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## PARTNERSHIPS AND TRUSTS AS LEGAL PERSONS ... WHAT ABOUT THE TAX?

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### Abstract

An English partnership, for tax purposes, is transparent, meaning that the partners are subject to tax on the income and capital profits; however, in many respects a partnership is an express trust—which is not transparent for tax purposes. There has already been some consideration from a legal perspective as to the personality of a partnership and for the potential tax status of a limited liability partnership, but how does this tie into the tax treatment of trusts if the two structures are so similar? The Law Commission and Scottish Law Commission joint report of 2003 recommended that partnerships be treated as a “*sui generis*”—a unique legal person in law—to reflect commercial reality and encourage continuity, but not to become a body corporate. It also suggested that limited partnerships might have the option to avoid legal personalities. A trust is arguably a *sui generis* legal person as well as an “opaque” entity for tax purposes, so if the Law Commissions’ recommendation could ever be carried out to bring trusts and partnerships into line from a legal and commercial perspective, could the tax treatment not be brought into line too?

**Keywords:** partnership; trusts; *sui generis*; personality; beneficial ownership.

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### [A] INTRODUCTION

In September 2000, the Law Commission and Scottish Law Commission issued a joint consultation on partnership law covering aspects such as partnership property, fiduciary duty, insolvency and legal personality. In November 2003, a final report outlined the Commissions’ final recommendations and included a draft Bill formulating and bringing to life those recommendations.

One of the recommendations (within part 5) was that English partnerships should be *sui generis* entities with their own separate legal personality, as Scottish partnerships currently are—but not be bodies corporate like limited companies or limited liability partnership

(LLPs). This was on the basis that the perception and commercial reality of partnerships is that they are essentially firms holding their own property in the partnership's own name, operating as an identifiable entity rather than as a collection of individuals. In its response to the initial consultation to the report, the Construction Industry Council summarized its position:

Partnerships often operate as though they were an entity. ... Not only will [independent legal personality] bring the law into line with practice, it will make a legal reality of the relationship assumed by clients (Law Commission & Scottish Law Commission 2003: paragraph 5.6).

Another issue is that:

There is a gulf between the commercial perception of, and the legal characterisation of, partnerships (ibid paragraph 5.8).

This alludes to the fact that partnerships are deemed to cease when a partner leaves/dies and a new partnership is formed when a new partner joins—their clients want to deal with one firm and one name. By making an English partnership akin to a Scottish partnership (so that it is indeed a “firm” with its own legal personality) this would align the law with commercial expectations and the modern reality of business and partnerships.

Critically, however, the report did not address the position of tax and partnerships; indeed, within paragraphs 3.50-3.53 it explained the current position but also confirmed that partnerships' transparent status for tax purposes will remain. The disconnect between legal status and tax status should be addressed.

The report did address limited partnerships and suggested that those partnerships created under the Limited Partnership Act 1907 with one managing partner with unlimited liability should be given the option of whether or not to adopt a legal personality; those without a legal personality would be “special” limited partnerships.

Where do trusts fit into this discussion? A partnership is a trust in many respects—from a tax perspective it is a bare trust and, under section 20(2) Partnership Act 1890, holds land in trust for the partners as beneficial owners. Express trusts have a *sui generis* legal personality and have their own identity and their own tax regime, tax returns, rates and allowances. Their trustees have the ability to split their roles between individual and custodian—under the latter they can hold property separate from their own personal property. The trust is a separate entity but not a body corporate. Why cannot partnerships therefore be the same? I support the

report's finding in this legal regard but would argue the Law Commissions could have gone further with respect to the tax.

I have previously suggested that LLPs should have the option to be transparent or opaque for tax purposes (Thorpe 2024) and perhaps it is worth considering whether ordinary partnerships can do the same. The Commissions' report did not address the possibility of changing the transparent tax status of all partnerships, but the matter may be worth revisiting more than 22 years after the report's publication, especially as the onset of LLPs and their place in the business world has changed the entire discussion.

This article will therefore revisit the 2003 Commissions' report and consider some of its findings, including those tax matters "not dealt with" (2003: paragraph 3.49).

## [B] THE DIFFERENCE BETWEEN LEGAL PERSONALITY AND BODY CORPORATE

It may be a fine line, but a legal personality and body corporate are different things; a body corporate, by definition, has a legal personality but an entity can have a legal personality without being a body corporate.

According to Smith (1928: 283), what defines legal personality is the bestowal of rights and imposition of duties on that entity such that legal relations can be entered into and with respect to interaction with other people:

the ship, the corporation and the natural person all require the same thing to make them legal persons, namely, to be a party to legal relations. None of them requires anything more (Smith 1928: 292)

...

it (legal personality) is to regulate also the conduct of human beings toward the subject or toward each other. It suits the purposes of society to make a ship a legal person, not because the ship's conduct will be any different, of course, but because its personality is an effective instrument to control in certain particulars the conduct of its owner or of other human beings. The broad purpose of legal personality, whether of a ship, an idol, a molecule, or a man, and upon whomever or whatever conferred, is to facilitate the regulation, by organized society, of human conduct and intercourse (ibid 296).

Smith points out that it is too simplistic to say that limited companies have legal personality while partnerships do not—he points out that partnerships have been held to have legal personality (*West & Co v*

*The Valley Bank* 1856: 169; *Second National Bank of Oswego v Burt* 1883: 233).

From a legal perspective, being a body corporate means having one's identity and status conferred by legislation; whereas legal *personality* looks at the more human aspects and their interactions. The Commissions' report refers to the "often-antiquated" corporation rules, but unlike the Companies Act 1985, it references the common law; LLPs hold corporate personality with separate legal personality by virtue of section 1(2) Limited Liability Partnerships Act 2000. Legal personality is referred to in the report as being possessed by a "*sui generis*" entity which does not automatically mean it is a body corporate; indeed, the report recommends against that being the case. As with the rights and duties which constitute legal personality, the report highlights sources of those *sui generis* rights and duties as being a part of the partnership contract (ie the rules of partnership and, if there is one, the express partnership agreement which embodies the partners' intentions). The report also included a draft Partnership Bill, which the Commissions submitted as a proposed piece of legislation to define partnerships and as a partial rewrite of the 1890 Partnership Act, to embody their recommendations.

If a partnership can be *sui generis* by virtue of commercial realities, partnership law, a partnership agreement or by a new statute, could it not be said that a trust should also have a *sui generis* legal personality?

## [C] TRUSTS AND THEIR RELATIONSHIP WITH PARTNERSHIPS

Partnerships are essentially trusts—land is held by partners on trust for themselves, and for tax purposes they are bare trusts with a transparent tax treatment. Even LLPs, which are bodies corporate, are bare trusts for tax purposes, so it would seem reasonable to examine the two entities and consider whether the status of trusts might further support the idea that a partnership could adopt a legal personality. The government says trusts do not have a legal personality (Department for Business Innovation and Skills 2011). However, given some of the points made above with respect to partnerships, I would suggest it is arguable that trusts already do have such a personality. A trustee, whilst an individual, wears two hats—one for their own assets with absolute ownership, and another as custodian for trust assets. That trustee will enter contracts, hold property and interact with other people as a custodian without affecting the status of their own personal assets; such individuals are even subject to their own

income tax, capital gains tax (CGT) and inheritance tax (IHT) rules. Smith refers to trustees' multiple capacities when considering partnerships:

As an individual in his own right, A can transfer property to himself as trustee or do business with himself as a member of a firm to which he belongs or, in a triple capacity, as an executor he can transfer property to himself as a trustee. What shall we call such distinctions as these, if not distinctions of legal personality? (1928: 289-290)

Aside from this argument that a trust is *sui generis*, another argument proposed by Ben McFarlane and Robert Stevens (McFarlane 2008: 23-27; McFarlane & Stevens 2010a: 1-2) that a beneficiary's right is not a right to a thing (a proprietary right) or against a person (ie the trustee—a personal right), but is a *sui generis* “right to/against a right” or a “persistent” right not attaching to any thing or person, but stems from other rights. Zaccaria (2019: 466) gives a review of this suggestion by McFarlane and Stevens (2010b: 38) when considering beneficiary rights:

The advantage for equity, in recognising the concept of a right to a right, is that “it permits B to enjoy the benefit of a right without holding that right directly, whilst also recognising that B has more than a mere personal right against A, the holder of the right.” (472).

So, if a partnership is essentially a trust, and an express trust is arguably a *sui generis* legal person, then this would in turn seemingly lend further support to the Commissions' recommendation. But what about the tax element? The analogy between partnerships and trusts starts to fall apart when one looks at tax. An express trust has its own tax regime, even its own self-assessment tax returns, even subject to value-added tax as a separate taxable person, lending more support to the argument that trusts are *sui generis* entities; but a partnership is transparent—essentially only a bare trust as far as tax is concerned. There is thus a notable gap between the legal status and the tax status of a partnership. With an express trust, the trustees are subject to income tax, CGT (and IHT in most cases), and the subsequent income tax consequences for the beneficiaries will depend on whether the trust is discretionary or an interest-in-possession (IIP). The discretionary trust beneficiary receives the income as a payment distinct from the form in which the trustees received it (eg rental income, dividends etc); the beneficiary receives that payment with a refundable 45% tax credit which can be offset against their own personal tax liability. The IIP trust beneficiary (known as the “life tenant”) will receive the income in the same form as it was received by the trustee, but the latter will have already paid basic rate income tax, for which the life tenant gets credit when the same income is reported on their personal income tax return. CGT is dealt with solely by the trustees,

though it is subject to half the annual exemption of an individual and at a rate of 24%; indeed, trustees have their own CGT reliefs, such as provisions within the Business Asset Disposal Relief and Principal Private Residence relief legislation (sections 169J and 225 Taxation of Chargeable Gains Act (TCGA) 1992 respectively).

Whatever their form, express trusts have their own regime which one would expect from an entity with a legal personality, namely that the entity itself is taxed in the first instance and the same income is not subject to tax again when received by the beneficiaries. Partnerships are transparent for tax purposes, irrespective of whether they have a legal personality (like Scottish partnerships) or are bodies corporate, namely, LLPs, so the end result is the same as with trusts in that the profits are taxed only once, except that the partnership is never taxed in the first place—only the partners are taxed in full.

The Commissions' report did not address the tax element, recommending that the transparent treatment remains and that its importance in the decision as to legal status is not conclusive:

It appears that separate legal personality in many jurisdictions is only one factor which tax authorities will take into account in deciding whether a partnership is transparent for tax purposes and that it is rarely determinative of that issue (2003: 19.7).

The fact that LLPs remain transparent for tax despite their body corporate status would seem to support the Commissions' view. In the report, the reasons given for retaining the transparent status—citing (the then) Inland Revenue—were based upon three characteristics of partnerships:

- (1) the partners carry on the business of the partnership with a view to profit;
- (2) every partner is liable jointly or "jointly and severally" with the other partners for all the debts and obligations of the partnership; and
- (3) the partners own the business, each having at least an indirect share in the net assets of the partnership.

It is clearly in the commercial interests of UK partnerships to preserve the existing tax treatment (2003: 4.28).

However, this justification for transparent treatment would seem to contradict the arguments the Commissions made for partnerships having a legal personality, that is, the commercial reality that their clients engage with the partnership as an entity and that the partnership continues despite partners' coming and going and that English partnerships should be able to hold property in their own name. Whilst characteristics 1 and

3 which the Inland Revenue cited above accurately reflect the current tax rules, they would seem an odd justification for not changing them. The recommendations made in the report are on the basis that an English partnership should be a legal person precisely because commercial interests would best be served if the partnership could have flexibility and a degree of continuity—being the “face” which its clients see and deal with, the entity which they assume owns its own property and continues irrespective of what happens to its partners.

Surely if partnerships are to have a legal personality (whether it be English, Scottish, or an LLP with its corporate personality), should they not also have their own tax regime—or at the very least, an option to adopt one?

## [D] TRANSPARENT TAX TREATMENT

As the Inland Revenue stated, the current transparent tax treatment is such that the partners conduct the business. The partnership is the coming together of two or more partners to carry on a common business with a view to making a profit (to paraphrase section 1(1) Partnership Act 1890); the same applies to LLPs. By this transparent treatment, partners/LLP members are subject to income tax (and national insurance) as well as CGT on their revenue and capital profits respectively, and their losses are their own—the partnership itself is not subject to any tax (though the partnership discloses revenue profits and proceeds of capital disposals on its own tax return under its own HMRC unique tax reference (UTR) number). The partnership tax return gives partners their share of the profits which are then disclosed again on their personal self-assessment returns through which the tax is paid. By placing the tax burden on the partners entirely, the partnership is analogous to the bare trust but has nothing in common with the tax personality of an express trust whereby the trustees are the taxable persons with respect to trust income and capital.

So, if partnerships are arguably capable of being *sui generis* for legal purposes and have their own area of common and statutory law, and if express trusts are arguably *sui generis* and trusts have their own opaque tax regime, why cannot partnerships also be *sui generis* and opaque with their own tax regime as well?

## [E] ELECTION WITHIN PARTNERSHIPS?

Within part XIX of their report, the Commissions addressed the proposed concept of a “special limited partnership”, which would be a type of limited partnership but which does not have a legal personality. The report highlighted how venture capitalists have used limited partnerships as a standard structure for their investments and will choose between Scottish or English limited partnerships depending on whether they want a partnership with or without legal personality respectively, based on the particular product. Respondents to the consultation had highlighted the competitive advantage which the UK has over other jurisdictions and the degree of competition within the European Union in particular. The Netherlands and Guernsey have both allowed partnerships to choose whether or not to adopt legal personality as this status will often determine whether other jurisdictions would regard the partnership as being transparent for tax purposes or not. Australia and Belgium were cited (Law Commission & Scottish Law Commission 2003: paragraph 19.7) as examples of countries that will regard a partnership as a corporation for tax purposes if that partnership has legal personality in its own country. The United States (US) too has moved to an “entity” (ie opaque) recognition of partnerships through the Revised Uniform Partnership Act 1994, allowing general and limited liability partnerships to continue after a partner leaves/is disassociated. Clearly, the ability to choose whether to adopt legal personality was seen as reinforcing British competitiveness and the idea of an election mechanism was planted.

In my November 2024 article, I put forward the suggestion that LLPs should be able to elect whether or not to be treated as corporations for tax purposes; LLPs are bodies corporate in law already, but transparent for tax purposes like any other partnership. My suggestion was that LLPs should be able to elect to be opaque for tax purposes, akin to limited companies, with the LLP paying corporation tax and members being able to make drawings and undertake employment contracts. This is along the lines of elections available to Limited Liability Companies (LLCs) in the US (a hybrid statutory entity comparative to the UK LLP) which are treated as transparent entities for federal tax purposes by default, unless they opt to be treated as a corporation with IRS Form 8832. Single-entity LLCs are “disregarded entities”, so the profits are recorded on the owner’s federal tax return—akin to a sole trader. With two or more members, an LLC is treated as a transparent entity filing partnership tax returns unless it elects to be treated as a corporation. Furthermore, corporations (and LLCs can be treated as a corporations rather than as partnerships) have the option to elect to move away from their opaque tax status and become a transparent

“S corporation” (via IRS Form 2553). These S corporations, whilst retaining full corporate liability protection, are transparent for tax purposes so the shareholders enter the income onto their own personal tax returns.

However, this option to become opaque need not be confined to LLPs as there is also the precedent from the US for UK general partnerships to also be opaque for tax purposes. Within the US, general, limited and limited liability partnerships can also elect to be treated as opaque entities rather than retain their default transparent status—they can be taxed as a “C corporation” which subjects the partnership’s profits to corporation tax and the shareholders again to income tax on dividends—as in the UK. Elections made via Form 8832 are binding on the business for the next five years to prevent annual switching, for example, to minimize the tax burden (only if the election is made under a mistake of fact or the business changes more than 50% of its ownership can a further election be held within the five years).

The UK tax rules could take a leaf out of the US book; if it is possible for an entity to elect how it is treated for tax purposes, irrespective of its legal status, it could resolve the tax-legal personality anomaly we have in the UK with respect to partnerships. The Commissions’ report missed a prime opportunity to address the disparity in both the legal *and* tax differences; whilst the Commissions’ touched upon the possibility of limited partnerships choosing whether or not to adopt a legal personality, the same sentiment could have been taken further on the matter of tax and general partnerships.

## [F] OPAQUE PARTNERSHIPS?

If general partnerships in the UK were given the same option to afford themselves legal personality for tax in the same way as US LLCs/corporations are able to, the partners would have to worry about something which often leads to questions to accountants: should I incorporate to pay lower tax? A general partnership or LLP (like a sole trader) pays income tax (and national insurance) on its profits irrespective of what it actually withdraw from the business. A partnership profit share might be above £100,000, taking the partner/member into the 60% marginal income tax bracket with the gradual loss of their personal allowance, but they might only withdraw half that amount (maybe because of the business’s cash needs).

From my days in practice, I found many a sole trader and partner/member would look for solutions to this problem—one obvious (though

not necessarily simple) option was to incorporate into a limited company, subjecting business profits to corporation tax but only exposing themselves to income tax insofar as profits were actually withdrawn from the company (as salary and/or dividend). However, the process of incorporation leads to further tax (and non-tax) complications. CGT is one issue where business assets are transferred from the sole trader/partnership, although incorporation or holdover reliefs (under sections 162 and 165 TCGA 1992 respectively) are potentially available to defer any tax charge. Stamp duty land tax is probably even more prominent an issue if land/buildings are incorporated, as deemed market value consideration will be imposed for the transaction. That tax needs to be paid within 14 days of completion of the transfer, too, so it can be a significant strain on a business's cash flow. Furthermore, if a sole trader or general partnership transfers the business into a limited company, there can be significant cost increases with respect to compliance fees and administration: Companies House submissions, pro-forma accounts, as well as corporation tax returns, plus payroll and/or dividend reporting when the profits are withdrawn.

Instead of having to go to the extremes of incorporation with the upfront tax and ongoing compliance costs, it would be much easier and cheaper for sole traders/partners to retain their existing business model but simply elect for opaque tax treatment.

## [G] OPAQUE PARTNERSHIPS AND TRUSTS

If the US rules concerning transparent/opaque elections were to be adopted in the UK, with general partnerships being *sui generis* legal personalities and the option available to extend that to the tax regime, what would this do to the suggested analogy between general partnerships and trusts? The simple answer is that it would merely reinforce the analogy, giving partnerships the same *sui generis* legal personality which trusts now have; giving partnerships the option to become opaque for tax purposes would move them from being bare trusts to express trusts with two layers of taxation—trusts and beneficiaries akin to partnerships and partners.

## [H] CONCLUSION

The Commissions' report of 2003 raised an interesting point concerning the legal identity of an English partnership being a *sui generis* personality, short of being a body corporate. Whilst nothing ever came of the report and the Commissions' draft Bill was never enacted, they were right about the

fact that the reality of partnerships in the modern commercial world, their separate identity to their clients, their longevity and continuity despite partners' coming and going, means that they are *de facto sui generis* personalities already. But for tax purposes (aside from having their own tax returns and UTR numbers) they are not separate personalities at all, they are entirely transparent with the beneficiaries—rather than the legal owners—being subject to tax.

Partnerships are bare trusts with respect to UK tax but are, or could be, so much more similar to express trusts with respect to tax. Despite the government's view, express trusts are, I would suggest, *sui generis* entities with their own identities—the trustees are acting in a completely different capacity from themselves, as custodians, subject to completely different sets of tax rules, rates, reliefs and allowances, in the same way that a corporation would be. So, why could a partnership also not be treated as a corporation for tax purposes? Previously, I had suggested that LLPs—already bodies corporate in law—should have the option to elect to be opaque for tax purposes too. However, this same logic can arguably be extended to all partnerships if the logic of the recommendations in the Commissions' report were to be followed. If partnerships can be separate personalities in law, then it would also seem logical for them to be so for tax, in the same way as express trusts are. However, instead of imposing an opaque tax regime on a potentially unwilling partnership, allowing the partners to elect in the same way as US partnerships would give a great deal of flexibility and likely make partnerships an even more popular business vehicle than they already are.

The Commissions' report expressly avoided this tax issue (except with respect to foreign jurisdictions) and confirmed the Inland Revenue's preference for the *status quo*. However, this consultation would have been a good opportunity to address the separate personality and whether partnerships should be *sui generis* for tax as well as legal purposes. The fact that the report's recommendations were not pursued was disappointing, as addressing the legal personality status could have been a prelude to addressing the tax personality status. Now, 22 years on from the publication of the Commissions' final recommendations, maybe the time has come to actually address this elephant in the room with a view to resolving this issue; the business world has changed a lot in the intervening time.

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