ALERTS

UK Tax Authority Consultation on the Taxation of Partnerships

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HM Revenue & Customs ("HMRC"), the United Kingdom tax authority, has published its Consultation Document on proposed changes to the tax rules for partnerships. The Consultation Document is focussed in two areas: (i) preventing the avoidance of tax and national insurance contributions ("NICs") by the "disguising" of employees as members of limited liability partnerships ("LLPs"); and (ii) preventing LLPs from deriving a "tax advantage" from the use of a corporate member of the LLP.

Summary

The proposed changes will be relevant to all investment managers operating in the UK as LLPs, including US managers with UK subsidiaries who have frequently used the LLP as an entity by which to carry on their UK activities. Where an LLP is used, individuals engaged in the UK business may become members (partners) of the LLP, which gives a more favourable tax treatment than if the individuals were employees. It is also common to include a UK limited company (a corporate member) as a member of the LLP, so that some part of the profits of the LLP may be taxed at more favourable corporation tax rates, rather than at individual income tax rates. In some cases, LLPs have sought to achieve a more favourable tax treatment for individual members from the use of a corporate member, by allocating profits to the corporate member and subsequently enabling individual members, directly or indirectly, to receive a benefit from that allocation to the corporate member.

All investment managers structured as LLPs (including US managers with UK subsidiary LLPs) are likely to have to review their arrangements to determine compliance with the proposed changes. The position of individual LLP members should be considered carefully, to ensure that the membership terms of those individuals are not such that the individual is at risk of being deemed to be an employee of the LLP. Where one of the members of the LLP is a corporate member, the LLP will need to review the role and function of that corporate member, and consider to what extent it remains appropriate to allocate profits to the corporate member in the future.

Responses to the Consultation Document are requested by 9 Aug. 2013. The proposed new rules (with any changes to the detail of the proposals resulting from the consultation process) will take effect from 6 April 2014, with no grandfathering for arrangements entered into before this date.

Disguised Employment Relationships

The current tax rules treat individual LLP members as partners, even if the membership terms for individual members are such that their relationship with the LLP is equivalent to an employer/employee relationship. This partner status gives rise to income tax and NIC advantages for individual LLP members (since LLP members are required to account for income tax and NICs on their remuneration much later than they would if they were employees) and is also advantageous for the LLP itself. Because individual LLP members are treated as self-employed for tax purposes, the LLP is not required to pay Class 1 (employer's) NICs — currently a rate of 13.8 percent — in regard to an individual member's remuneration from the LLP. The only NIC charge applicable to individual LLP members is Class 4 NICs, which are charged at a rate of approximately two percent on the member's remuneration, the same rate at which an employee is subject to Class 1 (primary) NICs on remuneration from an employer.

HMRC proposes to remove this "presumption of self-employment" by classifying an individual LLP member as a "salaried member," where either one of two conditions (designed to identify situations where an individual's relationship with an LLP is tantamount to employment) is met. Where an individual LLP member is classified as a "salaried member," the individual LLP member will be treated as an employee of the LLP for all tax purposes, so that the LLP would be obliged to pay Class 1 NICs (including

13.8 percent Class 1 (employer's) NICs) in regard to the individual LLP member's remuneration. The LLP also would have an ongoing obligation to deduct income tax and Class 1 (primary) NICs from the individual LLP member's remuneration and account to HMRC for the amounts deducted, under the PAYE system.

The first condition states that an individual LLP member will be regarded as a "salaried member" where that individual, if the LLP had been a traditional partnership with two or more partners, would have been regarded as employed by that partnership (and not as a partner in that partnership). This is effectively a removal of any presumption of self-employment, which permits HMRC to apply its normal tests (as set out in HMRC's Employment Status Manual) to determine whether an individual should be regarded as employed or self-employed.

HMRC considers, however, that this first condition may not be applicable to certain individual LLP members whose relationship with the LLP is expressed in terms that are of a type found in a traditional partnership agreement, even if the practical effect of those terms is equivalent to employment. Accordingly, HMRC proposes a second condition under which an individual LLP member will be classified as a "salaried member" where that individual LLP member:

- Has no economic risk (loss of contributed capital or repayment of drawings) in the event that the LLP makes a loss or is wound up;
- Is not entitled to a share of profits (but receives only salary or other fixed compensation); and
- Is not entitled to a share of any surplus assets on a winding-up of the LLP.

The Consultation Document also proposes there should be a targeted anti-avoidance rule so that taxpayers are not able to circumvent the proposed changes by putting in place arrangements that are intended to have no practical effect other than to disapply the legislation. If, for example, an individual LLP member's terms provided that the member would be entitled to receive a 10 percent share of profits only if profits exceeded a figure that was, in reality, many times the actual turnover of the LLP, no account would be taken of these terms and the individual LLP member would be treated as not entitled to a share of profits.

HMRC does, however, confirm that these two conditions are not intended to apply to individual LLP members who, if the LLP had been a traditional partnership and not an LLP, would have been properly regarded as partners in that traditional partnership. The changes are not, therefore, intended to affect the status of members who carry on the business in common with a view to profit, who take risk in the business and who are to a significant degree rewarded on the basis of a share in the profits. It is also acknowledged that some persons may be taken on as members at an appropriate point in their career and may sacrifice an entitlement to salary in exchange for the opportunity to participate in the business in much the same way as a senior partner, even if as junior partners they are substantially rewarded by a fixed profit share.

Profit and Loss Allocation Schemes

It has become commonplace for LLPs (and other partnerships) to include among their members a limited company (a corporate member) which is liable to corporation tax on its allocation of profits from the LLP. Since the rates of corporation tax are generally lower than the income tax rate that is payable by individual LLP members, this ability to allocate profits to a corporate member can be used in a variety of ways to minimise the overall amount of tax paid by the members. For example, where profits are to be retained in the business and not distributed to the members, allocation of those profits to a corporate member allows profits to be invested in the business after being taxed at the lower corporation tax rate. HMRC is also aware of what it considers "tax-motivated arrangements" under which profits are first allocated to a corporate member, but then wider arrangements are put in place which result in those profits flowing to the economic benefit of individual members, in some cases in such a way that the individual members suffer no further tax on those profits.

HMRC proposes to counteract these arrangements by introducing measures applicable to "mixed partnerships" — partnerships where some of the members are subject to income tax (individual members) and others are subject to corporation tax (corporate members) — such that where there is an "economic connection" which enables individual members subject to income tax to benefit, directly or indirectly, from partnership profits allocated to corporate members subject to corporation tax, all or part of the profits allocated to a corporate member will be reallocated for tax purposes (on a just and reasonable basis) and treated as profits allocated to individual members. Individual members will

then be subject to income tax on the profits so reallocated to them for tax purposes.

Some interested parties (particularly in the banking and hedge fund sectors) have outlined to HMRC the use of corporate members to facilitate profit-deferral and staff-retention arrangements, where it may be considered to be unfair to tax profits on individual members in a period during which those individuals are unable to access those profits or while the profit allocation remains to some extent contingent. New regulatory rules on remuneration to be introduced under the EU Alternative Investment Fund Managers Directive ("AIFM Directive") may soon mean that LLPs that are alternative investment fund managers will be required to defer a portion of the remuneration of their individual LLP members. HMRC states that whilst the UK Government acknowledges these arguments, it considers that they do not override the risks of unfairness and market distortion. In particular, it is considered that allowing the use of corporate members for these purposes (or for the retention of working capital) would put those partnerships that do not have a corporate member in a disadvantageous position, such that the use of corporate members might become the norm resulting in overall tax loss.

Generally, it is clear that HMRC does not propose to limit the scope of the measures on the use of corporate members and profit and loss allocation schemes to what it considers "abusive tax avoidance schemes." HMRC intends that these new rules should also apply to the use of corporate members in what might in the past have been regarded as acceptable tax-planning arrangements, such as the use of a corporate member as a tax-efficient means of retaining working capital for use in the business or in deferral and retention arrangements.

The Consultation Document also sets out how HMRC intends to introduce counteracting measures in two other areas:

- The allocation of losses to individual members who pay a higher rate of tax; and

- The transfers of partnership interests (including income streams) between members with different tax attributes, whereby a more highly taxed member may agree to reduce his profit entitlement in return for a payment made by another member who will be more favourably taxed on those profits (e.g., a corporate member or a non-UK resident member).

Future Action

Although these proposed changes are set out only in a Consultation Document, it is highly likely that HMRC will introduce measures in both these areas. HMRC states that it is seeking responses on the detailed design and potential impact of these changes so as to inform the detailed policy design, and is not seeking comments on the substance of the measures themselves.

LLPs and their members should review their arrangements in both these areas. The position and membership terms of individual LLP members — particularly more junior members — should be considered to determine the risks of those members being treated as "salaried members" (effectively as employees) under the new proposals. It may be necessary to alter the terms of membership of certain individual LLP members to ensure that such members are subject to economic risk and have a genuine entitlement to share in profits of the LLP. In some cases, LLPs may conclude that it would be more appropriate for such members to become employees of the LLP.

LLPs with corporate members that are allocated a share of profits of the LLP will also need to review these arrangements and may have to vary their practice in the future. Where corporate members are used as part of more sophisticated tax planning arrangements (such as in member deferral or remuneration planning), LLPs may have to proceed on the basis that such arrangements are unlikely to be effective after April 2014, when the measures proposed in the Consultation Document are to be introduced.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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