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Automatic accrual arrangements

Synopsis: Practical and tax considerations of automatic accrual.

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What is automatic accrual?

Automatic accrual is an arrangement that lets a partner's business interest pass automatically to the surviving partners on retirement or death.

To the extent that an automatic accrual agreement exists, the problem of the purchase of business interests, whether on death or retirement, will be substantially removed.

The main asset of value for many partnerships (particularly professional and other 'service' businesses) is its goodwill which will often not be incorporated into the balance sheet but which, nevertheless, will have a very real value.

The goodwill of a business is, broadly, its reputation and connection with customers and the value of the attraction to the customers which the name and reputation of the business possesses.

The partnership agreement could provide for the automatic accrual of the goodwill (and sometimes, but not commonly, also capital). In the event of, say, the death or retirement of a partner, the value of their share of goodwill (and perhaps capital) would automatically accrue to the surviving or the continuing partners.

Any loan accounts of a partner or undrawn profits forming a current account (which effectively already belong to the partner) would be excluded from automatic accrual. This would mean that the continuing partners would still need cash to enable them to repay the loan/current accounts, so automatic accrual does not solve the entire problem of the liquidity need even if there are no other partnership assets of value to speak of.

Automatic accrual of goodwill is by far the most common type of automatic accrual arrangement. However, automatic accrual does not mean that goodwill ceases to exist; it merely means that it has no value in dealings between the partners. One of the problems of attracting new partners can be that they may have insufficient assets to purchase a share of the goodwill. By having an automatic accrual clause for goodwill, this problem is overcome.

The best time to introduce an automatic accrual arrangement is when the partnership commences. If such a clause is introduced later, senior partners nearing retirement may be unlikely to agree to this or will expect some form of compensation. This will generally have to be arranged by the other partners. It may take the form of increased pension contributions on their behalf, these being allowed as a first charge on profits, a partnership annuity, or a cash sum for which borrowing may be necessary. In many cases, therefore, automatic accrual may not be appropriate (or at least problematic) for existing, well-established firms.

The taxation effects of automatic accrual clauses

(i) Capital gains tax

There should be no capital gains tax consequences if the decision to “write out” goodwill (i.e. agree to provide for its future automatic accrual) is made at the time the partnership commences, or subsequently if no payment was made by the partners. This is because the writing out of goodwill will be part of a bona fide commercial transaction and substitution of market value for the disposal proceeds will not be necessary. Special care must be taken where the partners are connected persons other than as a result of their being in partnership (eg. parent and child) and one partner owning all, or a greater part, of the goodwill being written out. It is necessary to show then that the arrangement is on terms similar to those that would have existed had the partners not been otherwise connected.

If, by entering into an accrual agreement, a partner writes out goodwill, having previously acquired it for consideration, or by way of gift when it had value, it may be possible for them to argue that they have incurred a capital gains tax loss. The loss would arise because their asset had become of negligible value (S24(2) TCGA 1992).

There are a couple of reported cases where taxpayers won an argument with HMRC that goodwill had become of negligible value because it was unsaleable as a result of the agreement. At present, it is not entirely clear whether HMRC fully accept this principle. The current position appears to be that the cases which have been decided were dependent upon the appropriate findings of fact by the Commissioners. It therefore may be advisable that planning is carried out on the assumption that loss relief will not be available. This does not mean, however, that claims should not be made.

(ii) Inheritance tax (IHT)

Automatic accrual clauses can apply to partnership goodwill and capital on death and/or retirement. Provided there is no marked disparity in the ages and state of health of the partners, or in the value of their assets subject to the agreement, it should be possible to avoid any charge to IHT because there is no gratuitous intent. Of course, in most cases business relief would be available to avoid any IHT concerns.

However, subject to this, it should be possible to sustain an argument that what takes place is a commercial arrangement at arm’s length, either between persons not connected with each other, or on terms which might have been expected to exist in a transaction between persons not connected with each other (S10(1) IHTA 1984). Furthermore, if there is no element of bounty involved there would not appear to be a gift with a reservation of benefit.

If there is a marked disparity in ages, health or values, it may be possible to rely on the decision in the case of AG v Boden (1912) to avoid a charge to tax. This requires that the greater value effectively acquired, by what would usually be the younger partner(s), has been adequately compensated by their agreeing to work for a greater part of the overall partnership time spent on business. The older partner, who on the face of it would be the one making the disposition, would only spend such time as was necessary on the business. Clearly, such an argument needs to be supported by the facts.

Where such arrangements exist between connected persons, e.g. parent and child, there will always be a presumption of gratuitous intent and the taxpayers must prove that this was not the case. If a transfer with gratuitous intent occurs, it would be a gift between individuals and thus a potentially exempt transfer and only chargeable to tax if the transferor dies within seven years.

However, if the transferor has made a gift, the problem is in deciding whether it is a gift with a reservation of benefit. They will still be involved in the partnership and taking a share of the profits. This could be regarded as a reservation of benefit even if their share of the profits was only reasonable for their contribution to the partnership (Oakes v Commissioners of Stamp Duty NSW (1954)).

To stand any chance of success, therefore, the disposer's profit share should reduce to reflect the capital given. Obviously, as long as 100% business relief applies to partnership interests (subject to the usual conditions), provided the conditions are duly satisfied, it appears that even if there is a reservation of benefit this should not cause any IHT liability to arise.

(iii) Compensation for family for automatic accrual on death

To the extent that goodwill/capital accrues automatically to the continuing partners on death, there will be a need to provide compensation to the deceased partner's family (or to the retiring partner if the accrual occurs on critical illness or retirement).

The easiest way to ensure that a deceased partner's family is adequately protected is to make it compulsory for each partner to effect suitable life assurance policies written in trust for their family. The family will be financially compensated by the policy proceeds and the continuing partners will be absolved from any moral responsibility to provide for their family. New partners would be brought into this arrangement and, to ensure that premiums are maintained, it is recommended that the following steps are taken…

- The automatic accrual clause should state that, to the extent of the automatic accrual, neither the partner, nor their estate, shall have any claim on the partnership.
- A memorandum should be signed by all the partners agreeing to effect suitable life assurance policies and to maintain premiums thereunder. This could be incorporated into the partnership agreement.
- Premiums should be paid as a first charge on the profits of the firm and then rateably apportioned among the partners according to age and cover provided. Alternatively, if it is desired to equalise premiums, they can be treated as an expense of the partnership in the distribution of profits. The

- premiums will not, however, be a deductible item for income tax purposes. Any disparity in the true cost of cover provided for a partner, over the amount by which their share of profits is actually reduced, will result in a prima facie transfer from the other partners for IHT purposes. In practice, however, in non-family partnerships, it would usually be possible to argue that the whole arrangement was commercial with no gratuitous intent. HMRC have confirmed that if full consideration is provided, there will be no gift with reservation of benefit.

- The policies should be written subject to a trust with the members of the partner's family as beneficiaries. In this way there should be no adverse IHT implications. Provided additional trustees survive the life assured, the policy proceeds will pass free of tax to the intended persons without the need to wait for probate.

Summary

Advantages of automatic accrual...

- Ease of attracting new partners.

- Possibility of creating a capital gains tax loss if consideration was previously given.

- Generally, no adverse IHT consequences, provided there is no gratuitous intent.

- The reduction of the financial need for the continuing partners to compensate an outgoing partner, or their family, for their share in the firm.

Disadvantages of automatic accrual...

- In the event of business relief for IHT not applying, then possible IHT liabilities could arise if the disparity is too great and the "Boden" argument (please see above) is not successful, or the gift with reservation rules apply.

- The need to find other methods of compensation.