

This article takes up where Patrick Harney left off (*Tax Adviser*, May 2008, p 24), and should be read as a follow-on to that article.

Despite the initial excitement over family limited partnerships (FLPs), there has been surprisingly little take-up of them, due to their high set-up and running costs. In response to client demand, the authors have advised a number of clients on the use of family general partnerships (FGPs), which are essentially family partnerships under the *Partnership Act 1890*, as an alternative family investment vehicle. By way of

overview, FGPs offer most of the benefits of FLPs but without the associated regulatory, set-up and running costs. Accordingly, the authors believe that FGPs are an exciting, non-aggressive, tax-planning tool that will be of considerable interest to wealthy UK domestic families.

Why was the take-up limited?

FLPs – a term coined by professional advisers rather than a defined term in legislation – are partnerships between family members, structured as limited partnerships under the *Limited*

Partnership Act 1907. This type of vehicle has been popular in the US for many years, and it was thought that they would take off in this country as well after the *Finance Act* changes on 22 March 2006. However, a combination of high set-up and administration costs (not least due to the need for FSA-regulated investment advisers and operators) and the general industry consensus that a minimum investment of £10m would need to be put into the vehicle to make it worthwhile, has meant that take-up for FLPs has been relatively modest.

IN FLPs WE TRUST,
in FGPs even more!



FGPs as an alternative?

Faced with this, there was a need to think of an alternative structure that combined the favourable IHT analysis of FLPs with a more cost-effective vehicle, though one which still achieved the client's dual objectives of:

- passing wealth down a generation (or generations) free of tax; and
- separating control from ownership of the assets in question.

One solution that the authors have produced, in response to demand from a number of their clients, is to set up a general partnership under the *Partnership Act 1890*, though there are still certain pitfalls and traps that must be avoided to ensure that this is a tax-efficient tool for passing wealth down to younger generations.

Sample structure

Henry (H) and Wendy (W) are a wealthy couple who wish to provide for their daughter's twin children, Simon (S) and Diana (D), who are nine years old. They have £1m of cash that they have earmarked for this purpose. They want income to be available to pay the grandchildren's school fees, but are concerned that S and D should not have

Trusts have been penalised by *Finance Act 2006*. FLPs have been mooted as a replacement, but have significant set-up and running costs. *Patrick Harney* and *Angus Hunter Smart* ask if FGPs are the holy grail we never looked for

access to capital at the age of 18, and would ideally like to defer that until the age of 30. They are not, therefore, in favour of setting up straightforward bare trusts. They do not have any of their nil-rate bands available, because they recently set up discretionary trusts for other family members.

H and W are advised to set up an FGP. H is the wealthier of the two, so it is decided that he will put up £990,000 of the cash, with just £10,000 being provided by W. The FGP will initially be set up between H, W and two nominees, A and B, who hold their partnership interests as nominees, or bare trustees, for H. The partnership capital account at the outset will be as shown in Figure 1 below.

Once the partnership has been set up, H will irrevocably direct his nominees to hold their respective 45% interests for the grandchildren (ie, A will hold for S and B will hold for D). The partnership capital account will then be as indicated in Figure 2.

The £1m will be invested, with the profit-sharing ratios being in line with the capital shares. If there is a worry over excessive income entitlements after the grandchildren's 18th birthdays (the bare trustees' s. 31 power to accumulate income can of course be exercised before then), non-income producing assets could be invested in.

On the twin grandchildren's 18th

birthdays, they will become partners in their own right. However, the partnership agreement will be structured in such a way that, subject to the points raised below about the law of minors, the partners will not be able to draw capital from the partnership before S and D's 30th birthdays, without the unanimous consent of the partners – ie, H and W could block any attempt by the grandchildren to withdraw capital. A further level of protection can be added by making H the managing partner, and giving him a casting vote in deadlock situations¹.

To provide for the eventuality of H and/or W dying before the grandchildren reach the age of 30, they will make provision for their partnership interests to be left to trustees of discretionary trusts set up under their wills for this purpose. Although it is not normally possible to make the recipients partners automatically, without the consent of the other partners², the partnership agreement will expressly provide otherwise, and will require the other partners to accept the trustees (in practice one of them) as new partners.

Tax analysis – creation and funding of the partnership

There should be no income tax liability on the creation or funding of the partnership, because these activities do not of themselves generate any income.

Equally, provided that H and W fund the partnership with cash (in sterling), or with unappreciated assets, there should be no capital gains tax liability either. Also, as in the case of an FLP, assets that qualify for business assets holdover relief are suitable for funding an FGP and, again, this is a key advantage over a settlor-interested trust.

There should also be no inheritance tax to pay on the creation or funding of the partnership. The gifts of the two 45% partnership interests to the grandchildren, by way of H's irrevocable instructions to A and B, are structured as PETs, and as such will be exempt from inheritance tax if H survives for seven years.

- Two further issues should be pointed out:
- (a) Bare trusts (ie, declarations of trust for a minor absolutely) are not considered to be 'settlements' for the purposes of inheritance tax, as they do not fall within the definition of 'settlement' in *IHTA 1984*, s. 43. This has been accepted by HMRC in correspondence with the Society of Trust and Estate Practitioners³. This is true even if *Trustee Act 1925*, s. 31 (accumulation of income and power to pay or apply income for a minor's maintenance, education or benefit) is not excluded.
 - (b) The provisions of *Finance Act 1986*, s. 102(2) covering 'gifts with reservation of benefit' should not apply to the PETs provided that the grandchildren

Figure 1

W H Nominee A (for H) Nominee B (for H)

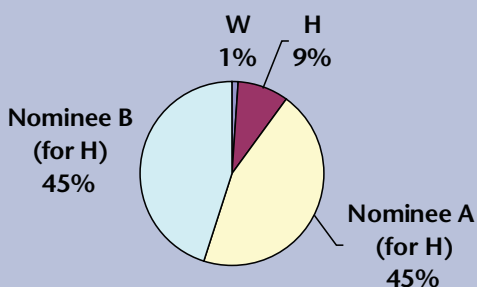
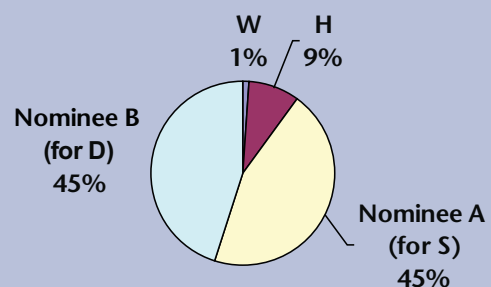


Figure 2

W H Nominee A (for S) Nominee B (for D)



FGPs provide a cost-efficient, familiar and easily understandable vehicle for wealthy families

(or their nominees) will actually assume *bona fide* possession and enjoyment of the partnership shares to the exclusion of H, and provided that H will not and cannot under any circumstances receive any benefit whatsoever from the gifted partnership shares or the underlying assets (over and above the percentage that he retains) from the date of the PETs⁴. Equally, the retention of an element of control over the assets, for example because H remains managing partner, does not, of itself, amount to a GROB⁵.

Tax analysis – going forward

The partnership will be transparent for income tax purposes⁶, and income will be assessed on the individual partners in the usual way, with tax being paid by them with reference to their own personal allowances and at their own marginal rate of taxation. Because the beneficiaries of the bare trusts are H and W's grandchildren, rather than their children, the usual child-of-settlor anti-avoidance provisions⁷, which deem the income resulting from a gift from a parent to a minor child to be the parent's income, do not apply.

The partnership will also be transparent for capital gains tax purposes⁸. Accordingly, gains (to the extent that there are any on sales of partnership assets) may be extracted from the partnership without any further charge to tax.

Inheritance tax will also be charged on individual partners' shares in the partnership on their deaths. It is unlikely that business property relief would be available on the partners' shares unless the partnership was a trading entity⁹.

Additional points

- The structure envisaged in this article should not fall foul of the *Ramsay* principle, because it is not aggressive and simply makes use of existing reliefs (ie, PETs). Equally, there is no settlement created for IHT purposes, and, provided the partnership agreement is drafted carefully to exclude the possibility of H or W ever benefiting from the gifted shares in

the future, there should not be a sustainable technical argument that there has been a GROB.

- There is a risk that S and D could, on reaching the age of majority, choose to repudiate the partnership. They must do this within a reasonable time after their 18th birthdays, or they will incur full liability as a partner. However, even if S or D were successful, could they recoup the underlying capital? The law in this area is far from clear, but it seems that they could only recover a premium paid for their partnership shares if they can show that there has been a total failure of consideration – which would be difficult to prove in this scenario, since they would have received income from the partnership and, in any event, did not pay anything to receive their partnership shares. Nevertheless, to make the structure as watertight as possible, S and D's partnership shares are gifted to them fully constituted, rather than cash held on bare trust for them being invested in the partnership, as this means that they have not made any direct contribution to the partnership.
- Care must be taken to avoid the arrangement becoming a collective investment scheme¹⁰. In the above structure, all the partners are entitled to participate in the day-to-day management of the partnership, and, on that basis, it should not fall foul of the rules. However, it is important that the partnership agreement does not entitle the managing partner to exercise day-to-day management to the exclusion of the other partners, as this would cause the agreement to stray into the area of potentially being a collective investment scheme (with the consequential, expensive, regulatory requirements that this would bring).
- Partnership property¹¹ is held on trust for the partnership by the holders of the legal title (ie, in line with the terms of the partnership agreement). This is significant, because it means that the partnership agreement should be able to override the usual

statutory provisions relating to beneficial co-ownership of land. Thus, *TLATA* 1996, s. 12 and s. 13 (rights of occupation) and s. 14 (orders for sale) should be expressly excluded in the partnership agreement.

- The disadvantages of FLPs compared to trusts, outlined in the FLP article, apply equally to FGPs.

Conclusion

Like their FLP cousins, FGPs are not the holy grail of family investment vehicles, again because no such vehicle exists! They do, however, provide a cost-efficient, familiar and easily understandable vehicle that can facilitate the tax-efficient passing of wealth to younger generations, while providing a degree of control to the senior generation and preventing immediate access to underlying capital. They are a very useful tool in the armoury of the private-client adviser, and have a significant role to play in providing tax-planning solutions for wealthy families in the UK.

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1. This raises some collective investment scheme issues but, with careful planning, they can be managed.
2. *Partnership Act* 1890, s. 24(7) – unanimous consent of the existing partners is required for the admission of new partners; a simple assignment of a partnership interest will not automatically make the assignee a partner (*Bray v Fromont* (1826) 6 Madd 5).
3. Letter from HMRC Charity, Assets & Residence to the UK Technical Committee of STEP, dated 23 March 2007.
4. Paragraph 14332 HMRC IHT Manual
5. Paragraph 14394 HMRC IHT Manual
6. *ITTOIA* 2005, s. 848
7. *ITTOIA* 2005, s. 629
8. *TCGA* 1992, s. 59
9. *IHTA* 1984, s. 105(3)
10. *FSMA* 2000, s. 235
11. *PA* 1890, s. 20(1)