous governments and promising better tax legislation if implemented consistently. The Report commended the Government on its adoption of this new approach and welcomed the establishment of the TPF. And it concluded that, with a couple of notable exceptions, "most of the measures in Finance Bill 2011 were developed in accordance with the principles of the new approach to tax policy making."[173]

198. The Report recommended that "the Government observe the five-stage process for progressing from policy objective to final evaluation, with consultation at each stage, in all but the most exceptional cases, and that the reasons for any such exceptions be explained fully after the announcement."[174] It emphasised the need for the principles of the new approach to be firmly embedded in the day-to-day practice of tax policy-making and made a number of recommendations, the main ones being that the Government should:

    (a) publish the findings of an internal review of the policy partnership between HMT and HMRC and undertake "a comprehensive audit of the tax skills and experience of HMT and HMRC staff working on developing tax policy and legislation"[175] and of the incentives to recruit and retain the best talents to this work;

    (b) seek to consult with a wider range of smaller businesses and "develop and publish a comprehensive strategy for consulting non-business stakeholders on tax proposals likely to affect them";[176]

    (c) consult taxpayers potentially affected by proposed changes from the outset when drawing up initial Tax Impact and Information Notes (TIINs);[177]

    (d) "add to the new framework a formal requirement for all significant tax reforms to be evaluated against their stated objectives once they have bedded in",[178] and that "such evaluations should be carried out with the support of independent experts and that their results should be published;[179] and

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[173] Select Committee on Economic Affairs, *The Finance Bill 2011* (4th Report, Session 2010–12, HL Paper 158),paragraph 52.

[174] *Ibid.*, paragraph 56.

[175] *Ibid.*, paragraph 76.

[176] *Ibid.*, paragraph 90.

[177] *Ibid.*, paragraph 95.

[178] *Ibid.*, paragraph 102.

[179] *Ibid.*, paragraph102.

(e) outline its strategic objectives for different parts of the tax system, even where it has no immediate plans for change, so as to reinforce the certainty, predictability and stability the new approach aims to achieve.[180]

199. The Report also noted that all the private sector organisations submitting evidence to the inquiry suggested that the new approach should also lead to consequential changes in the way Parliament scrutinised tax legislation.[181] As a result, in 2012, the House of Lords revised the terms of reference of the Finance Bill Sub-Committee (FBSC) so that it could start its work earlier in the year and examine the provisions which appear in the draft Finance Bill. Its first such inquiry was carried out in 2013.

### Previous Assessments of Performance Against New Framework

200. The TPF's membership is drawn from the accountancy, tax and legal professions and it meets bi-annually under the chairmanship of the Exchequer Secretary. It has so far published two reports, the first in December 2011 and the second in March 2013.

201. The first covered broadly the first year of operation of the new model and concluded that "the approach adopted for most of the measures in the Finance Act 2011 complied with that outlined in the New Approach to Policy Making. In particular the corporate tax reform package and the measures relating to tax relief on pensions were excellent illustrations of best practice in the conduct of the policy process."[182] This echoed the conclusion of this Committee's Report earlier in 2011, as did its reservations about the disguised remuneration provisions and the oil and gas supplementary charge in that year's Bill.

202. The second Report,[183] covering the period from 6 December 2011 to 30 November 2012, also came to mixed, though predominantly positive, conclusions. While it reported "a number of good examples where the five stages have been or are being followed, in particular the consultations on the changes to the CFC rules, the Statutory Residence test, the reform of the taxation of non-domiciliaries",[184] there were other cases that year where the consultations had started part way through the process, or "without a clear articulation of the policy involved" or "without any discussion of the policy".[185]

203. It also concluded that

> "more thought needs to be given to the timetable for the legislative process. Even where there is a full and valuable consultation where government and taxpayer understand the intended policy, the legislation implementing that policy can be overlong, over complex and very occasionally not reflect the intended policy if instructions have to be

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[180] Select Committee on Economic Affairs, *The Finance Bill 2011* (4th Report, Session 2010–12, HL Paper 158),.paragraphs 107, 108.

[181] *Ibid.*, paragraphs 121–123.

[182] *Tax Professionals Forum, Independent Annual Report,* 6 December 2011, page 10 section 3.

[183] *Tax Professionals Forum, Second Independent Annual Report,* 27 March 2013.

[184] *Ibid.*, page 5, section 4.

[185] *Ibid.*, page 6, section 4.

given to Parliamentary Counsel on a timeframe which starts before part of the consultation process has ended."[186]

204. The TPF has not yet published its conclusions on the 2013 Finance Act. This Committee, when it looked the draft 2013 Bill last year, commended "HM Treasury, HMRC and all those involved in the development of the GAAR on an exemplary tax policy-making process",[187] but went on to recommend that the two departments "examine closely why the new policy-making process worked well in developing the GAAR and less well in developing the ARPT [now the Annual Tax on Enveloped Dwellings] package and the cap on reliefs. Whatever steps are necessary to achieve a uniformly good outcome should then be taken."[188]

## The Partnerships Package and the New Approach

205. Turning to the package of measures affecting partnerships, the Government chose to roll together the first two stages of the process recommended in the Tax Policy Framework before beginning consultations.[189]

206. Nonetheless, Baker Tilly, thought the May consultation document met the requirements of the new approach in that it outlined "a coherent view of why change was necessary: it set out the policy objective; it set out the circumstances where that objective was not being met; it proposed solutions; and it set out a test of whether or not the outcome would be successful."[190] And they went on to say that there had been "an extensive consultation process with a high level of engagement between HMRC and interested parties".[191] In contrast, the LSEW, complained that "neither the proposals in the May 2013 consultation nor those in the December 2013 technical note were preceded by any consultation",[192] as did Grant Thornton.[193]

207. Most witnesses were content with the way the consultation had been run from May until August 2013 when it closed. Mr Baker thought that "the consultation got off to quite a good start in the summer, with the document that was published."[194] Similarly, Mr Hale, talking of his discussions around the impact of the AIFMD, said: "In the period from early June to the end of September, we had, I think, three substantial meetings of two hours or more with a considerable team of HMRC, HMT and FCA representatives."[195]

208. However, the same does not apply to the later stages of the policy development process. Our witnesses maintained that, although the draft clauses were available for consultation from 10 December, the change to the proposals on salaried members was so radical that the Government should have allowed time to go back and debate again stages I and II of the new

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186 *Tax Professionals Forum, Second Independent Annual Report,* 27 March 2013, page 12, section 8.

187 Select Committee on Economic Affairs, *The Finance Bill 2013* (1st Report, Session 2012–13, HL Paper 139), paragraph 171.

188 *Ibid.*, paragraph 244.

189 *Partnerships: A review of two aspects of the tax rules, Consultation document*, HMRC, 20 May 2013, Annex A.

190 Baker Tilly, paragraph 8.

191 *Ibid.*, paragraph 9.

192 LSEW, paragraph 20.

193 Grant Thornton, paragraph 4.2.

194 Q 93.

195 Q 61.

approach instead of, in effect, skipping straight to stage III of the process with consultation only on the technical detail of the legislation.

209. Mr Haskew saw the process as moving "from a consultation that was going down one track to suddenly something completely different, with no obvious linkage as to how they really got there, and I do not think that is very satisfactory."[196] And the CLLS commented that "The consultation process has also been managed in a regrettable manner. It is extremely unusual, as was the case here, for the second iteration of proposals to be more aggressive to taxpayers than the first … This does not promote trust and confidence in the consultation process."[197]

210. As for the consequences of the late change of direction, Mazars claimed that it would create uncertainty and provisions that are not properly road-tested, "thus seriously undermining the consultation process."[198] Deloitte "query whether a full impact assessment has been undertaken given the late change from proposals designed to address tax-avoidance to proposals with more fundamental impact across the professions."[199]

211. As discussed extensively in Chapters 3 and 4, Ms Knott considered that, to the extent that the approach to the legislation had changed between May and December 2013, that was as a result of the representations received about the use of the case law tests (as set out in the Employment Status Manuals) to determine whether a member of a LLP was a partner or an employee. In spite of the changes, she did not accept the case for delaying their introduction in order to hold a more comprehensive consultation, not least because the yield from the measure had been estimated on the premise that the change would be in place from 6 April 2014. Notwithstanding the evidence submitted on the later policy-development stages, both Ms Knott and Ms Morgan thought there had been a lot of praise for the consultation process: "it has been a very well run consultation."[200]

212. **The evidence we have heard leads us to conclude that, although it would have been preferable not to have compressed the first two stages of the process, the partnership consultation carried out between May and August 2013 was well-conducted, open and responsive. We commend HMRC and HMT for that and particularly for their interaction with representatives of the AIFM sector.**

213. **That has, however, not been the case since December when the draft Finance Bill proposals concerning salaried members turned out to be significantly different from the ones discussed in the summer. We have already concluded that insufficient time has been allowed for proper consultation on the new proposals if the April start date is to be maintained. This constitutes practice that is not compatible with the new policy-making process.**

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196 Q 52.

197 CLLS, paragraph 24.

198 Mazars, paragraph 10.4.

199 Deloitte, paragraph 4.3.

200 Q 133.

## Developing Tax Legislation 2011–2014

214. The Sub-Committee's main recommendation in its 2011 Report was that the Government should abide by the full five-stage process for progressing from policy objectives to final evaluation of outcomes in all but the most exceptional cases. We therefore took evidence on how consistently the new approach had been applied to the development of tax policy since 2011.

### *Consistent Application of the New Approach*

215. The evidence we received was very positive about the effects of the new five-stage process: where it is applied comprehensively, the result is good consultation and good legislation. Mr Sanger commented that

> "there is much more formality around how we go forward with tax policy. That provides a real opportunity for many more people to be engaged in the debate, and that is absolutely to the good … We are moving to a world where good policy-making and good communication of that policy are becoming the norm, and that is a good result."[201]

The British Bankers Association (BBA) noted that "In the main, the consultation process is working in a constructive manner, resulting in better final legislation for the benefit of both the Exchequer and business."[202] Others thought likewise, including Mr Whiting who cited a variety of examples of good tax policy-making.[203]

216. Mr Whiting also compared the UK favourably with other jurisdictions: "Comparing notes with opposite numbers in other countries, we can see that many of them are immensely jealous of the process that we go through and think it is a much better process."[204] Mr Król agreed, commenting that "the UK Government's consultation procedure is incredibly open and is much more thorough than what we experience in other jurisdictions."[205] This view is very much in line with the findings of a recent Oxford University Centre for Business Taxation (OUCBT) report which, comparing consultative arrangements, concludes that "the UK has among the strongest processes. There is a clear, ministerial commitment to consultation; formally documented and articulated in a series of government publications."[206]

217. **We commend the Government, HMRC and HMT on the quality of the consultations conducted and the tax legislation produced since 2011 in those areas (the large majority) where the new approach to tax policy-making has been applied comprehensively.**

218. However, each year there seem to be a minority of cases where that high standard fails to be achieved because the new approach has not been observed, or it has only been nominally adhered to, or time pressures around the third stage (drafting legislation) have curtailed consultation and prevented the resulting legislation from being as considered as it might

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201 Q 28.

202 BBA, page 1.

203 Q 12.

204 Q 12.

205 Q 64.

206 *Structures, processes and governance in tax policy-making: an initial report,* C J Wales and C P Wales, OUCBT, December 2012, page 120.

otherwise have been. Cases of this sort led the ACCA to conclude that "The overall process of consultation on tax legislation has shown some signs of improvement, but is still very much a curate's egg."[207]

219. The main areas of concern where the policy-making framework was not fully adhered to were covered earlier in this chapter. More recent examples are the current partnership measures, also discussed above, and the frequently cited consultation on tax and public procurement where, according to the CBI, "Not only was the policy unexpected, it also came with a very short consultation period and the implementation schedule did not follow the recommended practice".[208]

220. There was also some concern that, although the requirement to consult is met, the Government's commitment to consultation is not always wholehearted. The ICAEW wrote "we are not convinced that the Government is always listening to the responses and ensuring that the proposals are amended to take account of legitimate concerns. There is a danger that the process is still seen more as an end in itself rather than a means to an end".[209] ICAS commented in similar vein.[210]

221. On time pressures curtailing consultation on draft Finance Bill clauses, KPMG wrote that "In many cases, the consultation seems to progress in a satisfactory manner but at the end there is a rush to get legislation drafted in time for the Finance Bill. This often results in badly drafted legislation which then has to be 'corrected' in guidance notes".[211] The TPF's second report picked up a similar point, noting that the new approach exacerbated the risk "because draft legislation has necessarily to be produced at an earlier stage … before all responses have been fully evaluated. It may then become difficult to alter or recast the legislation sufficiently prior to enactment."[212]

222. **As we recommended in past reports, we urge the Government to examine why the new policy-making process worked less well in a minority of cases, and take the necessary steps to ensure a uniformly good result in all cases. In particular, we recommend that, where the approach decided on after the closure of a Stage II consultation differs radically from that consulted on, the policy development timetable should be amended. This would allow for further consultation on the revised proposals, building on the outcome of the earlier stages, before proceeding to publish clauses in a draft Finance Bill.**

### The Tax Policy Partnership

223. A policy partnership between HMT and HMRC that works well is a critical factor in applying the new approach consistently and developing good tax legislation. Our 2011 inquiry uncovered some disquiet among witnesses about the effectiveness of the policy partnership. Officials responded by

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[207] ACCA, paragraph 18.

[208] CBI, paragraph 8.

[209] ICAEW, paragraph 39.2.

[210] ICAS, paragraph 28.

[211] KPMG, paragraph 2.

[212] *Tax Professionals Forum, Second Independent Annual Report*, 27 March 2013, page 12, section 8.

assuring us that a joint review by senior officials had led to a 'reinvigorated' partnership.[213]

224. This year there was not the same groundswell of criticism, but the current state of the policy partnership between the Treasury and HMRC was far from clear. There was some evidence that it was working more effectively. Mr Whiting argued that the partnership worked "pretty well" and was "going in the right direction", but, on the other hand, he still had "some concerns, such as whether the Treasury people have the tax experience, and indeed the commercial experience, that they would have ideally. They tend to move on very quickly. I still have concerns as to whether policy work in HMRC has the status that it might".[214]

225. Asked about the findings of the 2010–11 review into the policy partnership, Ms Morgan said that she "was not sure that they [Mr Hartnett and Mr Troup] referred to a formal internal review".[215] She offered to give further detail, but was asked for a note. The note from HMRC did not contain any information about the 2010–11 review, but assured us that "HM Treasury and HMRC keep the Policy Partnership continually under review and seek improvements in the working relationship between the departments."[216] Among the improvements listed in the note, the main ones were the establishment of The Policy Partnership Oversight Group, chaired by senior HMT and HMRC officials and charged with monitoring "effective allocation of resources and the skills in both parts of the partnership" and of The Budget Policy Oversight Panel, whose role is to "scrutinise tax policy development to provide high-level stress testing and challenge for emerging tax measures".[217]

226. Other witnesses were concerned about the range and depth of knowledge and expertise in the two departments. Professor Freedman commented that although there was a lot of consultation she was not always sure that

> "HMRC and the Treasury know quite what to do with it. Unless you go out consulting with some clear background knowledge so that you can evaluate what is coming back, there is a danger that you lose your way … and sometimes the people working on the consultations, who are all very, very bright, have just not had long enough in the area to know about that detail and so mistakes are made that way."[218]

Mr Murphy agreed that "the people who might be involved in creating some of this draft legislation and the processes inside the Treasury do not have the experience for what happens inside the commercial world",[219]adding that there was a particular lack of understanding of what happened in small businesses.

227. As will be clear from earlier in the report, there was also some criticism of HMRC's lack of understanding of how partnership structures are used.

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213 Select Committee on Economic Affairs, *The Finance Bill 2011* (4th Report, Session 2010–12, HL Paper 158), paragraphs 72–74.

214 Q 13.

215 Q 138.

216 HMRC and HMT, further evidence, page 1.

217 *Ibid.*, page 1.

218 Q 28.

219 Q 39.

Mr Roy-Chowdhury made the point that "Whoever thought up these tests does not seem to understand how partnerships, say accountancy practices across different jurisdictions, across different countries, come together … They do not seem to properly understand commercial reality and how businesses operate in partnerships."[220]

228. Ms Knott felt that there was

> "a considerable amount of expertise in HMRC on partnerships in terms of our operations—the large business service has a partnerships unit … But it is fair to say that it was when we went to consultation that we realised the extent [to which mixed partnerships are used in the AIFM sector]. We certainly learnt a lot from the consultation."[221]

And Mr Quelch added that the department had

> "an ever growing understanding of the UK business population … through ever more sophisticated exploitation of our significant data sets … and … extensive research into the business population … In addition, we are always happy to engage with external experts to help us identify where the market is changing, commercial trends being what they are."[222]

229. Policy initiatives come from a number of different sources, including, most importantly, from Ministers themselves. Our witnesses focused on the detailed development of policy initiatives and expressed concerns about the apparent lack of internal challenge which some attributed to the current division of policy responsibilities between HMRC and HMT. Mr Sanger and others argued that

> "if HMRC's role was to 'own' the policies, ensuring that any proposals are rigorously evaluated by both the policy lead and those with practical experience of the operation of the tax system, then a number of the concerns of detail might be identified and addressed up front. HM Treasury would then have a clearer 'scrutiny' role, which would provide the 'challenge function' to the policies being developed."[223]

230. **We were heartened to hear that the tax policy partnership between HMT and HMRC was working more effectively and of the measures taken to strengthen it. We recommend that the interdepartmental Policy Partnership Oversight Group and Budget Policy Oversight Panel build on these achievements by taking further steps to encourage officials in both departments to improve their tax skills and their knowledge of evolving commercial practice, and to subject proposals to more rigorous challenge.**

231. **We were disappointed, however, to be told that a formal review into the policy partnership was not carried out in 2011. We recommend that such a review should now be undertaken into the effectiveness of the current division of policy responsibilities between HMT and HMRC, including the scope for re-balancing those responsibilities.**

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[220] Q 45.

[221] Q 129.

[222] Q 131.

[223] Chris Sanger, supplementary evidence, page 2.

## Scope and Reach of Consultations

232. We also considered evidence on whether there had been significant progress in extending the scope and reach of HMRC and HMT's consultations. Two aspects of this issue were covered by the recommendations in our 2011 Report: consulting, albeit informally, with those likely to be affected by a proposal when drawing up its initial impact assessment at stage I; and widening the range of small business and non-business stakeholders consulted throughout the policy development process.

### *Consulting Early on Potential Impacts*

233. On the first aspect, the ICAEW assert that "impact assessments used to underpin policy changes are not based on robust and realistic costings"[224] and that officials need to consult "with business and professional advisers at an early stage to identify in detail what needs to be done and by whom so that such processes can be built into any costings."[225] And the Federation for Small Business (FSB) go further and recommend that "all tax impact assessments should be subjected to independent scrutiny at both consultation and final stage".[226]

234. **We have commented in chapter 5 on the estimated additional yield from the proposed measures on the taxation of partnerships that became evident only during the consultation period. That showed that the draft impact assessment that had been published as part of the May consultation paper was a long way wide of the mark. We regret the apparent absence of consultation in the earliest parts of this process. Building on the conclusions of the Committee's 2011 report, we recommend that, whenever possible, officials consult fully and openly with those affected when drawing up Tax Impact and Information Notes (TIINs) and costing tax proposals.**

### *Consulting More Widely*

235. On the second aspect, the reach of the consultation process, Mr Murphy argued that "there is a relatively widespread understanding of what happens in big business and big partnerships, because they are the people who are being consulted and they are even on the board of HMRC" but that there were very few consultation responses from small businesses "because they do not have the resources or the funding to do it".[227] Ms McCormick thought that the most efficient way for small businesses to feed views into consultations is "through trade associations and the like, because a small business just does not have the capacity. They are too busy running their business to get involved in all of this."[228]

236. Both Mr Murphy and Mr Brooks denied seeing any improvement in HMRC's record of consulting smaller businesses and non-business stakeholders.[229] In contrast, representatives of the largest accountancy firms

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224 ICAEW, paragraph 39.1.

225 ICAEW, paragraph 40.

226 FSB, paragraph 6.

227 Q 39.

228 Q 112.

229 Q 40.

argued that the breadth of views reflected in consultations was much greater than suggested, both because the firms involved in consultations took account of the views and interests of their clients, and because the membership of the various institutes covered a wide range of experience.[230] Mr Dodwell also pointed to the role of "the Low Incomes Tax Reform Group, which is part of the CIOT, to help provide that unrepresented input."[231]

237. Mr Quelch rebutted criticism of HMRC's contacts with small business by explaining how the department engaged with its customers by way of "formal interactions through standing consultative groups, informal interactions and extensive consultations on particular proposals."[232] Mr Quelch went on to elaborate on the measures HMRC had taken to simplify procedures and guidance for small business and the extensive consultation that informed those changes.

238. Mr Murphy suggested that the consultation process was a closed shop because the people who had real influence were those who were invited to "face-to-face meetings in the Treasury, and very few smaller firms will be invited in to do that, I suspect."[233] Mr Brooks thought that officials were unwilling to engage with individuals or organisations outside the mainstream.[234] A similar theme emerged from the OUCBT report which concluded that, in all tax jurisdictions, "tax policy is made and influenced by a very small group of people …The narrowness of the process has the potential to create unbalanced outcomes in the absence of other safeguards."[235]

239. Asked about the difficulties individuals, academics and non-mainstream organisations might face in accessing HMRC and Treasury officials, Mr Quelch maintained that HMRC's consultation processes were very open and transparent and that he could see nothing "preventing any individuals who have an interest in UK tax legislation providing that response in that way through a consultation exercise."[236]

240. **We recognise the progress made by the Government in formalising and extending the scope and quality of consultation processes on tax policy-making. We also understand how difficult it is to engage with small businesses and with individual taxpayers, but we consider that more needs to be done to devise innovative ways of reaching out to these groups. We therefore recommend, as did our predecessor Committee in 2011, that HMRC and HMT urgently develop and publish comprehensive strategies for consulting smaller businesses, non-business stakeholders and other groups.**

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230 Q 112.

231 Q 112.

232 Q 133

233 Q 39.

234 Q 40.

235 *Structures, processes and governance in tax policy-making: an initial report,* C J Wales and C P Wales, OUCBT, December 2012, page 7 (Executive Summary).

236 Q 134.

## Post-implementation Reviews

241. A strong theme in our 2011 inquiry was the need for post-implementation reviews of tax changes, essentially extending and formalising the final stage of the policy development process. Much of the evidence we received this year concerned the absence of any information on whether, and with what result, stage V (reviewing and evaluating the change after its implementation) of the new approach had been carried out. Most witnesses called for independent post-implementation reviews of all significant changes in line with the recommendation in this Committee's 2011 Report.

242. Mr Murphy argued that in many cases it was not clear what the Government's objectives were and that made it difficult to evaluate policies: "How, as a consequence, can anybody undertake a review of outcome against objectives when it was not clear what government policy was in this area?"[237] Deloitte's view was that they had "not yet seen a good example of this being carried out."[238]

243. Mr Gammie assumed that reviews took place within departments but said he "would suspect that they come at a lot of these issues with a rather more limited eye than I certainly would think desirable in trying to tackle some of the ongoing problems of the tax system."[239] Mr Sanger agreed that there was "little evidence to the outside world of those reviews being undertaken. They may be happening inside the Treasury and HMRC, but it would be good for the outcome of that to be far more visible."[240] Mr Nicholson thought that "post-implementation is good business."[241]

244. Responding to these criticisms Ms Morgan said that

> "The Treasury and HMRC undertake a really wide range of work both internally and externally to improve the evidence base on the impact of previously implemented policies and to inform policy development going forward. If you look on HMRC's website, there are more than 300 research reports, some of which are evaluative in nature, that are a really core part of our evidence base to inform policy-making. There is a joint Treasury-HMRC steering group, which oversees the evaluation programme and ensures that our resources are being prioritised correctly in that area."[242]

She added that "All formal evaluations are published on HMRC's website" and that HMRC co-funds "the Tax Administration Research Centre, which often carries out independent research and adds to the evidence base".[243]

245. While we recognise the large volume and variety of research carried out and published by HMRC, very few of the 300 items referred to appear to constitute post-implementation reviews of significant tax changes.

246. Asked about plans for evaluating the partnership measures, Ms Morgan said that HMRC would

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237 Q 41.

238 Deloitte, page 6.

239 Q 30.

240 Q 30.

241 Q 116.

242 Q 136.

243 Q 136.

> "monitor the receipts from this sector as the change comes into effect and look at the behavioural responses that we see in the sector, to test that against the assumptions that we made when we proposed the measure. However, it is too early at this stage to commit to a more formal evaluation, or to what form that evaluation may take, because it will need to be looked at in the round against other competing pressures on that resource once the measure is in effect."[244]

This last comment suggests that there may be a long way to go before post-implementation reviews become a normal last stage of the policy-making process.

247. **We regret the lack of progress in carrying out and publishing formal evaluations of tax changes implemented so far. We reaffirm the recommendation of 2011 that the Government should commit to undertaking post-implementation reviews of all significant tax reforms, preferably with the support of independent experts, and that their results should be published.**

## Strategic Context

248. There were two strands to the evidence submitted on the strategic context of tax policy changes: that individual tax proposals should be looked at in a much wider (non-tax) context and that, within the tax system, proposals need to be seen against the background of the Government's longer term strategy for that part of the tax system.

### *Changes in a Broader Context*

249. On the first strand Professor Freedman argued that

> "we are also still not very good at looking at these tax policy changes in a wider context and in a holistic context. We are not looking at benefits legislation at the same time as we are looking at tax. We are not looking at employment law and we are not looking at partnership law when we are changing partnership taxation. There is not enough joined-up government here, so that can cause problems."[245]

250. Baker Tilly thought that, on the partnership measures, "there should have been a consultation across Government about clause 4(4) of the LLP Act in order to correct the defect and agree a set of rules to govern the circumstances in which a person who is a member of an LLP is treated *for all purposes* as an employee."[246]

251. Ms Knott responded that the partnership consultation "was looking at the taxation consequences to make sure that the tax consequences were fair and consistent. It has focused on that rather than looking at employment law. That would be a very different undertaking and not something that we could have done from the Treasury and Revenue and Customs."[247]

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[244] Q 136.

[245] Q 28.

[246] Baker Tilly, paragraph 30.

[247] Q 135.

252. Some felt that the Government should have waited for the OTS's final report, or held a much wider consultation on partnerships, including the implications for employment rights of any proposed changes in tax treatment. The LSEW wrote

> "the consultation considers just two aspects of the tax rules relating to partnerships. Such a piecemeal approach is not conducive to making better tax law. In our view, it would be better to delay the introduction of the present proposals until the Office of Tax Simplification has completed its review of all aspects of the taxation of partnerships."[248]

253. In response, Ms Morgan explained that "It would not have been appropriate, given the revenue that was at risk … for the Government to await the outcome of the OTS work before proceeding with those changes."[249]

254. **We accept the Government's reasons for not awaiting the conclusions of the Office of Tax Simplification's reports on partnership taxation, particularly where it was seeking to counter tax loss. But we have sympathy with the view that the proposals might have been developed more coherently against the background of a clearer statement of the Government's objectives for the overall tax treatment of partnerships.**

### *Changes and Road Maps*

255. On the second strand, the need for the Government to outline its overall plans for different parts of the tax system, Mr Sanger pointed to the

> "ongoing benefit to providing taxpayers with a clear strategy as to the tax policies that the Government will look to adopt, both in this parliament and beyond. Whilst some of these will necessarily be political in nature, there could be a considerable amount of common ground where clarity would benefit the UK."[250]

256. On expressing the Government's strategy in the form of a 'road map', the ICAEW wrote "In November 2010, the Government published a Roadmap for Corporation Tax which has been welcomed by business. We would now like a similar document to be published for personal tax. Certainty about the taxes individuals must pay on their income and chargeable gains is a contributory factor to a business's decision to base itself in the UK."[251] Mr Dixon argued for a long-term vision of the tax system.[252]

257. Mr Sanger suggested that such maps should focus "on the different types of taxpayer/stakeholder, rather than the technical form of the tax … to allow the taxpayer to understand the overall strategy".[253] The ICAS wrote in similar terms and wanted to level "the inconsistencies between employment and self-employment."[254]

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248 LSEW, paragraph 20.

249 Q 135.

250 Chris Sanger, supplementary evidence, page 1.

251 ICAEW paragraph 43.

252 Q 111.

253 Chris Sanger, supplementary evidence, page 1.

254 ICAS, paragraph 20.

258. Ms Morgan replied to the call for further road maps by saying that

> "The road map that was published for corporation tax has been very popular and widely endorsed by many stakeholders. We receive regular calls for similar road maps to be published on a wide range of aspects of the UK tax system. Ultimately, a decision to do that has to be one for Ministers, but as far as possible we try to signal what the Government's approach might be towards a particular area of taxation."[255]

259. **We recognise the political dimension to tax reform and the fact that the Government cannot bind the hands of its successors. However, we agree that the Government should, as far as possible, avoid making piecemeal, reactive changes to the tax system. We continue to believe that tax policy would be developed more coherently if, at the beginning of every government, clear statements were to be published, similar to the 2010 company tax road map. These would give details of the government's overall strategic aims for different parts of the tax system. We recommend this for the future.**

[255] Q 135.

## CHAPTER 7: SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

### The Consultation and the Draft Legislation

260. The failure of the Limited Liability Partnerships Act 2000 to achieve its policy objective of aligning the tax treatment of LLP members with that of partners in a general partnership is at the heart of the problems that have arisen with LLP members all being treated as self-employed. (paragraph 59)

261. We accept the evidence of our private sector witnesses on the provisions concerning salaried members of LLPs, and agree that the December proposals are significantly different from those proposed in the earlier consultation. (paragraph 60)

262. This change of direction in December has implications for the way in which this consultation should have been handled and the way in which consultations generally should be handled. We return to this in Chapter 6. (paragraph 61)

### Salaried Members of Limited Liability Partnerships

263. It is clear that there are alternative ways of achieving the policy outcome of aligning the tax treatment of LLP members with partners in a general partnership. One approach would be to remove the presumption of self-employment from the tax legislation and to rely on partnership case law to determine whether a LLP member is an employee or a self-employed partner. Another approach would be to adopt legislative tests designed to achieve the same outcome. (paragraph 92)

264. In our view, it is still open to question which is the better approach. We agree strongly with those who stressed that, if legislative tests are adopted, it is vital that they achieve the intended policy outcome of aligning the tax treatment of members of LLPs with that of partners in a general partnership. (paragraph 93)

265. If our recommendation on commencement of the provisions on salaried LLP members (paragraph 273 below) is accepted, it will provide time to enable a reassessment of both approaches and for HMT and HMRC to have further discussions with all interested parties. (paragraph 94)

266. Nearly all the evidence that we received supported the view that the proposed legislative tests to determine who is a partner for tax purposes do not achieve their policy objective. If the Government continues with the approach in the draft legislation, it is vital that they address all the points made and amend those tests so that they place members of LLPs in the same position as partners in a general partnership. (paragraph 122)

267. The Government should also consider the position of non-UK LLPs carrying on a business in the UK with a view to aligning their treatment with that of UK LLPs. (paragraph 123)

268. We expect that many points on the detailed drafting of the legislative tests will have been made to HMRC. It is essential that the drafting of the legislation is tightened so that, as far as possible, any subjectivity and resulting uncertainty is minimised. We **recommend** that this be done in

close consultation with all interested parties so that, where possible, consensus is reached. (paragraph 129)

269. We **recommend** that the guidance should then be redrafted so that it performs its proper function of clarifying rather than extending the primary legislation. (paragraph 130)

270. We **recommend** that the Government consider with interested parties the case for changing the basis of the tests decided on so that they operate by reference to the accounting period of the partnership rather than over a fiscal year. This would avoid some administrative difficulties that would otherwise arise. (paragraph 131)

271. Given the change of approach to the provisions that took place in December, we conclude that there is too little time to settle all the outstanding issues, get the legislation right and enable businesses to adapt to that legislation in time for a 6 April start. (paragraph 136)

272. We recognise the importance to the Government of the tax yield from these measures. However, taking the time necessary to target these provisions more precisely would ensure that the resulting legislation was more robust and effective and that the new rules gained greater acceptability amongst taxpayers. (paragraph 141)

273. Accordingly, we **recommend** that the Government give urgent consideration to delaying these provisions until next year. That would give time for a reassessment of the alternative approaches to achieving the policy outcome and, if the present approach in the legislation prevailed, to target that legislation more accurately. (paragraph 142)

274. A delay would also give time to make a proper assessment of whether these provisions should apply for the accounting periods of partnerships rather than for the fiscal year in order to reduce the administrative burden on partnerships affected. (paragraph 143)

### The Other Elements of the Partnerships Package

275. We acknowledge that it is open to the Government to make structural changes of the kind proposed for mixed partnerships to prevent or reduce tax loss, although it should state its objectives clearly at the outset. (paragraph 169)

276. We are concerned, however, at the apparent disconnect that can develop between business and HMRC over what is acceptable for tax purposes. Had HMRC been aware of the scale of the practice of profit shifting earlier and dealt with it then, there might have been less resistance to the proposed changes. We are also concerned by the loss of tax that can arise if potentially unacceptable practices are not addressed as early as possible. (paragraph 170)

277. We are sure that all the points that have been made to us on the drafting of the legislation will have been made directly to HMRC. We strongly **recommend** that HMT and HMRC consider them all very carefully with a view to tightening the legislation so that it is drafted as precisely as possible and the reliance on guidance is reduced. (paragraph 171)

278. If this can achieved in the time available, we see no reason why the mixed membership proposals should not go ahead with effect from 6 April, thus retaining most of the yield from the partnership package. (paragraph 172)

279. We fail to understand why HMRC has been so unwilling to provide more detail on how it has arrived at the figures for the additional yield of £1.92 billion scored in the 2013 Autumn Statement. Of course, we wholly accept that HMRC is prevented from doing so if that would identify individual taxpayers, or even smaller groups of taxpayers. But we think that is unlikely to be the issue here. (paragraph 183)

280. We **recommend** that, within the normal constraints of taxpayer confidentiality, HMRC should be more open about how figures for yield from structural changes to the tax system have been computed. (paragraph 184)

281. We are concerned that the additional yield from the AIFM sector clearly came as a surprise to HMRC and that it was not aware of the extent to which profit deferral using corporate members was happening in the sector. (paragraph 185)

282. We **recommend** that HMRC should take additional steps to become even more aware of developments in the businesses from which it collects tax and particularly of practices to which it might object. This would not only help prevent such practices becoming embedded but, as seems to be the case with the Alternative Investment Fund Management sector, may also prevent the loss of a very large amount of tax. (paragraph 186)

283. We agree with our witnesses that it is entirely appropriate for the Government to introduce a targeted anti-avoidance rule to stop avoidance by means of tax-motivated transfers of assets and income streams through partnerships. (paragraph 190)

### The New Approach to Tax Policy-Making since 2011

284. The evidence we have heard leads us to conclude that, although it would have been preferable not to have compressed the first two stages of the process, the partnership consultation carried out between May and August 2013 was well-conducted, open and responsive. We commend HMRC and HMT for that and particularly for their interaction with representatives of the AIFM sector. (paragraph 212)

285. That has, however, not been the case since December when the draft Finance Bill proposals concerning salaried members turned out to be significantly different from the ones discussed in the summer. We have already concluded that insufficient time has been allowed for proper consultation on the new proposals if the April start date is to be maintained. This constitutes practice that is not compatible with the new policy-making process. (paragraph 213)

286. We commend the Government, HMRC and HMT on the quality of the consultations conducted and the tax legislation produced since 2011 in those areas (the large majority) where the new approach to tax policy-making has been applied comprehensively. (paragraph 217)

287. As we recommended in past reports, we urge the Government to examine why the new policy-making process worked less well in a minority of cases, and take the necessary steps to ensure a uniformly good result in all cases. In

particular, we **recommend** that, where the approach decided on after the closure of a Stage II consultation differs radically from that consulted on, the policy development timetable should be amended. This would allow for further consultation on the revised proposals, building on the outcome of the earlier stages, before proceeding to publish clauses in a draft Finance Bill. (paragraph 222)

288. We were heartened to hear that the tax policy partnership between HMT and HMRC was working more effectively and of the measures taken to strengthen it. We **recommend** that the interdepartmental Policy Partnership Oversight Group and Budget Policy Oversight Panel build on these achievements by taking further steps to encourage officials in both departments to improve their tax skills and their knowledge of evolving commercial practice, and to subject proposals to more rigorous challenge. (paragraph 230)

289. We were disappointed, however, to be told that a formal review into the policy partnership was not carried out in 2011. We **recommend** that such a review should now be undertaken into the effectiveness of the current division of policy responsibilities between HMT and HMRC, including the scope for re-balancing those responsibilities. (paragraph 231)

290. We have commented in chapter 5 on the estimated additional yield from the proposed measures on the taxation of partnerships that became evident only during the consultation period. That showed that the draft impact assessment that had been published as part of the May consultation paper was a long way wide of the mark. We regret the apparent absence of consultation in the earliest parts of this process. Building on the conclusions of the Committee's 2011 report, we **recommend** that, whenever possible, officials consult fully and openly with those affected when drawing up Tax Impact and Information Notes (TIINs) and costing tax proposals. (paragraph 234)

291. We recognise the progress made by the Government in formalising and extending the scope and quality of consultation processes on tax policy-making. We also understand how difficult it is to engage with small businesses and with individual taxpayers, but we consider that more needs to be done to devise innovative ways of reaching out to these groups. We therefore **recommend**, as did our predecessor Committee in 2011, that HMRC and HMT urgently develop and publish comprehensive strategies for consulting smaller businesses, non-business stakeholders and other groups. (paragraph 240)

292. We regret the lack of progress in carrying out and publishing formal evaluations of tax changes implemented so far. We reaffirm the recommendation of 2011 that the Government should commit to undertaking post-implementation reviews of all significant tax reforms, preferably with the support of independent experts, and that their results should be published. (paragraph 247)

293. We accept the Government's reasons for not awaiting the conclusions of the Office of Tax Simplification's reports on partnership taxation, particularly where it was seeking to counter tax loss. But we have sympathy with the view that the proposals might have been developed more coherently against the background of a clearer statement of the Government's objectives for the overall tax treatment of partnerships. (paragraph 254)

294. We recognise the political dimension to tax reform and the fact that the Government cannot bind the hands of its successors. However, we agree that the Government should, as far as possible, avoid making piecemeal, reactive changes to the tax system. We continue to believe that tax policy would be developed more coherently if, at the beginning of every government, clear statements were to be published, similar to the 2010 company tax road map. These would give details of the government's overall strategic aims for different parts of the tax system. We **recommend** this for the future. (paragraph 259)

# APPENDIX 1: LIST OF MEMBERS AND DECLARATIONS OF INTEREST

## Members

The members of the Sub-Committee which conducted the inquiry were:

Lord Bilimoria
Baroness Blackstone
Baroness Drake
Lord Hollick*
Lord Joffe
Lord Leigh of Hurley
Lord MacGregor of Pulham Market (Chairman)
Lord Rowe-Beddoe
Lord Wakeham
Baroness Wheatcroft
Lord Wrigglesworth

* Lord Hollick was unable to attend most meetings.

Dr Trevor Evans CBE JP and Mr Tony Orhnial CB, retired senior officials of HM Revenue and Customs and HM Treasury, were appointed as Specialist Advisers to the inquiry.

## Declarations of Interest

Members of the Finance Bill Sub-Committee declared the following interests as relevant to the inquiry:

Lord Bilimoria

*Chairman of the Cobra Beer Partnership Limited*
*Chairman of Molson Coors Cobra India Private Limited*
*Association Member of BUPA*
*Qualified Chartered Accountant for Ernst & Young*
*Fellow of the Institute of Chartered Accountants in England and Wales*
*President of the UK India Business Council*
*Member of the Prime Minister of India's Global Advisory Council*
*Visiting Entrepreneur at the Centre for Entrepreneurial Learning, University of Cambridge*
*Member of the Advisory Board for Judge Business School, University of Cambridge*
*Member of the World President's Organisation/CEA*
*Companion of the Chartered Management Institute*
*Visiting Professor at the London Metropolitan University*
*Governor of the Ditchley Foundation*
*Council Member of the Ditchley Foundation*
*Member of the Birmingham Business School Advisory Board*
*Fellow of the Institute of Directors*
*Member of the Cranfield School of Management Advisory Board*
*Patron of Oxford Entrepreneurs*
*Non-executive Director and Senior Independent Director, Booker Group plc (food wholesaler)*
*Directorship of Minmar (900) Limited (business services)*
*Directorship of BHL Group (home and leisure products)*

*Directorship of Bilimoria & Bilimoria LLP*
*Directorship of General Bilimoria Wines Limited*
*Directorship of Cobra India Beer Limited*
*Directorship of Cobra India New Company Limited*
*Shareholding in Bilimoria Holdings Limited (holding company)*
*Shareholding in Cobra India Newco*
*Shareholding in Booker Group plc (food wholesaler)*
*Advisory Board, Seven Hills (public relations/communications firm)*
*Member of Advisory Board, Judge Business School, Cambridge University*
*Visiting Professor, CfEL, Cambridge Judge Business School*
*Member of Advisory Board, Birmingham Business School*
*Member of Vice Chancellor's Circle of Advisors for India, Cambridge University*
*Visiting Professor of London Metropolitan University*
*Member of Advisory Board, Cranfield School of Management*
*Board of Directors of Harvard Graduate School Leadership Institute*
*Member of E20 Steering Group (advocacy group for entrepreneurs to engage with, inspire and support enterprise in UK)*
*Founding Chairman of UK-India Business Council*
*Trustee of Cobra Foundation*
*Trustee of British Cardiac Research Trust*
*Enterprise Leader of Prince's Trust*

Baroness Blackstone

*None declared*

Baroness Drake

*Independent Member of the Walker Guidelines Monitoring Group for the Private Equity Industry. Fee paid by British Venture Capital Association (BVCA).*

Lord Hollick

*None declared*

Lord Joffe

*Active supporter of tax reform to prevent tax evasion and avoidance; providing financial support to individuals and organisations undertaking research and/or campaigning in relation to these issues.*

Lord Leigh of Hurley

*Member of various LLPs, most principally Cavendish Corporate Finance LLP*
*Member of The Institute of Chartered Accountants in England and Wales*
*Member of The Chartered Institute of Taxation*
*Member of the British Private Equity and Venture Capital Association.*
*Senior Treasurer of the Conservative Party*

Lord MacGregor of Pulham Market

*None declared*

Lord Rowe-Beddoe

*None declared*

Lord Wakeham

*Director, Genner Securities Ltd*
*Director, Genner Farms Ltd*
*Director, Genner Holdings Ltd*
*Shareholdings in Genner Securities Ltd*
*Shareholdings in Genner Holdings Ltd*

*Shareholdings in Genner Farms Ltd*

Baroness Wheatcroft
*None declared*

Lord Wrigglesworth
*Director of and shareholdings in Durham Group Estates Ltd*
*Director of and shareholdings in Durham Group Investments Ltd*

A full list of Members' interests can be found in the Register of Lords' Interests:

http://www.parliament.uk/mps-lords-and-offices/standards-and-interests/register-of-lords-interests/

## APPENDIX 2: LIST OF WITNESSES

Evidence is published online at www.parliament.uk/hlfinancebill and available for inspection at the Parliamentary Archives (020 7219 5314).

Evidence received by the Committee is listed below in chronological order of oral evidence session and in alphabetical order. Those witnesses marked with * gave both oral evidence and written evidence. Those marked with ** gave oral evidence and did not submit any written evidence. All other witnesses submitted written evidence only.

### Oral evidence in chronological order

| | | |
|---|---|---|
| ** | (QQ 1–16) | Office of Tax Simplification |
| ** | (QQ 17–31) | Professor Judith Freedman |
| ** | | Malcolm Gammie CBE QC |
| * | | Chris Sanger |
| ** | (QQ 32–42) | Richard Brooks |
| ** | | Richard Murphy |
| * | (QQ 43–56) | Association of Chartered Certified Accountants |
| * | | Institute of Chartered Accountants in England and Wales |
| * | | Institute of Chartered Accountants in Scotland |
| ** | (QQ 57–67) | Alternative Investment Management Association |
| ** | | National Farmers Union |
| ** | (QQ 68–82) | Chartered Institute of Taxation |
| * | | Law Society of England and Wales |
| * | (QQ 83–94) | Association of Partnership Practitioners |
| * | | British Private Equity and Venture Capital Association |
| ** | | Institute of Directors |
| * | | New City Initiative |
| * | (QQ 95–116) | Deloitte |
| ** | | EY |
| * | | KPMG |
| ** | | PwC |
| * | (QQ 117–138) | HM Revenue and Customs |
| * | | HM Treasury |

### Alphabetical list of all witnesses

| | |
|---|---|
| | Association of British Insurers |
| * | Association of Chartered Certified Accountants |
| ** | Alternative Investment Management Association |

* Association of Partnership Practioners
Baker Tilly
Wendy Bradley
British Bankers' Association
* British Private Equity and Venture Capital Association
** Richard Brooks
** Chartered Institute of Taxation
City of London Law Society
Confederation of British Industry
* Deloitte
** EY
Federation of Small Businesses
** Professor Judith Freedman
** Malcolm Gammie CBE QC
Grant Thornton UK LLP
Herbert Smith Freehills LLP
* HM Revenue and Customs
* HM Treasury
* Institute of Chartered Accountants in England and Wales
* Institute of Chartered Accountants of Scotland
** Institute of Directors
Andrew Jackson
* KPMG
* The Law Society of England and Wales
Mazars LLP
** Richard Murphy
** The National Farmers Union
* New City Initiative
** Office of Tax Simplification
** PwC
Professional and Business Services Council
Michael Richards
* Chris Sanger
War on Want and Change to Win

## APPENDIX 3: CALL FOR EVIDENCE

The House of Lords Economic Affairs Committee has set up a Finance Bill Sub-Committee (the FBSC) to inquire into the draft Finance Bill 2014 which was published on 10 December 2013. The FBSC would welcome written evidence by 23 January on the two topics set out below:

### Taxation of Partnerships

The first relates to the schedule in the draft Bill which makes provision in relation to partnerships (Parts 1, 2, 3 and 4 of the Schedule). The FBSC invites evidence on the specifics of this draft legislation.

In order to understand fully the context in which the proposed changes would be applied, FBSC wishes to consider more generally the legislation in relation to the taxation of partnerships. Evidence is invited on whether the approach of the legislation is appropriate or whether the provisions such as those in the draft Finance Bill 2014 are a symptom of underlying problems with that approach.

The FBSC expects the report on the taxation of partnerships which the Office of Tax Simplification will publish shortly to provide an important input to its inquiry, and also invites evidence on the conclusions in that report.

### New approach to Tax Policy Making

It is now over three years since the Government announced its new approach to tax policy making with the aim of bringing about a clearer, more stable and predictable tax system with better tax legislation and more effective scrutiny of tax changes. As part of its inquiry into the Finance Bill 2011, the FBSC heard evidence on the new approach and published its report in March that year.

The FBSC now invites evidence on the extent to which the new approach has been implemented and is delivering the objectives set out for it.

To the extent that the new approach has not been fully implemented in particular areas or on specific topics, the FBSC invites evidence on why there is this variability. It would be helpful to have specific examples taken from recent Finance Bills, including, in particular, the current draft Finance Bill.

### Terms of Reference of the FBSC

The FBSC's inquiries generally focus on technical issues of tax administration, clarification and simplification rather than on rates or incidence of tax. It aims to publish its report before the Budget.

## APPENDIX 4: GLOSSARY

| | |
|---|---|
| ACCA | Association of Chartered Certified Accountants |
| AIFM | Alternative Investment Fund Manager |
| AIFMD | Alternative Investment Fund Managers EU Directive |
| AIMA | Alternative Investment Management Association |
| APP | the Association of Partnership Practitioners |
| ARPT | Annual Residential Property Tax |
| BBA | British Bankers Association |
| BVCA | British Private Equity and Venture Capital Association |
| CBI | Confederation of British Industry |
| CFC | Controlled Foreign Companies |
| CGT | Capital Gains Tax |
| CIOT | the Chartered Institute of Taxation |
| CLLS | the City of London Law Society |
| CTSA | Corporation Tax Self Assessment |
| FBSC | Finance Bill Sub-Committee |
| FCA | Financial Conduct Authority |
| FSB | Federation for Small Business |
| GAAR | General Anti-Abuse Rule |
| HMRC | HM Revenue and Customs |
| HMT | HM Treasury |
| ICAEW | The Institute of Chartered Accountants in England & Wales |
| ICAS | The Institute of Chartered Accountants of Scotland |
| IoD | Institute of Directors |
| ITTOIA | Income Tax (Trading and Other Income) Act 2005 |
| LLPA 2000 | Limited Liability Partnerships Act 2000 |
| LLP | Limited Liability Partnership |
| LSEW | Law Society of England and Wales |
| NCI | New City Initiative |
| NFU | National Farmers Union |
| NIC | National Insurance Contribution |
| OTS | Office of Tax Simplification |
| OUCBT | Oxford University Centre for Business Taxation (OUCBT) |
| PAYE | Pay As You Earn |
| PBSC | Professional and Business Services Council |
| SA | Self Assessment |

| | |
|---|---|
| SDLT | Stamp Duty Land Tax |
| TIINs | Tax Impact and Information Notes |
| TPF | Tax Professionals Forum |
| VAT | Value Added Tax |