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SHADES OF NORTHERN DIFFERENCE: THE SCOTS LAW OF PARTNERSHIP AS APPLIED TO ICTA 1988 SECTION 419

Julian Ghosh¹

In this article I shall explore the application of the Scots doctrine that a partnership governed by Scots law has a separate legal persona and the implications of that doctrine in the context of a loan made by a close company within the meaning of ICTA 1988 s.414 to a Scottish partnership² which holds shares in that company.

Section 419(1) of ICTA 1988 reads as follows:

" ... where a close company, otherwise than in the ordinary course of a business carried on by it which includes the lending of money, makes any loan or advances any money to an **individual** who is a participator in the company or an associate of a participator, there shall be due from the company, as if it were an amount of corporation tax chargeable on the company for the accounting period in which the loan or advance is made, an amount equal to such proportion of the amount of the loan or advance as corresponds to the rate of advance corporation tax in

¹ Julian Ghosh, Barrister, Tax Chambers, 24 Old Buildings, Lincoln's Inn, London WC2A 3UJ Tel: (0171) 242 2744 Fax: (0171) 831 8095. Fellow of Queen Mary & Westfield College, University of London; Managing Editor of this *Review* and *The Offshore Tax Planning Review*.

I have relied heavily, in analysing the history and jurisprudence of the Scots partnership, on two very fine articles by, respectively, Peter Hemphill in the 1984 *Juridical Review* 208 and George Gretton, 1987 *Juridical Review* 163.

² Such a loan to a partnership governed by English law is, of course, properly viewed as a loan to the individual partners. My conclusion (see *infra*) that the loan is made to the Scots partnership as a distinct persona, as opposed to the individual partners themselves undoubtedly has implications for certain other provisions within the Taxes Acts. I shall, however, in this article, concentrate solely on s.419 of ICTA 1988, for sake of convenience.

force for the financial year in which the loan or advance is made."
[emphasis added].

"Individual" is amplified in s.419(6) to include a company receiving a loan or advance in a fiduciary or representative capacity and a company not resident in the UK.

A Scots partnership, if it possesses a separate persona, will clearly be a participator in any close company in which it holds shares under s.417 of ICTA 1988. However, it follows that if a loan from a close company to a Scots partnership is, in Scots general legal theory, a loan to the Scots partnership as a separate legal persona as distinct from the individual partners who comprise that partnership and the Scots partnership which has that separate legal persona cannot be described as an "individual", the loan is not subject to the terms of s.419(1) and "notional ACT" will not be payable in respect of it.

Let us assume that individual persons who would otherwise be shareholders in a close company form a Scots partnership and hold the shares in the close company as partnership property. The close company makes a loan to the partnership.

There are two questions here. Firstly, are the close company shares the property of the partnership or of the partners? Secondly, do the "partners" have a "business" in common with a view to profit?

Provisions in the Taxes Acts which make Special Provision for Scots Partnerships

There are several provisions (e.g. s.59(a)) in UK fiscal legislation which make special provision for Scots partnerships. These are not, however, of any consequence in determining the existence, nature or extent of the separate personality of a Scots partnership, which is entirely dependent on the application of Scots general law. While they may serve as a guide that the draftsmen of these fiscal provisions recognises that a Scots partnership has a separate legal personality and provision must be made to accommodate this, if Scots general law did not itself give rise to the conclusion that a Scots partnership had a persona quite distinct from the individual partners which were members of it, (and this had consequences in general law) the existence of these fiscal provisions would not permit a contrary conclusion.

Is there a Partnership At All?

A partnership is defined³ as "the relation which subsists between persons carrying on a business in common with a view to profit". "Business" includes every trade, occupation or profession.⁴ However, the relationship of the members of any company registered under the Companies Acts⁵ is expressly excluded from the term "partnership".⁶

Bearing in mind that the partners would, in the normal course of events, have simply been shareholders in the company, can the shares constitute partnership property, especially if the purported partnership property comprises 100% of the issued share capital of the company in question? The short answer is "Yes". There is no reason in principle why the partnership should be "looked through" and s.1(2) of the 1890 Act be applied to govern the relationship amongst the "partners". If the profits and losses of each partner are demonstrably governed as a matter of both fact and law by a partnership agreement and not by the articles of association of the company governing the rights of equity holders in the company, there is no reason whatsoever why shares (whether comprising a 100% holding or not) cannot constitute partnership property. It appears tolerably clear that partnership property in Scotland is vested in the partners in trust for the firm or, alternatively, held by the partnership directly.⁷ Thus it is quite clear that the shares will constitute partnership property and not the property of the individual partners.

If the shares (once again, in particular a 100% holding in a company) constitute the *only* partnership property, does the holding of these shares comprise a "business in common with a view to profit"? Once again, I see no reason why not. There is no impediment to two persons agreeing to be bound by a partnership agreement as to the sharing of profits and losses, seeking in common to profit

³ Partnership Act 1890 s.1.

⁴ Section 45.

⁵ Or incorporated under a private act, royal charter or letters patent.

⁶ Section 1(2).

⁷ See Gretton [1987] *Juridical Review* 163 at 173-177, "Whatever ... becomes the property of the company [partnership] must be taken as held in trust for the uses and purposes of the company": (Clarke *op cit* at p 168, cited by Gretton *op cit* at 173,174). The proposition that partnership property may be held by the firm itself directly is approved by Gretton *op cit* at 174, 175 by reference to *Erskine III*, iii.20, *Forsyth v Hare* (1834) 13 S 42, *Denniston MacNayr & Co v Macfarlane* 1808 Mor. App. Tack No. 15.

from the activities of a company whose shares comprise the partnership property.⁸ *A fortiori*, the holding, as partnership property, of a less than 100% holding in a company, where the investment is managed, whether close or not, or the holding of a portfolio of investments, can constitute a "business in common with a view to profit" for the purposes of s.1 of the 1890 Act.

Separate Legal Personality

The Partnership Act 1890 does not, in any way, define the separate legal personality of a Scots partnership. The separate persona is recognised by s.4(2), which provides that "in Scotland a firm is a legal person distinct from the partners of which it is composed, but an individual partner may be charged on a decree or diligence directed against the firm, and on payment of the debt is entitled to relief pro rata from the firm and its other members". Section 5⁹ provides that "every partner is an agent of the firm and his other partners". These provisions demonstrate some uncertainty on the part of the draftsman¹⁰ as to whether a Scottish partnership truly does have a distinct legal personality, since the possession of a legal personality would render the words "and its other members" in s.4(2) and the words "and his other partners" in s.5 redundant. The words of s.4(2) make it clear that a Scots partnership must have a separate personality to some degree, however. In order to examine the extent to which that personality exists and the consequences of it, we must turn to the Institutional Writers.

The basic principle of the separate legal persona of a Scots partnership first appears in Bell's *Commentaries on the Law of Scotland*.¹¹ In his *Commentaries* Bell declares that "the partnership is held in law a separate person, capable of maintaining independently the relations of debtor and creditor. As a separate

⁸ It is true that s.2(2) of the 1890 Act provides that the mere sharing gross returns does not, per se, constitute a partnership. However, provided that the partnership conducts *some* business, beyond that of merely holding the shares (e.g., managing the investment). This provision will not be fatal to my proposition. I am grateful to Colin Tyre for ensuring that I addressed this point.

⁹ Which applies to both Scots and English partnerships.

¹⁰ Sir Frederick Pollock, whose Partnership Act, it must be said, is in other respects properly acknowledged as the epitome of elegant drafting; see Hemphill [1984] *Juridical Review* 208 at 211, noting that the Partnership Act was a lucid and coherent example of legislation, "in a generally undistinguished tradition of legislative drafting".

¹¹ Which is considered Institutional: for the benefit of non-Scots lawyers, Scotland regards certain writers as "Institutional", by which is meant that certain of their writings are authoritative as a matter of law.

person, the company¹² is known and recognised in obligations and contracts by its separate name or firm, as its personal appellation."¹³

Consequences of Separate Legal Personality

So much for the existence of the separate legal personality of the Scots partnership. Where does this take us? The answer can be found in the dictum of Lord President Cooper in *Mair v Wood*.¹⁴

"It is fundamental to the Scots law of partnership that the firm is a legal persona distinct from the individuals who compose it. This rule, which dates from the seventeenth century,¹⁵ has been expressly preserved by the Partnership Act, s.4(2), and it is the source of most of our distinctive rules both of substantive law and of procedure ... One of the leading consequences of the doctrine of the separate persona is the principle that a firm may stand in the relation of debtor or creditor to any of its partners."

There we have it. A Scots personality may be a debtor in its own name: "... an action cannot be maintained against a partner for the debts of the company. The demand must first be made against the company, or the company must have failed to pay or have dishonoured their [sic] bill before a partner can be called upon."¹⁶ In other words, debts and credits of a firm in Scotland belong to it as a separate

¹² "Company" and "partnership" were used inter-changeably at the time that *Commentaries* first appeared, being sometime after 1800.

¹³ See Hemphill *op cit* at 212-216, concluding that none of the Institutional Writers who preceded Bell had arrived at the doctrine of the separate persona of the firm in any meaningful form. See also Hemphill *op cit* at 217-220, concluding that the origins of the separate persona were not Roman (on the footing that Roman law was almost exclusively interested in the relations of the partners amongst themselves: J A C Thomas *Textbook of Roman Law* (1976), page 302; the only *societas* in Roman law which gave rise to a separate personality, rather than merely forming contractual relationships, was a *societas* formed for the purpose of tax-farming: see Jolowicz, referring to the text at D.39.4.12.3; 13 pr that a *societas publicanorum* could have a personality was unlikely — *Historical Introduction to the Study of Roman Law* (1952)). Nor were they continental (on the footing that Grotius (in *The Jurisprudence of Holland*) and Voet (*Commentary on the Pandects*) did not consider any notion of a separate legal personality for partnerships); Hemphill does not express any definite conclusions of his own as to the origins of the separate persona for Scots partnerships.

¹⁴ [1948] SC 83 at 86.

¹⁵ See *supra* for Hemphill's challenge to this proposition.

¹⁶ Bell *op cit* Vol II, p 507.

legal person, not to its partners collectively (as would be the case in England).¹⁷ Bell¹⁸ declares that "... the partners are guarantees [sic] or sureties for the company [partnership], not proper or principal debtors"¹⁹ and postulates that partners can only be charged with debts of the partnership after the firm has failed to pay and that in bankruptcy proceedings the estate of the partner can be charged only with the balance remaining after the firm's assets are exhausted. It has been suggested that whether partners collectively are primary debtors to an outside creditor or are merely cautioners for the debt of which the partnership is the primary debtor is theoretical rather than practical.²⁰ In the context of s.419(1) of ICTA 1988, the distinction is crucial. As a matter of Scots general law, the Scots partnership is the primary creditor. In other words the loan is made to the partnership, which is merely guaranteed by the partners (i.e., the partners are cautioners to the debt incurred by the partnership). Thus the loan is made to the partnership, not the individual partners.

Hemphill also demonstrates²¹ that the forms of diligence or execution available to a judgment creditor of a partner flow from the concept of the separate legal persona of the Scots partnership. Thus "another consequence [of the separate legal personality] is that the creditors of a partner, if they would attach his share, must rest in the hands of the company [i.e., partnership] as a separate person."²² The converse is also true, in the sense that "in as much as a company is a distinct person at law, all contributions, whether in money or effects, which the parties are bound to make to it, are attachable ... for its debts, so long as they remain in the partners' possession and continue to form a portion of their separate estate."²³

¹⁷ Burgess and Morse, *Partnership Law and Practice in England and Scotland* (1980) p 10. Primary liability for its own debts resides in the partnership. The liability of the partners is only secondary, as cautioners ("guarantors", in English terminology). This analysis is expounded in Hemphill *op cit* at p 225.

¹⁸ Cited in Hemphill *op cit* at 232, 233.

¹⁹ Bell *op cit* at 508.

²⁰ Hemphill *op cit* at p 225.

²¹ *op cit* at p 227.

²² Bell *op cit* Vol II p 507.

²³ Clarke, *A Treatise on the Law of Partnership and Joint Stock Companies according to the Law of Scotland* (1866).

Finally, the doctrine of the separate legal personality of the Scots partnership has the unexceptionable consequence that a partner can be either a debtor or a creditor of the partnership of which he is a partner.²⁴

The separate legal personality of the Scots partnership is qualified in several ways, two of the most important being that it is considered good practice to sue the Scots partnership both in the partnership name and call some of the partners as individuals²⁵ and, in the context of the rules of set-off, where the partnership is sued for a debt due by the firm, the company may set-off a private debt due by the creditor to one of its partners, and that without any assignation from such partner.²⁷ Neither of these qualifications impinge on the proposition that the Scots partnership, in the example of the loan from a close company which I have postulated, is the primary debtor. The fact that the partners who comprise the partnership are cautioners is neither here nor there. They only become debtors if and to the extent that the partnership fails to meet its primary obligations.

In other words, the first hurdle to be overcome in avoiding the application of s.419(1), namely that the loan must be to the partnership and not the individual partners, is overcome.

Scots Partnership and "Individuals" Inextricably Linked? (Is the "Partnership" also an "Individual"?)

I have already observed that the terms of s.4(2) and s.5 exhibit some uncertainty as to the scope of the separate personality of the Scots partnership. Furthermore, it is worth recalling that s.1 defines a partnership as "the relation which exists between **persons** carrying on a business ... " In other words, a "partnership" is, by definition, comprised of "persons". In the example I have postulated, the "persons" are individuals. Can it be said then, that simply because the Scots partnership is the primary debtor in the loan from the close company, the loan is not to "individuals"? After all, the very essence of the partnership is the individuals who comprise it and this is recognised in s.1 of the 1890 Act. These observations do not lead me to the conclusion that the loan to the Scots partnership is, in essence, a loan to "individuals". Of course it is true to say that a partnership is, by definition, comprised of two or more persons. It is also true to say that in the example which I give in this article, the partnership is, by definition, two or more individuals in business in common with a view to profit. However, once the

²⁴ See *Encyclopedia of the Laws of Scotland* (2nd ed) Vol XI p 29.

²⁵ Clarke *op cit* p 543, cited in Hemphill *op cit* at 226.

²⁷ Clarke *op cit* Vol II, p 421, and the authorities cited there. Equally when a partner sues a partnership creditor for a private debt he may be met by the creditor setting of a debt due by the partnership to the creditor (Clarke *op cit* at 423), cited by Hemphill at *op cit* 235.

partnership has been formed, in terms of s.1, the point is that the general law of Scotland throws up a consequence that a separate personality appears on the scene, which personality does not, at least in theory or in legal rhetoric, appear in England. Put another way, individuals get together to form a partnership and in Scotland that means a separate "person" appears, namely the partnership itself. This latter "person" is clearly not an "individual". It is a "person" created by legal fiction, analogous to a company.²⁸ Gretton²⁹ makes the most interesting point that the 1890 Act does not use the words "partnership" and "firm" as synonyms. Section 1 defines "partnership" as a relationship between persons. Section 4(1) defines "firm" as meaning the members of a partnership. Section 4(1) applies to England but not to Scotland. Section 4(2), however, which does apply to Scotland, defines the term "firm" as the partnership itself, not the members of it. Thus a loan made to a Scots partnership is a loan made to a "firm", i.e., the separate personality which appears when the persons come together to form a "partnership" within the meaning of s.1. Thus a Scots "partnership" and the individuals who comprise it are not "siamese twins" who are inextricably linked in every partnership dealing. To return to the loan made by the close company, this loan is to the Scots partnership, that is, the legal personality which appeared after the individuals entered business together with a view to making profit in common so as to comprise a "partnership" within the meaning of s.1 of the 1890 Act.

Thus the second hurdle which the partners in the Scots partnership had to clear in order to avoid the application of s.419(1) (that the partnership must not itself be properly described as "individuals") has also been successfully surmounted.

Conclusion

Section 419(1) will not apply to a loan made by a close company to a Scots partnership, on the footing that the debtor in that loan relationship is a legal person, not a natural person, and therefore not an "individual" within the meaning of s.419(1).

One final point is this: I have not considered, in this article, the conditions to be fulfilled before a partnership can properly constitute a "Scots" partnership. I should say that it is completely inadequate for two parties who are neither Scots resident nor Scots domiciled, who have no business in Scotland whatsoever and [to take an extreme case] whose principal office is not in Scotland, to purport to be

²⁸ It is worth while recalling that a separate legal personality of the Scots partnership, even accepting Hemphill's conclusion that it was not definitively formed until Bell's *Commentaries*, was formed well before the introduction of joint stock companies and incorporated associations.

²⁹ Gretton *op cit* at 167, Footnote 8.

partners in a Scots partnership simply by reason of the partnership deed containing a clause declaring that the partnership is to be governed by the law of Scotland. Those who wish to form Scots partnerships to take advantage of its consequences in the context of s.419 (or other fiscal provisions) should take adequate advice to ensure that the partnership is indeed governed by Scots law, so far as third parties (such as the Revenue) are concerned.