

ENTITY CLASSIFICATION

By David Goldberg QC

Basically the UK tax system recognises four types of taxpayer:

- 1) individuals;
- 2) companies;
- 3) private trusts, a term of the author's which covers all form of trusts except those which fall into the category of business trusts;
- 4) business trusts, in which category the author includes all forms of non-corporate collective investment scheme as involving the use of a trust such as unit trusts and certain types of pension fund.

Questions of transparency never, of course, arise in relation to individuals: they are taxed on their income and gains.

Companies are never treated as tax transparent at all: the company is taxed on its income and gains and the question of how distributions from the company are taxed is dealt with separately according to the nature of the recipient.

In certain cases the settlor of a private trust may be taxed on the income and gains of the trust and in other cases involving trusts resident outside the UK. UK resident beneficiaries of the trust may be taxed by reference to the gains made by the trustees.

Subject to these cases, private and business trusts are always taxed on their capital gains as if they were not transparent, but some types of trust (for example, private trusts where there is an interest in possession) are transparent as far as their income is concerned.

Apart from the case of trusts, there is no business organisation known to the legal systems of the United Kingdom which is fiscally transparent for one type of tax but not for another.

A partnership which is recognised by one or other of the legal systems of the United Kingdom as a partnership is fiscally transparent for all taxes.

Accordingly the members of a partnership pay tax on the income or gains of the partnership, rather than the partnership itself.

When the legal systems of the United Kingdom are confronted with a business organisation of a character which they do not themselves have, the question which arises is whether the organisation should be characterised as a company or a trust or as something else which might, perhaps, be a partnership.

The case of organisations which are similar to trusts does not usually create difficulties.

For example, an anstalt or a stiftung are both organisations with which civilian lawyers are familiar, but they are unknown to the common law of England and do not seem to have found a place in the Roman law based system of Scotland.

On the whole, English lawyers tend to regard organisations of this kind as a species of trust rather than as a species of body corporate: in order for there to be a corporation there must be a forming of members (the plural is important) into a body corporate: a corporation is the body created by the coming together of more than two persons into a body different from themselves.

Nothing of this kind happens with an anstalt or a stiftung which is created, or which can be created, by the whim of a single individual.

It is because there is no association between persons in order to create an anstalt or a stiftung that common lawyers do not regard them as bodies corporate.

The most interesting classification question faced by common lawyers is that posed by partnerships.

The common law of England - it is different in some states of America - does not clothe its partnerships with legal personality.

Civilian systems, on the other hand, seem universally to clothe their partnerships with separate legal personality: this happens in Scotland as well as in other Roman law based countries and it also happens in some states of America.

When the United Kingdom tax system is faced with a partnership which does not have legal personality, no difficulty arises: the members are taxed and not the business organisation.

But what happens when the United Kingdom tax system meets an organisation which calls itself a partnership but is clothed with legal personality?

Is the legal person to be taxed or is it the members who are to bear the burden?

The answer is that, so long as the organisation is a partnership, the existence of legal personality makes no difference to the tax treatment: again it is the members who are taxed on the profit and gains and not the organisation.

That this is the case is clear because the situation described here is common in the United Kingdom: the UK tax systems has to cope with Scottish partnerships which have legal personality, own their own property and own, in the first place, the profits which arise from their businesses and it does so by taxing the members of the partnership directly on the profits and gains of the partnership.

There is no legislative provision that stipulates that income of a Scottish partnership is to be taxed on the members directly and the method of taxation adopted is one understood to be correct without any significant analysis having been made as to why it is.

But to say this tells us only that the existence of legal personality does not, of itself, determine whether a business organisation is to be taxed as a person or is to be treated as transparent.

It is still necessary to determine what it is that makes an organisation which is given legal personality by its local law transparent for UK tax purposes.

Ownership of the profits as they arise is not the feature which makes an organisation fiscally transparent because partners in a Scottish partnership do not have that kind of property in the profits, so there must be something else which makes an organisation transparent.

The answer seems to be that the feature which makes a business organisation transparent for UK tax purposes is the ability of the members to remove profits from the organisation without there being any other person who can restrict that ability.