CLIENT UPDATE

PROPOSED CHANGES TO THE TAXATION OF UK PARTNERSHIPS

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In May 2013, HM Revenue & Customs ("HMRC") published a consultation document looking at various aspects of partnership taxation. As a result of this consultation process, the UK government announced two main anti-avoidance provisions in its Autumn Statement last month. The first deals with the taxation of salaried LLP members and the second with the allocation of profits in partnerships with a mix of individual and non-individual members. On December 10, 2013, the UK government published draft legislation, together with a technical guidance note drafted by HMRC setting out the government's opening gambit and HMRC's interpretation of the legislation.

TAXATION OF SALARIED MEMBERS OF LLPS

Overview

Currently, a UK member of an LLP is taxed on profits and gains arising in the LLP in the same way as a partner in a traditional partnership. Since LLPs are principally used for operating rather than investment activities, the main benefit derived from an LLP structure compared with a classic corporate structure is that a member's profit share is not subject to national insurance in the same way as a salary would be. This particularly benefits the LLP since it does not pay employer's national insurance contribution.

The point is an issue in respect of LLPs but not traditional partnerships because members of LLPs, unlike partners in commercial partnerships, are all treated as self-employed for tax purposes, whether or not their rights and obligations resemble those of partners in a conventional partnership. HMRC comments in its draft guidance that "*many LLPs have members engaged on terms more closely resembling those of employees, who work for the business, than of traditional partners, who carry on the business.*"

To deal with this perceived problem, the government proposes taxing profits and gains arising from an LLP as employment income provided that three conditions are satisfied (note that the way that the legislation is drafted means that, for a member, it is a bad thing if a condition is satisfied).

Condition A

The first of these conditions, Condition A, applies where a member provides services to an LLP and receives payment that is wholly, or substantially wholly (more than 80%), a disguised salary. For these purposes, an amount is a disguised salary if it is:

- fixed;
- variable, without reference to the overall profits and losses of the partnership; or
- it is not, in practice, affected by the overall profits and losses of the partnership.

This appears to be a straightforward test to follow and, in many circumstances, it will be immediately clear whether the test has been satisfied or not. However, its simplicity means that it is quite difficult to see how the test fits in with some common features that arise in the use of LLPs as advisers in the fund management industry.

For example, one area on which clarity will be required is what happens where the income of an LLP is directly related to the members' profits. This type of situation arises in many private equity management vehicles where the income of the LLP is fixed. At face value, Condition A would not be satisfied (which is a positive result for a member), because a member of a management LLP is remunerated entirely in accordance with the overall profits and losses of the partnership. We note that this type of situation may be caught by the second set of anti-avoidance provisions which are being proposed, discussed further below.

It is also unclear how the proposed legislation interacts with the Alternative Investment Fund Manager Directive's ("AIFMD") remuneration policy requirements. At first glance it would appear that designating an amount as remuneration for the purposes of AIFMD could taint the tax treatment of a member's profit share. However, the test for identifying a disguised salary is completely different to the AIFMD remuneration test. In paragraph 2.5 of HMRC's draft guidance, HMRC states that, although benefits equivalent to statutory sick pay, maternity leave, holiday entitlement and termination rights make a member look like an employee, they are not taken account in the salaried member test. The implication being that HMRC will apply Condition A in a vacuum. The AIFMD remuneration policy is not referred to in the draft legislation or by HMRC in its draft guidance note. This absence suggests that AIFMD in not relevant to this test since in other anti-avoidance provisions relating to the taxation of partnerships, published within the same document, AIFMD is explicitly considered.

Condition B

Condition B requires that the mutual rights and duties of the members of the LLP do not give a member significant influence over the affairs of the partnership. HMRC's draft guidance summarises this condition as follows: "*Condition B is in essence looking at the role played by the individual in the business. Put simply, can it be said that the individual is the business rather than merely working for the business?*"

The use of the word "influence" rather than "control" is, in our view, significant. Control is a familiar concept used in tax legislation, which suggests that control is not what is required for this test, but rather something less. It is unclear exactly what "significant influence" means, although HMRC does provide examples of what it is not. Significant influence is not obtained where:

- there is a management committee;
- a member is responsible for only part of the business; or
- there are a large number of members, which dilutes each member's influence.

The examples provided by HMRC suggest that this will be an incredibly difficult condition not to satisfy. Indeed, HMRC, in its draft guidance states that "*[i]t is unlikely that this Condition will exclude many members of very large partnerships, since, in such cases, it is likely that only a minority of individuals have significant influence over the affairs of the whole partnership.*" Whether a member would fail the condition if all members of the LLP were members of a management board or committee is not clear; if important decisions were taken only by unanimous voting, it is arguable that each member has significant influence.

What is made clear is that HMRC believes that a member needs to have influence over the whole partnership, not just a business division or aspect of the business, which works to the disadvantage of medium to large LLPs.

The extraordinarily wide way in which this condition is drafted means that only members of very small partnerships are able, under the current drafting, to determine, with any degree of comfort whether they are likely to fail this condition.

This may help private equity fund managers operating through an LLP because the numbers of members are likely to be quite low. However, the influence of members in these cases may still be difficult to categorise as significant.

We understand that this condition will be subject to significant further discussion between the BVCA and HMRC.

Condition C

Condition A looks to financial rewards, Condition B to involvement in the business, Condition C looks at a third aspect of partnership, capital investment. If a member's contribution is less than 25% of a member's projected remuneration for services provided to the LLP for the relevant year (the "disguised salary" amount), then this condition is satisfied (there are special rules where a member joins or leaves an LLP part way through a year).

This test will be applied on April 6, 2014 in relation to existing partnerships or, if later, the point at which a person becomes a member of an LLP.

For individuals who have been members for some time, no account is taken of inflation, so although their contribution may have exceeded 25% at the time that the partnership was formed, it may not do so now.

HMRC has, in its draft guidance, provided examples of what will not constitute contributed capital:

- sums that the individual may be called upon to pay at some future date;
- undrawn profits unless by agreement they have been converted into capital;
- sums that are held by the LLP for a member, for example, sums held in a tax account; and

- amounts of capital that are part of arrangements to enhance the amount of capital to enable the individual to "avoid" being a "salaried member" where there is no intention that they have permanent effect or otherwise give rise to no economic risk to the relevant member.

It may be possible to use financing arrangements to enable a member to fall outside of this condition but care will need to be taken to ensure that the arrangements are not viewed as artificial constructs.

Anti-avoidance

Despite the fact that these provisions are themselves anti-avoidance provisions, they also contain a set of anti-avoidance rules. The rules, in essence, provide that if a person provides services, not as a member, or through a corporate member, and the main purpose, or one of the main purposes of such arrangements is to avoid the salaried partner rules applying, then the arrangements fail.

Comment

If these rules apply, a member will be treated as an employee "for the purposes of the Income Tax Acts". The Interpretation Act 1978 defines "the Income Tax Acts" as all enactments relating to income tax. Section 1 of the Income Tax Act 2007 lists the following acts as making provision for income tax:

- Income Tax (Earnings and Pensions) Act 2003;
- Income Tax (Trading and Other Income) Act 2005; and
- Income Tax Act 2007.

In addition, the section lists various parts of other acts. The wide ranging application of the rules to the Income Tax Acts means that the rules relating to disguised remuneration and employment-related securities may now be relevant to members of LLPs. Traditionally it has been accepted that an interest in a partnership is not a security for the purposes of the employment-related securities regime. It is unclear, as the draft legislation and guidance stands, whether these rules will change this established position.

However, the drafting does makes it clear that, although a member will suffer the taxation consequences of being an employee they will not receive any of the benefits of being an employee – such as enhanced employment rights and protections.

We will be making representations to HMRC regarding these proposals, which in their current form are far wider than we had expected and could have wide-reaching implications for the private equity sector. The British Venture Capital Association has released a statement saying that it "*will be working with HMRC to offer as much clarity as possible on what these proposals mean for private equity and venture capital, which are not the intended targets*".

It is likely that these rules will attract a lot of attention from professional services firms, many of whom structure their affairs to include both salaried and equity partners and who determine the profit split by reference to each partner's individual performance (rather than the profits and losses of the LLP). Given that it is these firms that commonly make representations to the government regarding new legislation, we expect a high volume of representations to be submitted.

We anticipate that these rules will change (we hope not insignificantly) before they reach final form. The examples given throughout HMRC's guidance note to the legislation need additional work as they sometimes lack clarity and are, at times, inconsistent. Also none of the examples provided by HMRC relate to the private equity industry's use of LLPs. HMRC has noted the deficiency of its examples in the introduction to its draft guidance and has specifically invited further comment.

TAX MOTIVATED ALLOCATIONS OF PROFITS AND LOSSES IN PARTNERSHIPS

The second swathe of anti-avoidance rules relating to partnerships cover, broadly, three situations:

- profit allocation to non-individual partners;
- loss allocation to individual partners; and
- transfers of asset and income streams through partnerships.

The rules have also been referred to as the mixed membership rules as they are aimed at partnerships that have a combination of individual and non-individual members.

Profit and loss allocation to non-individual partners

These rules operate to increase an individual partner's taxable income from a partnership and apply to the extent that a non-individual partner is allocated a profit share and one of two conditions (Condition X or Condition Y) is met.

Condition X is satisfied if it is reasonable to suppose that amounts representing an individual member's deferred profit share are included in the non-individual's profit share and in consequence, the individuals profit share (and the associated tax) is lower.

Condition Y is satisfied if:

- a non-individual's profit share exceeds the appropriate notional profit share;
- an individual partner has the power to enjoy the profit share;
- it is reasonable to suppose that the non-individual received its share of the profits because of the individual's power to enjoy such amounts; and
- in consequence, the individual's profit share (and the associated tax) is lower.

The reference to appropriate notional profit share comprises an arm's-length payment for services, together with an appropriate return on capital. The latter is calculated by looking at what commercial rate of return would have been achieved if the money had been put on deposit.

These rules also pick up the case where an individual is not a member of the partnership but provides services to the firm and a non-individual receives a profit share in respect of these services to the extent that it would be reasonable to suppose that such individual would have been a partner but for these provisions. This picks up individuals who are partners through personal service companies.

There are similar provisions applying to the allocation of losses between a partner which is not chargeable to UK income tax and partners that are subject to such tax.

Application to Alternative Investment Fund Managers

The Alternative Investment Fund Managers Directive requires that, to qualify as an AIFM the partnership must defer access to certain profits. The downside is that partners attract a dry tax charge on these deferred amounts as the deferred profits are taxed on an arising basis.

The rule proposed by the government in its draft legislation allow for partners in AIFMD partnerships to allocate their share of any deferred profits to the partnership. Such allocation needs to be undertaken by election and will mean that the partnership is treated as an individual and taxed accordingly (as if it were an additional rate taxpayer, so at 45%). When the partner ultimately receives these deferred profits he will receive a credit for the tax already paid.

Comment

The rules are effective from April 6, 2014 however, anti-forestalling provisions have been introduced as of December 5, 2013.

These rules will need to be considered with some care in relation to private equity fund structures, since they invariably use limited partnerships for the funds themselves, as well as for carry and co-invest arrangements. Our initial take on these rules is that they should have no impact as a general matter and in particular should not affect some of the "tax fundamentals" behind fund structuring in the UK, such as the tax treatment of carry. More aggressive forms of enhanced tax treatment for carry holders may, however, now be things of the past. General co-investment structures will need revisiting, as well as some structures where the general partner of the fund is a limited partnership.

Finally, HMRC does not comment but it would be interesting to know how these rules will interact with transfer pricing rules. If, for example, there is an advance pricing agreement in place between a partnership and a member, would the price agreed feed into the notional amount or would the two calculations exist entirely separately?

Transfers of asset and income streams through partnerships.

A further measure will apply from April 6, 2014 which imposes an extra tax charge in cases where an asset or income stream is transferred between partners, where such transfer is effected through a partnership provided that the main purpose, or one of the main purposes, of these arrangements is to obtain tax advantages for any person.

These changes are not dealt with in detail in this update as they are not as directly relevant as the changes discussed above

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