

Partnership tax changes

HMRC consultation paper

HM Revenue & Customs ("HMRC") has today published its anticipated consultation document, proposing two significant changes to LLP and partnership taxation:

- Removal of the presumption of self-employment for LLP members
- Measures to tackle profit and loss allocation schemes

1. Membership vs. employment: current position

HMRC does not currently challenge the self-employed status of members of limited liability partnerships ("LLPs") and so members can expect to be taxed on their return from the LLP in their capacity as a member.

There is not much case law on the dividing line between whether an individual is an employee or member of a LLP. However, in the recent employment case of *Tiffin v Lester* the Employment Tribunal held that there were four characteristics of membership:

- a capital contribution by the member;
- a share in the profits of the firm;
- a share in the surplus assets on a winding up of the LLP; and
- a voice in the management of the affairs of the LLP

In that case, a member of an LLP who had made a modest contribution to the firm's capital and who had a limited right to participate in management decisions was found to be a member of the LLP, even though his profit share was guaranteed.

2. Removal of presumption of self-employment for LLP members

HMRC is concerned that individual members of a LLP are benefiting from being treated as self-employed partners even if, absent their LLP membership interest, the individual would be regarded as an employee.

HMRC wants to remove any tax presumption of self-employment for LLP members. Instead, a new category of "salaried member" will apply if either of the following conditions is met:

Condition 1: the individual member would be regarded as employed by the LLP, if the normal factors which would indicate an employer/employee relationship are present; or

Condition 2: the individual member bears no economic risk in the event that the LLP makes a loss or is wound up, their returns from the LLP are not profit dependent and the member would not be entitled to a share of surplus assets on a winding up.

A "salaried member" will be liable to income tax and primary (Class 1) NICs as an employee. The LLP will be liable to pay secondary (Class 1) NICs as employer.

A targeted anti-avoidance rule will be introduced to deter LLPs from introducing terms with a main purpose of falling outside of Condition 1 and 2 (such as a member being entitled to variable profits in circumstances which will almost certainly never occur).

3. Measures to tackle profit and loss allocation schemes

HMRC is alarmed that partnership profit sharing ratios are being shared between partners in such a way as to minimise the overall tax paid by the partners. Such arrangements typically involve mixed membership partnerships (a combination of individual and corporate partners) and exploit the difference between income tax and corporation tax rates.

The proposed measures apply to all types of partnerships (not just LLPs) and are intended to tackle three types of profit and loss allocation schemes:

- Profit allocations in mixed membership partnerships;
- Loss allocations in mixed membership partnerships; and
- Transfers between partners with differing tax attributes

The measures are broadly drafted and make few allowances for circumstances where the partnership or LLP can argue that the corporate member has an important commercial function. HMRC says:

"Although the Government acknowledges these arguments, it considers that they do not override the risks of unfairness and market distortion"

These proposals are based on an assumption that if a transparent vehicle is employed by an individual they should not be able to divert profits to a corporate member with which they have an economic connection. Instead they should 'suffer' transparency on all profits which could be attributed to them. Yet if a director held shares in a company he could defer a larger tax bill by only paying himself a dividend at a later date. Under the new rules the LLP seems to have the worst of both worlds. Lip service only has been paid to the AIFMD remuneration requirements.

Mixed membership partnerships – profits

This measure applies where, for example, profits are allocated to a company member rather than to an individual member and there is an economic connection between the company and the individual. If the profit sharing arrangements would not have been entered into but for a tax benefit then an adjustment will be made to attribute the profit back to the individual for tax purposes.

HMRC has not attempted to set out rules as to how the re-allocation might occur. The proposed rules simply state that it must be just and reasonable depending on the nature of the economic connection.

Mixed membership partnerships – losses

This change is aimed at arrangements which allocate partnership losses to members paying the highest rates of tax. If a main purpose behind any such loss allocation is to enable the partner who is allocated the loss to obtain a tax benefit (whether this is relief from income tax or capital gains tax) then the proposed counteraction is that no income tax loss or capital gains loss will be allowed.

This is very broadly drafted and does not require there to be an economic connection between the relevant partners.

Transfers between partners with differing tax attributes

This measure is targeted at schemes in which one partner pays another in return for a new or increased share of profits. If the transferor would have otherwise been taxable on the profits and a main purpose of the arrangements is to secure a tax advantage then HMRC proposes that the payment is charged to tax as income in the hands of the transferor partner.

In effect, this provision would supplement the existing rules which apply to sales of income streams through partnerships (and in effect reverse the exclusion in those rules for certain transfers of partnership interests).

4. Changes to loans to participators rules

In addition to the consultation document, changes to the loans to participators rules were announced in the March 2013 Budget which will make it less easy to fund LLPs and support increased regulatory capital.

A loan by a closely held company to a partnership or LLP will trigger a corporation tax charge where any person is both a participator in the company and a partner in the partnership. There is no tax avoidance motive requirement, meaning that the charge could apply to genuine commercial loans.

Secondly, the rules will be extended to cover untaxed extractions of value to participators where there is a tax avoidance motive. This new charge is also broadly drafted and HMRC acknowledges that there is an overlap with the changes announced today: the consultation document states that the measures tackling profit allocations will take priority over the rules aimed at untaxed extractions of value to participators.

5. Comment

There are many strong commercial reasons why a partnership or LLP might have a corporate member. The partnership or LLP might be established as part of a much wider corporate group or the LLP's business may have originally belonged to the company. HMRC acknowledges the commercial background behind these structures in the consultation paper, but makes few allowances for these kinds of situations.

By 2015, with the reduction in corporation tax, it will be marginally more efficient to have a corporate structure paying dividends rather than a tax transparent LLP.

The combination of these two proposed measures (and the changes to the loans to participators rules) will, if implemented, make LLPs far less flexible in terms of succession and financing. To date, the flexibility of vehicles open to asset managers has been one of the reasons behind the UK's success as a centre for fund management.

In March 2013, the UK Government published an outline of their investment management strategy, aimed at improving the UK's competitive position. There is clearly a tension between this policy and the changes announced today, which may lessen the attractiveness of the UK as a location for fund management.

6. Next steps

The closing date for comments is 9 August 2013. We intend to engage fully in the consultation process, and will keep you informed of any developments as soon as we become aware of them.

How to find out more

If you have any questions or would like to know more about how these issues may be relevant to you, please contact any of the contacts below.

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