THE SMITH STORY

Milton Grundy

Mr. Smith lived in England. His daughter lived in Canada and his son in Australia. They wanted to be partners in the business of commodity-dealing – pork bellies in Chicago, buying long and selling short, hedging exchange risks and that sort of thing. The Smiths did not really understand it all, but that did not matter: they had managers to run it and the managers were not in the United Kingdom, Canada or Australia. They decided to form a partnership together, and they found three nominee companies in the Bahamas, who would form the partnership for them. But when they came to draw up a partnership agreement, they could not agree how the profits were to be divided. Father thought the bulk of the profits should go to the children. He did not need the money to live on, and he would be leaving his money to the children anyway. And he reckoned that rather than pay income tax when he got the money and inheritance tax on what was left when he died, it would be more tax-efficient for the profits to go straight to the children. But the children did not need the money to live on either. Their father would soon be retiring, and they thought he should put aside some money for his old age – for the expensive medical care, the nursing and the sheltered accommodation that an old man might very well need. Wasn't there some way, they wanted to know, in which partnership profits could be put to reserve? Couldn't they wait and see what the future brought, and then decide among themselves – in, say, ten years' time

– how the profits should be divided between them? So the partnership agreement provided for the profits to be divided in such proportions as the partners may unanimously decide, with the proviso that if they had not made a decision at the end of ten years, a person was to be appointed to make a decision for them. Let me call this kind of offshore partnership – just to give it a name – an *Offshore Discretionary Partnership*, and the person to be appointed to make any necessary decisions the *Family Counsellor*.

For many years, the partnership made profits, and the partners resolutely refrained from reaching any decision about how the money was to be divided between them. Please, dear Reader, put yourself in the shoes of those advising each of the partners about completing an income tax return. History does not relate what happened to the daughter's return in Canada or the son's in Australia, but father's advisers saw a parallel with the facts in *Franklin v. CIR* (15 TC 464). The partnership in that case was the banking firm of Samuel Montagu & Co. One of the partners had died, exercising by his will a right under the partnership deed to appoint his son to be a partner. The other partners did not regard the son as a suitable new partner, and there was disagreement – stretching over many years, and including two sets of proceedings in the High Court – between the son and the remaining partners. While all that was going on, what would have been the son's share of the profit, if he had succeeded in becoming a partner, was accumulated in a reserve. It was eventually decided that the partners were entitled to refuse the son admittance to the partnership and the accumulated reserve was distributed to the partners, so that each of them got the amount he would have received if the income put to reserve had been distributed year by year. What the case tells us is that where a taxpayer's entitlement to income is, as the judge put it, "contingent upon a fact which is going to happen in a future year. It is," he said, "impossible to say that he is entitled to it in the years which passed before that event happens." He is not talking about amounts which are uncertain, but can nevertheless be estimated. An estimate can be brought into an account. This was a case where no estimate could possibly be made: nobody knew at the time whether the partners would succeed in keeping the son of the deceased partner out of the partnership, or whether the son or they would ultimately become entitled to the money placed to reserve. In the light of this decision, the advisers to the father felt able to tell him that he had no income to declare from the Smith partnership. (They did not forget about s.714 of the Income Tax Act 2007: they concluded that the partnership profits were not income of the father's Bahamian nominee and that the only income the father could have power to enjoy would be his own.)

The story has several possible sequels, all of them replete with fiscal puzzles. In one version, the partners do eventually decide how the income is to be divided between them – or the Family Counsellor decides for them. Is each partner's share income of the year in which it is distributed or income of the year in which it was earned by the partnership? In another version of the story, one of the partners has assigned his partnership interest before distribution is resolved upon. When profits are distributed to the assignee, are they income of the assignee, and if so are they still income of the year in which they arose? An assignee may well say that the distribution cannot be his income for an earlier year, for in that earlier year he did not have that source of income. Suppose – to take an extreme case – the assignee is a newly-incorporated company. Can it be taxed on income which arose before it was incorporated?

In yet another version of the story, the father dies, at a time when some (or all) of the profits are undistributed. How should his partnership interest be valued for inheritance tax? What is its “market value”? Indeed, would anyone buy it at all? It looks at first sight as though what is an offer is something like a lottery ticket – that this is a lottery with three tickets, and the holder of any one of them may hit the jackpot. But the reality is not like that. The son and daughter have power to prevent the purchaser from getting anything, and will have every reason to exercise that power. And when the ten years has gone by and the Family Counsellor comes on the scene, what is he going to say? The son and daughter have between them the majority vote and one can safely assume that they are going to appoint a Family Counsellor who will act in the interests of the family and divide the profits between the son and the daughter, leaving nothing for father’s estate.

Here we have an asset which is assignable, but yet valueless. And yet again, it may become valuable, when circumstances require. It is like the Cheshire cat:

sometimes it is all cat, and sometimes it is just the smile. When it is the cat, it can provide medical treatment, education, travel – whatever is required, and perhaps even without a tax charge. When it is just the smile, it has an obvious role in estate planning – in the context of inheritance tax, gift tax, estate tax and the like. But it also has a role in relation to income and capital gains taxes, as well as to exit taxes and wealth taxes – roles which, as far as I have been able to ascertain – remains wholly unexplored.

Adapted from part of a talk to be given to the ITPA at its meeting in Vienna.