

Memorandum

Do You Need to Make Changes to Your UK LLP Agreement?

19 February 2014

Background

In May 2013, HM Revenue and Customs (“HMRC”) consulted on proposals in two areas to tackle perceived tax avoidance via partnerships. The first area was disguised employment in Limited Liability Partnerships (“LLPs”) and the second was the tax-motivated allocation of business profits and losses in partnerships (including LLPs), especially profit allocations to the corporate member of an LLP. The consultation has ended and HMRC issued final legislative proposals and a detailed draft Technical Note and Guidance (“Guidance”) in December 2013. The final form of the Legislation and Guidance is expected to be published in March 2014.

The new legislation will be effective from 6 April 2014 and, in substance, will: (1) tax individual LLP members who are treated as salaried members under the tests in the new legislation (“Salaried Members”) as employees; and (2) remove in most cases the tax advantages gained through profit allocations to corporate partners (“Corporate Members”), loss allocation to individual partners, and transfers of assets or income streams through partnerships. The Salaried Member rules and allocations of profits to Corporate Members are explored in this *Memorandum*.

Timing and Content of LLP Agreements

Note that for individuals who are members as of 6 April 2014, the Salaried Member tests need to be applied at that point. For individuals who become members after 6 April 2014, those tests need to be applied at the date on which they become members. There are a number of areas where the content of the LLP Agreement will have a direct impact on how the new legislation applies. Some LLPs will wish to make changes to their LLP Agreements before 6 April 2014 as a result.

SALARIED MEMBERS

The Salaried Member Test

The Salaried Member test will deem certain individual members to be employees for tax and national insurance purposes, resulting in the requirement for tax and national insurance contributions to be deducted from compensation under PAYE and liability to employer’s national insurance contributions (13.8 percent) for the LLP as the deemed employer and to tax for the individual on any benefits provided by the LLP under the employment “benefits-in-kind” rules.

In order for an individual member to be taxed as an employee, *all three of the following conditions* must be satisfied (or, put another way, failure of any of these conditions is sufficient for an individual not to be treated as a Salaried Member):

Condition A requires that, at the relevant time the individual is to perform services for the LLP, it is reasonable to expect that the amounts payable to him by the LLP will be wholly, or substantially wholly (HMRC interprets this to mean 80 percent or more), disguised salary. An amount is disguised salary if it:

- Is fixed;
- Is variable, but is varied without reference to the overall amount of the profits or losses of the LLP; or
- Is not, in practice, affected by the overall amount of those profits or losses.

Condition B requires that the terms of the LLP Agreement do not give the individual “significant influence over the affairs of the LLP”.

Condition C is that, at the relevant time, the individual’s capital contribution to the LLP is less than 25 percent of the total amount of disguised salary it is reasonable to expect will be paid in the relevant year.

General Comments

The Salaried Member test is *not* concerned with experience or professional qualifications. It looks at the role that the individual plays in the business and the affairs of the LLP. The Guidance acknowledges that provisions in an LLP Agreement whereby each member is entitled to an equivalent to statutory sick pay, maternity/paternity leave, holiday entitlement and termination rights are not taken into account in the Salaried Member test. Even though they may make the partner look like an employee, they can remain and are ignored.

The Guidance also gives a useful general example of an LLP in which each member receives a profit share, which varies from member to member, but everyone knows that if the business makes less profit they will have less income and if it makes a loss they get nothing. In this example, the Guidance acknowledges that all the members, from a secretary to a founder, know that their income from year to year depends on the level of profit. If the firm makes a loss, then they have no income for the year. This would mean that Condition A is not satisfied and no member of the LLP is a Salaried Member and no further action is needed.

However, see the commentary below on Condition A and the scope of what constitutes disguised salary, especially a bonus based on a member’s personal performance, guaranteed profit and non-refundable (advance) drawings.

Condition A

This is the most significant of the three conditions that determine whether an individual is a Salaried Member. It is intended to identify those members who, at first sight, are working for the LLP on terms that are like those of employees; that is, they are paid for their services without reference to the overall profitability of the firm. Condition A considers the manner in which the individual is rewarded for his or her performance of services to the LLP.

In order to avoid triggering Condition A, it must be reasonable to expect that *more than 20 percent* of the individual’s remuneration will be through a share of the profits of the overall business (i.e., not be

caught by the broad definition of what constitutes “disguised salary”). The Guidance provides some further colour on this and provides that “disguised salary” includes:

- A fixed sum such as a salary;
- Payment on a piece work basis — by the number of units produced or jobs done;
- A bonus based on a member’s personal performance rather than the success of the overall business;
- Guaranteed profit; and
- Non-refundable drawings.

The last three of these examples are likely to be the most relevant to hedge fund manager LLPs.

It is important to note that Condition A is framed in terms of the amounts that it is “reasonable to expect” the LLP to pay to the member. This is a question that should be answered by reference to the substance of the matter taking a realistic view of the facts. Those rewards that are unrealistic and are unlikely to be triggered will be ignored.

Condition B

This is designed to ensure that those individuals who have, as the Guidance puts it, a “significant say in the running of the business as a whole” rather than individual components of the business (effectively, who operate like the partners of the overall business) are permitted to enjoy the tax benefits of being an LLP member. Junior members of an LLP who do not participate in a day-to-day management committee or group are at risk of meeting this condition. Condition B is likely to be particularly important for members of smaller LLPs, particularly new or recently established hedge fund managers with a small number of members.

A junior member would not have “significant influence” and would meet Condition B (and be a potential Salaried Member) if he or she only has the right to vote on certain reserved matters along with all other members (e.g., to approve the accounts, on material changes to the business, appointing or removing the auditors etc.).

Condition C

This is based on the assumption that a partner in a traditional partnership risks losing money if the business fails. To reflect this, an individual will not be a Salaried Member if he has invested money in the LLP that is at least 25% of his disguised salary (i.e., his expected income from the LLP, which is fixed or variable income for the relevant tax year as described under Condition A).

Historically, many individual members of hedge fund manager LLPs will have made very small capital contributions (often between £5,000-£10,000) and, for some of those members, that is unlikely to amount to at least 25 percent of such expected income and they will potentially be Salaried Members (unless they fail to satisfy one of the other two conditions).

The capital contribution for this purpose is the amount that the individual has invested as capital in accordance with the LLP Agreement. The Guidance recognises that certain types of long-term loans by a

member to the LLP (if the terms are comparable to capital, e.g., only repayable on resignation or winding up) may also qualify as a capital contribution.

A capital contribution does not however include: (1) sums that the individual may be called upon to pay at some future date; (2) undrawn profits unless by agreement they have been converted into capital; or (3) sums that are held by the LLP for the member (e.g., sums held in a taxation account).

Anti-Avoidance

The legislation contains an anti-avoidance provision which applies to ignore any changes made to the terms on which an individual is a member of an LLP where the “main purpose” or “one of the main purposes” of those changes is to ensure that he is not a Salaried Member.

In contrast, the Guidance acknowledges that “it is not avoidance if the terms under which an individual is a member change and they become a member on genuine terms comparable to a partner in a traditional partnership”.

If any changes are to be made to the terms of an existing LLP Agreement in light of the new legislation, they must be implemented with caution and an eye to this test.

Specific Comments on Examples in the Guidance

Please refer to the Examples in the Annex to this note (which have been extracted from the Guidance) when considering the commentary below:

Example 1 (disguised salary vs. profit share)

The statement that a discretionary bonus paid out of a share of the firm’s profit is not caught as disguised salary is helpful (albeit partly stating the obvious), but note the forward-looking aspect of what it is reasonable to expect will happen subsequently when assessing whether more than 20 percent of total rewards is likely to be out of profit share.

The test depends on what it is reasonable to expect at the time the LLP Agreement is entered into by the relevant individual. The test is not revisited with the benefit of hindsight based on actual numbers. In making an assessment, HMRC will look not only at the terms of the LLP Agreement itself, but also any separate Deed of Adherence or Admission and the minutes of any relevant committee or body which exercises the discretion.

Example 2 (payments linked to turnover)

This theme could be applied to a marketing person within a hedge fund manager who is remunerated at least partly based on the level of assets raised in a particular year. Whilst payment by reference to assets under management/fee revenues procured during the relevant year is variable, it is “varied without reference to the overall amount of the profits or losses of the LLP” and would be disguised salary.

Example 3 (personal performance)

By analogy, a bonus paid by reference to the success of a portfolio manager's or analyst's particular fund (where there are at least two funds and/or managed accounts), or the success of part of the assets within a fund (even where it is the only fund/account managed by the business), would be likely to meet Condition A (i.e., not be regarded as a share of the profits of the business as a whole and would be regarded as disguised salary).

Note also that Condition A should be met both where an individual member is compensated by reference to his own individual performance (for example, a portfolio manager who received a percentage of fees generated by his own "book" of assets) and also where compensation is by reference to a particular division or sector, such as a particular fund or group of assets within a fund.

Example 4 (guaranteed profit and non-repayable advance drawings)

In the hedge fund manager context, it has been relatively common for an LLP Agreement to provide that the advance drawings of junior members are not repayable in the event that a subsequent loss arises or the LLP does not generate sufficient profits to "match" these drawings. Non-repayable drawings will be regarded as disguised salary. In this scenario, consideration should be given to changing the terms of the LLP Agreement if this would otherwise cause the individual to fail the more than 20% of total rewards out of true profit share test.

The Guidance does not contemplate how such drawings would be regarded if the LLP Agreement provides that the individual's share of any subsequent loss is to be offset against his capital contribution account (hopefully not disguised salary) or the capital of the Founder or the Corporate Member (probably disguised salary).

Example 5 and Condition B (significant influence)

The examples suggest that if there is a management committee (or equivalent) which effectively runs the LLP on a day-to-day basis, then if a member or members are not on that committee, he or they will not have significant influence (and will potentially be Salaried Members). This will be the case even if, as is very common in hedge fund manager LLP Agreements, they have a right to vote with all members on certain reserved/exceptional matters where the management committee does not decide.

In contrast, membership of a management committee which effectively runs the LLP on a day-to-day basis and thereby having a say (even a minority, non-controlling say) in the affairs of the LLP can amount to significant influence and should avoid that member triggering Condition B. Caution and common sense need to be exercised however — it may be effective and convincing to put certain junior members (e.g., a junior investment professional who is being promoted) on the management committee and give him a say and avoid him triggering Condition B, but that will not necessarily be the case for all junior members.

There may be difficult cases where significant individuals in the business (for example, a CIO) may have no interest in management matters and so not be on a management committee. It is hoped

that HMRC would acknowledge that such an individual has a significant influence on the running of the business as a whole, even though they are not on the management committee.

Hedge fund managers, particularly smaller LLPs, should review the terms of the current governance and decision-making arrangements in place under their LLP Agreements with Condition B in mind and consider whether any changes are appropriate.

Condition C Guidance (capital contribution)

Increases of capital by a member in order to avoid Condition C being triggered must be permanent and subject to economic risk to the member, otherwise they may be ignored. Regard must also be had to the anti-avoidance provision referred to above.

General Example 14

New/recently established and small hedge fund manager LLPs should be aware of this general example from the Guidance where all members, apart from the founders, are regarded as Salaried Members. The example also illustrates how the relevant arrangements might be changed to result in a different treatment.

Action Points

Hedge fund managers should consider, and, where appropriate, pursue the following action points prior to 6 April 2014:

1. Assess whether the LLP has any individual members who might be regarded as Salaried Members.
2. Assess whether any payments to members are linked to turnover/revenues, personal performance or performance of a particular division or sector or are guaranteed.
3. Check whether your LLP Agreement provides that in the event of a loss or insufficiency of profit arising any member is not required to repay his advance drawings. If so, consider the likely impact of this on Condition A for that member and whether the LLP Agreement should be amended in this regard.
4. In respect of each potential Salaried Member, assess the proportion of his likely remuneration going forward that might be regarded as disguised salary.
5. Review the existing governance and decision-making arrangements pursuant to the LLP Agreement and how they relate to the potential Salaried Member and consider whether any changes could be made with regard to Condition B significant influence.
6. Assess whether each potential Salaried Member meets Condition C regarding capital contribution and, if so, whether any changes could be made.
7. Be aware of the anti-avoidance provisions and seek appropriate professional advice on the nature and scope of any proposed changes to the LLP Agreement.
8. Consider whether any members should cease to be members and become employees.

TAX MOTIVATED ALLOCATIONS IN MIXED MEMBERSHIP PARTNERSHIPS

This aspect of the new legislation is a potentially very complex area given the nature and complexity of some of the tax mitigation schemes that have previously been deployed by some LLPs. The following is therefore a simple overview of the new provisions focussing on some basic issues that may be applicable to a wide range of LLPs.

What Is a Mixed Membership Partnership?

A mixed membership partnership is simply a partnership or LLP that has, as partners or members, both individuals and persons who are not individuals. Examples of non-individuals include companies, trustees or LLPs.

What Kind of Behaviour Is Being Targeted?

Partnerships may reduce the overall tax liability of the partners by allocating all or part of the profits of the partnership to a corporate partner who will be subject to corporation tax and will therefore pay less tax on that profit share than would an individual partner (who would be subject to marginal rate income tax and national insurance contributions). The new rules allow HMRC to override the profit sharing arrangements agreed by the partners/members so that individual partners are taxed on profits that have been allocated to a corporate partner in such circumstances, where the individual partners are connected with the corporate partner, or otherwise have “power to enjoy” the profits allocated to the corporate partner.

Tax avoidance arrangements may also be entered into with a view to individual partners being allocated losses of the partnership in order for them to claim relevant loss relief to reduce their total tax liability. The new rules are designed to ensure that relief for the losses will be restricted in such cases. These tax loss rules are not discussed further in this *Memorandum*.

Where Does the Legislation Apply?

In summary, for the legislation to apply: (1) profits must be allocated to a corporate partner which is connected to one or more of the individual partners, or one or more of the individual partners must have “power to enjoy” those profits; and (2) the profit share of the corporate partner has to be greater than the “appropriate notional profit”. The appropriate notional profit is made up of two elements: (1) the appropriate notional return on capital provided by the corporate partner; and (2) the appropriate notional consideration for services provided by the corporate partner.

Appropriate Notional Profit

The appropriate notional return on capital is simply a commercial rate of interest on the capital contributed. This is not a specific rate as the appropriate commercial rate will vary reflecting the level of risk involved. Where the level of capital varies during the relevant period of account, the notional return must be calculated from time to time on the varying amounts.

The appropriate notional consideration for services is the arm’s length value of any services provided by the corporate partner for the period, less any other amount received for those services (for example, a service fee) that is not part of the profit share.

In almost all cases, this notional consideration will be no more than the cost to the Corporate Partner in providing the services plus a modest mark-up. If any services provided involve other partners in the partnership, then the value of these services is not included in arriving at the notional return.

What About Working Capital?

The issue of working capital was addressed in the Summary of Responses paper issued by HMRC alongside the Guidance. HMRC noted that there was a suggestion from some respondents that it was appropriate to retain profits in a partnership to fund working capital, and to tax those profits at lower corporation tax rates rather than higher personal tax rates, and that preventing this would give incorporated businesses an advantage over partnerships. These respondents said that taxing retained profits at the income tax rates could result in a loss of access to working capital and significant cash flow issues for some smaller professional partnerships.

Despite this, the Government is introducing the mixed membership proposals as originally announced and has effectively not made any allowance for the retention of working capital beyond the amount determined to be appropriate notional profit. The Government seems to take the view that taxpayers must choose the most appropriate business entity for their purposes, and cannot have “the best of both worlds” by including corporation tax paying corporate partners in partnerships that also have individual partners.

An Example

The following is an example scenario extracted from the Guidance (see Example 31):

“The membership of ABC LLP consists of three individuals, A, B and C, who decide that they want to retain funds in the LLP for working capital. In order to avoid the retained profits being taxed at higher income tax rates, they introduce a corporate member, ABC Ltd, which is fully owned by A, B and C.

ABC Ltd does not provide any services and only a nominal amount of capital.

A, B and C work out what they wish to draw personally and allocate the balance of the profit to ABC Ltd. The profit share allocated is invested or retained in the partnership by the company member as additional partnership capital or advances.

The individual members have “power to enjoy” the sums allocated to their company. The three individual members are taxed on an additional profit, split on a just and reasonable basis, equal to the profit share allocated to ABC Ltd, less a sum that represents an appropriate notional return on the nominal amount of capital introduced by ABC Ltd..”

How Will AIFM Directive Deferrals Work?

The AIFM Directive remuneration provisions will, for some AIFM, in due course impose a deferral on individual partners’ access to profits of an AIFM partnership, which may mean that the individual partners may be required to pay tax on profits that they do not have access to (as a consequence of the mandatory deferral) at the time when the tax charge arises under existing partnership tax rules.

The new legislation therefore contains special AIFM provisions which will allow the AIFM partnership itself (or its delegate) to elect to pay the tax rather than the individual partner. The individual partner will then get a tax credit when the remuneration vests, but the partner will remain liable to Class 4 NICs at the time of vesting.

Anti-Avoidance Provisions

The new legislation also contains broad anti-avoidance provisions designed to result in HMRC's desired outcome irrespective of the complexity of the structure.

When Does the Legislation Apply?

The mixed membership partnership legislation applies to periods of account commencing on or after 6 April 2014. There are special rules which apply to partition a period of account where a period of account begins before 6 April 2014 and ends on or after 6 April 2014.

Action Points

Hedge fund managers should consider and pursue the following action points prior to 6 April 2014:

1. Almost all hedge fund manager LLPs to date have opted to include a Corporate Member in the structure and so the new provisions will be potentially applicable to many LLPs. Those LLPs should familiarise themselves with the new legislation and its potential impact.
2. Most profit allocation waterfall clauses in hedge fund manager LLP Agreements contain a provision allowing the allocation of profits to the Corporate Member to provide working capital. The language of such a provision (and its use going forward) should be reviewed and, if necessary, amended in light of the new rules.
3. Some existing LLPs (and all new ones), may wish to consider carefully the remaining pros and cons of retaining (or adding) a Corporate Member in the structure. Whilst working capital is an important consideration, it is not the only factor.
4. To the extent that a Corporate Member is retained and profits are to be allocated to it going forward, a careful calculation of "appropriate notional profit" will be required for each year in question.
5. For those AIFM LLPs who are likely to be caught by the AIFM Directive deferral requirements, bespoke additional provisions will be required in the LLP Agreement to facilitate the intended tax result for individual partners.
6. Be aware of the anti-avoidance provisions and seek appropriate professional advice on the nature and scope of any proposed changes to the LLP Agreement.

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If you have any questions concerning this *Memorandum*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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ANNEX

Condition A: Disguised Salary

Example 1 (disguised salary vs. share of profit)

“J works for the ABC LLP. He will receive a salary of £100,000 plus a bonus determined by a remuneration committee, at their discretion.

For the purposes of this legislation, the question is what are the terms governing the remuneration committee’s exercise of its discretion in determining the bonus payable. If the bonus is paid out of shares of the profit, then that is a share of the profit for the purposes of the legislation.

In this case, more information is needed - what are the terms of reference for the committee? How realistic is it that any profit share will be more than 25% of the fixed salary of £100,000 (such that less than 80% of the total rewards will be fixed salary).

A share of the profit of the business does not include a bonus by reference to the success of a particular sector, such as a shop, or how well an individual’s own client portfolio has done. It is by reference to the business as a whole.”

Example 2 (payments linked to an individual’s piece work or turnover vs. success of the business)

“W LLP operates sites offering “hand car washes”. The individuals who wash the cars are members of the LLP rather than being given contracts of employment. Member D washes cars at one of these sites. Member D is paid on a piece work basis; the more cars washed, the more he receives.

Member D will earn more if more cars come to be washed. However his income is based on his work, not the success of the business as a whole. Member D receives a disguised salary and Condition A is satisfied.”

Example 3 (personal performance vs. success of the business)

“The XYZ LLP decides to expand into a new business area. A new member, P, is recruited to run the new business area.

As it is expected that the new business area will initially make a loss, P will receive a guaranteed profit share of £100,000 plus a percentage of the turnover of the new business area.

Neither the guaranteed profit share nor the payment based on a percentage of the turnover of that business area is based on the profits of the LLP as a whole. Condition A is satisfied.

Condition A will be satisfied where the individual member receives a payment that is based on their own personal performance, rather than a share of the profits of the business as a whole. A bonus based on the performance of the individual is not a profit share. It is variable but is “varied without reference to the overall amount of the profits or losses of the limited liability partnership”

If a member is paid a fixed amount plus a bonus on the basis of the success of a particular branch or unit (but has no further reward), then Condition A is satisfied.”

Example 4 (guaranteed profits and non-repayable advance drawings)

“A is a member of the ABC LLP. Part of his reward package is that he is allowed drawings of £10,000 a month. Under the terms of the agreement he does not have to refund this, even if the LLP makes a loss.

A is treated as receiving a disguised salary of £120,000 as he will receive this irrespective of the profit of loss.

B is also a member of the ABC LLP. B can draw £10,000, but this is only an advance on his profit share. If the profit, after payment of non-refundable drawings of other members, is insufficient he will need to repay money to the LLP. If his share of profit is in the end more than £10,000 he will be entitled to a further payment.

B’s drawings are not a disguised salary. The timing of payments is not relevant to Condition A.

The key point is not how the payment is described; rather that it is a sum that the member expects to receive and will not in practice vary with the profit even if it is expressed to be linked to profit. It may be theoretically possible that a member is required to repay part of their drawings, or that the firm may make a loss, but if these are unlikely events, they will be ignored.

Here are some examples of arrangements which will be regarded as guaranteed profits:

- Member A is entitled to draw a salary of £10,000 a month.
- Member B is entitled to draw £10,000 a month. Under the terms of the agreement, he cannot be required to repay the money once drawn.
- Member C has a guaranteed profit of £120,000 a year.
- Member D is entitled to draw £10,000 a month. Realistically D will not be asked to refund this sum.

The reality is that all four members are entitled to £120,000; the level of profits does not affect this part of their reward package.”

Example 5: (significant influence)

“The Family Farm LLP has as members, a couple, A & B, and their adult son, X. The LLP Agreement has not been amended since before X was admitted. The way that the LLP operates in practice is that A, B and X all have a say in the running of the business, with A having a casting vote. Although the written agreement was not amended when X was admitted, the implied terms of the agreement under which X was admitted was that he would have a significant say in the business. As a result, Condition B is not satisfied and X is not a Salaried Member.”

Condition B: Significant Influence

“Some LLPs delegate management to a part of the membership. The LLP Agreement usually indicates what and how powers are so delegated.

If the members of the management committee effectively run the LLP, then Condition B will not be satisfied in respect of those members. Condition B will be satisfied for the remaining members, who are potentially Salaried Members.”

Condition C: Capital contribution

The Guidance states that “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 member.”

General Example from the Guidance

“Example 14: C LLP was founded by two individuals, A & B. A & B are entitled to the residual profits, make all the major decisions and they have invested all but a nominal amount of the capital. The other members receive a fixed monthly sum plus an annual discretionary bonus, typically 20% to 30% of the first charge.

The other members are all Salaried Members, satisfying Conditions A, B & C. Whilst the bonus is sometimes more than 20% of the reward package, this is a discretionary bonus, not linked to the profits. In addition, the individuals have no real influence and no capital contribution.

After a while, as had been the intention, C & D, two of the junior members, start to take on elements of the work done by A & B. As their terms have changed, the test needs to be applied again to C & D.

C & D will receive a lower monthly sum, and instead will receive a share of the profits. A reasonable estimate is that about 25 to 30% of their reward package will be in the form of a profit share. They will also take part in all major decisions.

C & D have sacrificed an entitlement to salary in exchange for the opportunity to participate in the business in much the same way as A & B the senior partners, even if as junior partners they are substantially rewarded by a fixed profit share. Conditions A and B are no longer met so C & D are no longer Salaried Members.”