# Partnerships – Approach with Caution:

## An Overview of Partnership from a Legal and Taxation Perspective

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### Introduction

Despite the fact that many substantive corporate relationships are constituted as partnerships, the area of partnership law is relatively ungoverned thereby leading to inherent risks in such structures. In addition, given that certain of the property structures that were put together during the recent property upturn were limited partnerships, it is likely that these structures will be "stress-tested" into the future as banks and financial assistance providers may seek to impose personal liability on the partners in the context of recouping loans.

It is worthwhile from the perspective of partnerships to consider:

› their legal basis;

› their tax position; and

› the consequences of their dissolution.

### What is a Partnership?

Section 1(2) of the Partnership Act 1890 (the "1890 Act") states that a partnership is a "relationship which subsists between persons carrying on a business in common with a view to profit."

Whenever two or more people carry on any form of business together with a view to profit but without incorporating as a limited company, they form a partnership, even where this may be unintended. This makes partnerships a very common form of business arrangement in Ireland, be they small, informal relationships where the parties may not actually realise they are partners or formal partnership agreements between large, professional firms. However, there is no requirement that the partnership arrangements must be reduced to writing, as the 1890 Act, in essence, offers a default (if imperfect) partnership agreement.

Informal arrangements, to include family arrangements, may also constitute a partnership, and this will evidently have a very important effect on succession planning structures, particularly if no formal/written partnership agreement is entered into.

## Why Form a Partnership?

There are many reasons why business people choose to form partnerships instead of incorporating. Unlike in other jurisdictions, professionals in Ireland such as accountants and lawyers are prohibited from forming companies as they must be personally liable to their clients. Other partnerships are formed to avoid disclosure requirements or to take advantage of the fact that partnerships are tax transparent. As compared to a limited company, which needs to comply with, for example, the Companies Acts' laws of distribution, it is much easier to invest and withdraw capital from a partnership.

## Disadvantages of Partnership

Although a partnership structure certainly has its benefits, which people tend to concentrate on, there are a number of disadvantages to partnership:

› A partnership is not a separate legal entity, and therefore the partners can be sued in their own names.

› Each partner is liable for the debts of the partnership without limit (in time or amount), and therefore a partner is technically personally liable for a partner whom he/she may never have met.

› A partnership cannot create a floating charge over its assets.

› A partner may not transfer his/her "share" in the partnership, whereas shares in a limited company are generally freely transferable.

› A partnership's creditors have a right of action against the individual partners, whereas a company's creditors have no such right of action, save where it may have been guilty of reckless trading, fraudulent trading etc. A partner's personal assets are not "ring-fenced" from a claim against the partnership.

## Legal Position

### Legislation

Partnerships do not have any legal personality. This means that the partnership cannot own property, as it is instead owned by the individual partners as a group (or by some as trustee for all). A partnership may be sued in the firm name or in the name of the individual partners.

The 1890 Act is still the principal piece of partnership legislation in Ireland and in many respects is very outdated. The existing legislation has been amended on a piecemeal basis since then, an example being s376 of the Companies Act 1963, which dealt with the bar on a partnership having more than 20 partners that arose from the now defunct nineteenth-century rule that, in order to sue a partnership, a person had to sue each partner individually. This limitation can now be quite inconvenient.

There are, however, a number of legislative exceptions.

› Section 376 of the Companies Act 1963 itself exempted banking partnerships from the limitation, although these are in fact extremely rare.

› Section 13(1) of the Companies (Amendment) Act 1982 specifically permitted firms of accountants (albeit the provision is quite badly drafted and in fact cross-refers to a repealed section of the Companies Acts) or solicitors to have more than 20 partners provided that all of the partners are either accountants or solicitors as the case may be.

› Section 13(2) of the Companies (Amendment) Act 1982 allowed the Minister for Finance to make further exemptions by order, and this has been done twice – limited partnerships formed to carry on or promote thoroughbred horse breeding were exempted in 1988, and in 2004 limited partnerships formed to provide certain investment or loan finance and services were allowed to have up to 50 partners.

Where partnerships are unable to avail of these exceptions, a number of other methods exist to circumvent the 20-partner limit. Perhaps the most common option (subject to regulations, in that it cannot be used for partnerships of solicitors/accountants) is for a number of individuals who wish to be partners to form a company that itself could then be made a single partner. The drawback is that the interest of a member of the company in the partnership is indirect, with consequent negative tax results.

In 2007 the Irish Company Law Review Group report (the "CLRG Report") – dealt with in more detail below – considered the issue of the size of partnerships but stated that it was reluctant to recommend the abolition of the rule as it was not known to present widespread problems. It did, however, state that further exceptions could be made for specific groups where the rule caused an impediment to doing business effectively: for example, in the case of property investment syndicates.

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### Salaried v Equity Partners

An issue that has exercised courts on an ongoing basis has been the existence and the determination of the status of salaried partners. A salaried partner is, in essence, an employee who is "held out" as a partner and is generally paid a salary as remuneration. There is obviously an important distinction between equity partnership, whereby the equity partner is a self-employed person and is taxed under Schedule D, and salaried partnership, where the salaried partner is an employee who enjoys the benefit of employee rights (such as rights to redundancy, maternity leave etc.) and in respect of whom the partnership must, for example, make employer PRSI contributions.

The concept of a self-employed "junior partner" has developed more recently in professional firms, where the partner must receive a fixed amount each year that is grossed up so that the relevant partner appears to be self-employed but in reality is not entitled to a profit share – also known as a "fixed share partner".

### Limited Partnership

The progression in the development of tax planning structures led to the use of limited liability partnerships, which appeared to offer the beauty of limited liability together with the tax transparency and the confidentiality of partnerships.

The Limited Partnerships Act 1907 ( the"1907 Act") provided for an alternative form of partnership where certain partners could limit their liability to the amount of their capital contribution. The 1890 Act also applies to limited partnerships, except where it is inconsistent with the 1907 Act, so the 1890 Act should not be disregarded when considering limited partnerships.

The main difference between a partnership and a limited partnership is that, in the case of a limited partnership, the liability of all of the partners except one can be limited to the amount that he/she has contributed to the firm. The 1907 Act provides that a limited partnership must have at least one partner whose liability is unlimited. This partner is termed a "general partner".

It is possible for the general partner to be a company, but if a company is the only general partner the EC (Accounts) Regulations 1993 require the limited partnership to file accounts as if it were a company. Limited partners may not play any role in the management of the firm, and all of the partners should be careful to avoid breaching this obligation as to do so could expose the limited partner to unlimited liability. Unlike general partnerships, limited partnerships must be registered with the Registrar of Companies.

## Tax Position

The main sections relating to the taxation of a partnership are contained in ss1007–1013 of the Taxes Consolidation Act 1997 ("TCA 1997").

For the purposes of taxation each partner is regarded as individually carrying on a separate trade; this concept is referred to as the partner's "several trade" and is taxed accordingly. As mentioned below, this is an artificial exercise carried out for the purposes of the computation of tax on the partners.

### Computation of Partnership Profits or Losses

As mentioned previously, a partnership is not a separate legal entity distinct from its members. However, for the purposes of computing the partnership's taxable profits, capital allowances and charges, the partnership is treated as a separate entity: once calculated, they are apportioned among the partners in accordance with the partnership agreement. In the absence of a partnership agreement, profits and losses are apportioned among the partners equally. In computing each partner's profits, the normal Case I/II rules apply.

In arriving at the tax-adjusted profit/loss of the partnership, the same add-backs and restrictions that apply for sole traders apply to the partnership. As with sole traders, no deductions can be made for expenditure attributable to the partners and not incurred "wholly and exclusively" for the purposes of the partnership. Furthermore, appropriations of profit such as partners' salaries and interest on partners' capital accounts are not allowed as deductions.

Where a partnership incurs a loss, the following should be noted:

- The loss cannot be apportioned so as to give any partner a profit for tax purposes, regardless of the provisions of the partnership agreement.
- Where a partnership makes a profit, no partner can claim relief for any loss.
- The loss relief claimed by individual partners cannot exceed the total partnership loss.
- The partners cannot be taxed on more than the partnership profit.

If a partnership incurs a loss, then the loss is apportioned between the partners in accordance with the profit-sharing agreement. Where a partner is entitled to share in a loss, he/she can use that loss relief in the same way as a sole trader can.

### Validity of Partnership

It is very worthwhile to mention at this stage that a partnership cannot be established simply to make a loss (which might be set off, perhaps, against the partners' income tax liability). In this regard it is worth noting the case of *McCarthaigh v Daly* [1985] IR 73, which related to a partnership established by a wealthy individual in respect of the Metropole Hotel in Cork solely for the purposes of the creation of a loss for use by the individual against his income tax liability. Following on from this case and others, it is important that the parties to a partnership are able to demonstrate some contemplation that a profit would be derived from the carrying on of the business of the partnership.

The case *Inspector of Taxes v Cafolla & Co* [1949] IR 210 considered a partnership in which one partner had effective control over the business. Mr Cafolla, who had run the business as a sole trader, decided to form a partnership with his sons in order to allow the principal to benefit from the tax-free allowances of his children and in this way reduce the overall tax bill. The Revenue Commissioners claimed unsuccessfully that in these circumstances the income of the partnership should be deemed to be the income of Mr Cafolla. The question as to the existence of a partnership was determined by confirming that a valid partnership existed. However, it is important to note that the mutual agency that should exist between partners was absent, as only Mr Cafolla was entitled to enter into contracts on behalf of the firm. For this reason, it is suggested that this decision should not be followed insofar as it treats such a partnership as valid.

### Assessment of a Partnership

It is necessary to have an understanding of the term "relevant period" in order to determine the basis of assessment that will apply to each partner. The relevant period is a continuous period during which a trade is carried on by a partnership in which there has on no one occasion been a complete change of partners. The definition of "relevant period" is contained in s1007(1) TCA 1997.

The relevant period commences:

- when the partnership commences to trade or
- when the partnership succeeds to a trade formerly carried on by
  - a sole trade or
  - another partnership none of whose members continues in the new partnership.

The relevant period ends:

- when the partnership ceases to trade or
- when the partnership is succeeded by
  - a sole trader (including a sole trader who had been a member of the partnership) or
  - another partnership none of whose members was a member of the previous partnership.

The normal commencement and cessation rules apply to each partner's several trade according to the partner's particular circumstances. By way of example, when a new partner joins a partnership the commencement provisions apply to the trade of the new partner while the existing partners remain on a current-year basis; likewise, when a partner leaves a partnership the cessation provisions apply to his/her trade only. On commencement or cessation of the partnership trade, the commencement or cessation provisions apply to all partners.

## Limited Partnerships

Anti-avoidance legislation exists to prevent the use of limited partnerships as a tax-avoidance vehicle.

The legislation restricts the rights of limited partners and certain general partners who are not active partners to offset losses, interest and capital allowances of the partnership against non-partnership income. It is worth noting that Finance Act 2005 amended the definition of a limited partner so that individuals in partnerships or similar arrangements that are registered under, or governed by, the laws of another country are within the definition.

Nonetheless, limited partnerships have proven very attractive entities for obtaining substantial tax benefits. For tax purposes, a partner's share is determined by the profit-sharing ratio of the partnership as set out in the partnership deed, and not by the amount of his/her capital contribution.

## Finance Act Changes

### Finance Act 2006

As experienced by professional practices recently, the publication by the Accounting Standards Board of Urgent Issue Task Force Abstract 40 required an element of profit to be included in the valuation of work in progress for service providers, e.g. accountants, tax consultants, solicitors etc. It should be noted that this applies only where partnerships produce accounts to GAAP standards. This resulted in an increase of the work-in-progress valuation in the balance sheet, with an immediate profit-and-loss effect.

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Finance Act 2006 recognised the difficulties caused by this abstract and, therefore, provided for a form of tax relief, allowing the tax arising from the adjustment to work in progress, as a result of the application of this abstract, to be spread over five years.

### Finance Act 2007

Before Finance Act 2007, s1008 TCA 1997 provided that undistributed profits of a partnership were assessed on the precedent acting partner at the standard tax rate.

Now the tax-adjusted profits of a partnership must, for tax purposes, be apportioned between the partners in full each year, with the apportioned profits being taxable at the partner's marginal income tax rate.

## Stamp Duty Considerations

### Retirement of partners

If, when a partner retires, he/she receives a payment from the continuing partners, the transaction may be regarded as a sale of the partnership share in consideration of payment received and any document giving effect to the transaction will be liable to stamp duty as a conveyance on sale. Darling LJ held in *Garnett v IRC* [1899] 81 LT 633 that, if the retiring partner simply withdraws his/her capital and undrawn profits, gives a receipt for them and acknowledges that he/she has no more claims on the co-partners, the transaction will not be a sale and will not attract stamp duty.

Alternatively, if, when a partner retires, the continuing partners agree to assume the liabilities of the retiring partner, s41 of the Stamp Duties Consolidation Act 1999 may apply and stamp duty could be charged at a rate of up to 6%. This situation might be avoided if the partnership agreement provided that retiring partners are automatically indemnified against any liabilities by the continuing partners.

### Transfer of a partner's share

There are planning opportunities in respect of the transfer of a partner's share in a partnership pursuant to a structure involving an oral declaration of trust. A structure involving an oral declaration of trust will comply with the Statute of Frauds Act 1695 only if the partnership share can be regarded as personalty i.e. moveable assets that are not real property. It should be noted, however, that a partner's share in a partnership can be regarded as personalty only between partners, and therefore, the transferee would have to be another partner in the firm.

## Dissolution of Partnerships

Given that certain of the taxation issues relating to partnerships involve issues arising from their dissolution, it is worthwhile considering briefly how dissolutions of partnerships occur. There is a very important distinction between:

- general dissolution and
- technical dissolution.

General dissolution is when the partnership comes to an end and its business is wound up.

Technical dissolution is when there is a change in membership but no winding-up of the old partnership, such as when a partner leaves or joins the partnership. A technical dissolution under the 1890 Act occurs whenever a partner joins or leaves the partnership because of the fact that a partnership is not itself a legal entity but rather the aggregate of its members.

Partnerships may be dissolved in a number of circumstances, such as by notice of any one of the partners (unless a partnership agreement provides otherwise) pursuant to s26 and s32(c) of the 1890 Act or where a partner applies for a dissolution to the court pursuant to statutory grounds set out in s35 of the 1890 Act. Section 35 prescribes specified circumstances that may permit the court to dissolve a partnership, such as if a partner is deemed to be of unsound mind of a permanent nature or where the business is running at a loss.

Partnership agreements should provide that the firm will carry on as before when a partner joins or leaves, and, furthermore, a partner's right under s39 of the 1890 Act to force the winding-up of the partnership on dissolution can be waived under the partnership agreement. Thus these technical dissolutions may not materialise into general dissolutions. The mental incapacity, retirement or expulsion of a partner will not *per se* lead to the dissolution of the partnership but may ultimately have that effect.

Notwithstanding that a partnership agreement may exist, the court (as mentioned above) may dissolve a partnership where a partner or partners wilfully or persistently break the said partnership agreement or conduct themselves in a manner that makes the continuance of the partnership arrangement untenable.

In the unfortunate scenario where the partnership is required to be dissolved, whether under a court order, automatically or pursuant to the enforcement of the relevant partnership agreement provision, the partnership would cease to be a going concern and would be required to be wound up. This would involve a collecting in and valuing of the assets of the partnership, which would be offset against any debts or liabilities owing by it, and the consequent distribution of any surplus to the partners of the dissolved partnership interest.

If there is no written agreement in place, then the distribution of capital profits and losses on a dissolution would fall to be dealt with under s44(a) and s44(b) of the 1890 Act, whereby capital losses and capital profits would be distributed between partners "in the proportion in which they are entitled to share profits".

A death of a partner can be an extremely contentious issue where there is no written agreement, as technically under the 1890 Act a partner's death will dissolve the relationship between all partners (to include the surviving partners), save where an agreement to the contrary exists.

To be clear, there is no entitlement of a personal representative (e.g. father to son) to become or be a partner; rather, they are simply entitled to an amount equalling the deceased partner's share of the partnership at the time of death.

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### Post-dissolution Profits

If there is no partnership agreement and a partner leaves a firm without any final settlement between the continuing partners and the outgoing partner, then an outgoing partner may at the option of him/herself or a personal representative claim either:

› such share of the profits made since the technical dissolution as the court may find to be attributable to the use of his/her share of the partnership assets, or

› interest at a rate of 5% per annum on the amount of his/her share of the partnership assets.

An example of the danger of this provision was shown in the case *Meagher v Meagher* [1961] IR 96, which concerned three brothers involved in the development of houses, one of whom died. The value of the assets of the partnership substantially increased after the death of the brother, and the Supreme Court in overruling a High Court decision determined that the estate of the deceased brother should receive its proportionate share of the increased value of the assets.

## Possible Future Developments in Partnership Law

The CLRG Report identified a number of shortcomings in existing partnership law in Ireland and considered the case for the introduction of limited liability partnerships (LLPs) in professional services firms that seek to limit the effects of unlimited personal liability in partnerships.

The degree to which professionals can limit their liability contractually is quite restricted. Section 44 of the Civil Law (Miscellaneous Provisions) Act 2008, for example, provides that, while solicitors can contractually limit their liability, they may not reduce it below the minimum required level of their indemnity cover.

The CLRG Report looked at models for LLPs that have been adopted in other jurisdictions to address the issue of partners' liability, bearing in mind the fact that many professionals do not have the option of incorporating or forming limited partnerships.

LLPs were introduced in the UK in 2001, and many legal and accounting firms have adopted the concept. The UK form of LLPs differs from its North American equivalents in that it has a separate legal personality, so that the firm itself is liable for the wrongful acts or omissions of a member. UK LLPs are governed by a hybrid of company and partnership law. There is no restriction on what type of firm can form an LLP, and they are tax transparent so that the firm itself is not taxed on income or gains.

The CLRG warned that before LLP legislation is introduced in Ireland it would be important to ensure that such a scheme could not be used for tax avoidance, which the CLRG felt could cause considerable damage to Ireland's reputation as a business centre, and that measures should be included to require LLPs to have a real and continuous link to an economic activity in Ireland.

The CLRG proposed to engage in further consultation before concluding whether to recommend the introduction of LLP legislation in Ireland or not. Both the Law Society of Ireland and the Institute of Chartered Accountants have indicated that they would welcome the introduction of LLPs and have called for legislation to provide for LLPs.