

THE OPAQUE PARTNERSHIP: A NOTE

by Milton Grundy

The name I have made up, but the concept is, basically, a traditional one. Generally, as we all know, the way the profit of a partnership is to be shared out between the partners is defined in the partnership agreement – for example, Mr. A is to receive 60% and Mr. B and Miss C are to receive 20% each. But it is not unusual for a certain share of the partnership profits – say 30% – to be left to be decided each year, once the results of the year are known, and there may be provision for the appointment of a committee, sometimes called the “Three “Wise Men”, with a discretion to decide how this 30% is to be divided among the partners. This division is generally to be done on the basis of an estimate of how much each of the partners has contributed to the success of the business during the past year. But their discretion may be exercised in other ways. I have heard of Quaker partnerships, where the Wise Men are to take into account the personal needs and aspirations of the individual partners. Whatever the nature of the discretion, it of course cannot be exercised until the amount of the profit has been arrived at. It follows that there is always going to be a gap between the date the partnership accounts are made up and the date on which the partners know how much they will each get out of the profit the subject of the discretion. Let us imagine a case where the gap is quite a long one – several years maybe. Now let us consider a case where the *whole* of the partnership profits are subject to the discretion of the Wise Men. I am calling a partnership in this state “opaque”; because it cannot be truly “transparent” until the entitlements of each of the partners have been arrived at. I can see that if the contributions of the partners to the partnership business were glaringly unequal, the partnership

might be regarded as a “settlement” for tax purposes. But if that is not so, then the question we need to ask ourselves is, “Do any of the partners have any taxable income until the Wise Men have made their decision?” There is the case of *Franklin v. CIR* (15 TC 464) which throws some light on this question, but really I think it is pure question of fact: either the partner has become entitled to something out of the partnership or he has not, and if he has not, then, unless he is caught by some deeming provision, he does not have anything you can call “income”, and it is hard to see that his partnership share has any value for inheritance tax. It seems therefore that so long as the Wise Men at the partnership level are still making up their minds, the partners have no income and their assets have no ascertainable value, and there does not seem to be any way of taxing the partnership profits.

“This,” one may say, “is not avoiding tax; it is just a postponement. Once a decision is made about how the partnership profits are to be distributed, the chickens will come home to roost”. Well, maybe. Even if that happens, the postponement may itself be worthwhile: if they can invest profitably money which would otherwise be paid to the government, the partners can take the eventual tax liability in their stride. Or perhaps the Wise Men will decide to postpone the decision indefinitely and cause the partnership to buy an island in the Caribbean for use as a holiday retreat. But is there necessarily a tax liability at the end of the day? Suppose the partnership carries on a trade and makes up accounts to 5th April and makes full disclosure of its profits. In year 1, the partnership makes a profit of £x. In year 5, the Wise Men decide that the partnership should distribute the whole of the £x, which is then part of the partners’ income. But the £x is still trading profit of Year 1, and there then appears to be no machinery for assessing it. There is an argument, I suppose, that if the income is in a joint account of the partners, it has

been *received* by them and should therefore be taxed at the basic rate as it arises; that argument does not run in the case of the Scottish partnership, where the income would be received and held by a body separate from the partners.

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