

Partnerships and service companies

Overview

For a number of reasons, not least of which is to take advantage of the disparity in tax rates between individuals and companies, firms are considering establishing and using service companies as an integral part of their group structure.

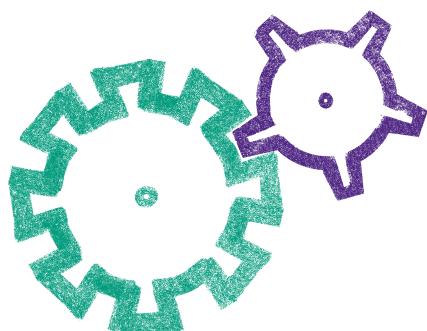
Using companies in this manner is not, in itself, controversial but HM Revenue & Customs (HMRC) is aware of and is monitoring the growing use of such companies. You should expect to be subject to a critical review of the planning by HMRC but, if implemented carefully and with a fully worked transfer pricing review, a service company can provide tax savings to the group.

Why the benefit arises

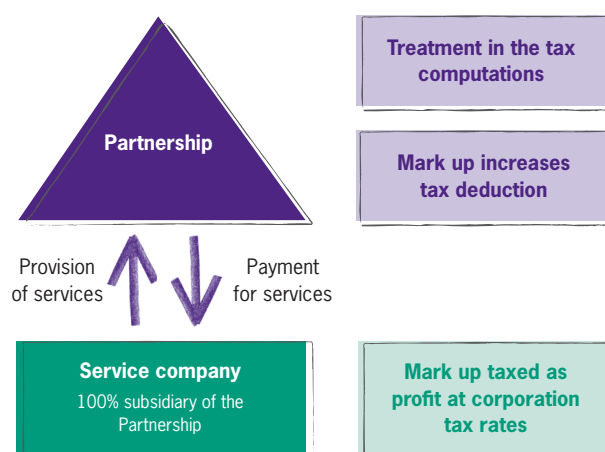
The tax code requires certain related entities to conduct any transactions between themselves at an 'arm's length price' in order to comply with transfer pricing legislation. These rules apply automatically where the combined entities are large but other UK entities may also opt to use the same rules.

Where both parties to the transaction are UK entities, the paying entity (in this situation the partnership) can make a claim to reduce its taxable profits by the same amount that the corporate entity has had to increase its taxable profits under the transfer pricing rules.

There is currently a significant disparity between the corporation tax rate and individual income tax rates. The benefits of this are detailed opposite.



The following diagram sets out a common scenario:



In a situation where the business grouping includes a service company, that company typically employs the staff who then provide their skills to the partnership, but the service company may also carry any number of other activities on behalf of the partnership. In general such services are charged to the partnership at cost.

However, where the transfer pricing legislation is in point, an adjustment is required to the tax computations of the service company to ensure that tax is paid as though an arm's length price had been paid. There is no requirement to actually pay the adjusted price, it is simply a tax adjustment. There is no value being rolled up and trapped in the service company.

This adjustment creates a taxable profit in the service company which will be charged at, typically, 28%. But this same adjustment can, on making a claim, be applied to reduce the partnership profits. The effect is to move profits out of the 51% tax rate into a 28% tax rate.

Example

A service company employs all the staff who perform a role in delivering the services of the partnership. The total salary cost for these employees is £10 million and a comparable arm's length mark up on cost of 5% has been agreed.

The effect is that £500,000 taxable profits are created in the company but deducted in the partnership resulting in an annual saving (at the current rates) of £115,000. In general terms, the annual savings generated by using a 5% mark up on services provided by a service company to the partnership, if it absorbs the £10 million of current partnership payroll, is:

**Saving per annum = salary cost x 5% x (51%-28%)
ie £115,000 per annum.**

Risk

The arrangements will feature on HMRC's risk assessment. Indeed we are aware that HMRC will be looking critically at any new service companies set up, so it is possible that a detailed enquiry could arise from implementing this planning. It is likely that this enquiry would focus on the transfer price used so it is essential that any mark up reflects a commercially justifiable arm's length price. We strongly advise that a thorough transfer pricing exercise is undertaken as part of the implementation process.

Defining an arm's length price

Essentially, the arm's length price is determined by the functions undertaken, the assets owned and the risks borne by the two parties to the transaction. The appropriate transfer pricing method will be determined both by the functions, assets and risks but also by external factors such as market trends and competitive activity.

The majority of the service companies operate as relatively low-risk service providers to the partnerships and, on this basis, the transfer pricing method which should be applied to the transactions is likely to be cost-plus. Discussion with HMRC indicates that a careful review of individual facts and circumstances is required in order to establish the rate that most appropriately reflects the commercial reality of a given partnership's position.

The cost base

Assuming cost plus is an appropriate method of calculating at an arm's length price, it is necessary to look at the costs that should be marked up. In principle the mark up should be applied only to true value added costs and not to what might be regarded as flow through costs (eg professional subscriptions and external training).

The mark up

In order to determine an appropriate level of mark-up, it will be necessary to undertake a transfer pricing exercise. Our transfer pricing specialists are experienced in preparing analysis that can be used to inform and support the mark up used in such transactions.

Practical points

As mentioned earlier, the introduction of a service company into your structure must be considered carefully and be implemented and operated properly if any of the potential benefits are to arise. In particular, you should note that:

- Employees contracts will need to be transferred under TUPE to the service company
- A transfer pricing review will be required to ensure that the mark up used is supported by a valid commercial rationale
- The limited company will require its own bank account so as to administer the salaries, receive the management fee income and settle the corporation tax liability
- The service company will require an audit and incur annual compliance costs.

Who should I contact?

Grant Thornton offices and staff are well equipped to advise you on partnerships and service companies issues. If you would like advice on any of the points covered in this document, please contact the person at Grant Thornton who normally advises you or the local office.

