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HMRC Turns Up the Pressure on UK LLPs

Following the announcement in Budget 2013, HM Revenue & Customs (HMRC) issued a consultation document on May 20, 2013 that focuses on two areas of partnership taxation where HMRC perceive "unintended inconsistencies":

- disguised employment; and
- corporate member planning.

HMRC is taking a hard line to shut down (albeit after a period of consultation) what it sees as an unfairness and a distortion of the U.K. tax system in connection with LLPs. The proposals are due to come into effect from April 6, 2014, and in their current form will have a wide impact, particularly in relation to partnership structures containing individual and corporate members — and potentially even where the reasoning for the corporate member is benign, *e.g.* it is present for regulatory or commercial deferred compensation purposes. In our view, it is likely that many of HMRC's proposals will remain intact.

Businesses structured as LLPs or other partnerships, particularly in the funds industry, should review their structures to understand the different possible impacts from these proposals. As no grandfathering is currently proposed, HMRC is likely to take swift action using the new provisions once the law is in force, albeit they claim that many of the existing "schemes" are already vulnerable under current law.

We set out below a summary of the proposals.

Disguised Employment

These proposals only apply to LLPs. LLP partners (known as members) are currently treated as self-employed and generally benefit from an automatic legal presumption on this point.

HMRC proposes to extend the employment tax rules to any individual member in an LLP who is a "salaried member", *i.e.* an individual member who is either:

- on the assumption that the LLP is carried on as a partnership by two or more members of the LLP, a person that would be regarded as employed by that LLP; or
- an individual member of an LLP who:
  - has no economic risk (loss of 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 the profits; and
  - is not entitled to a share of any surplus assets on a winding-up.

In relation to the latter condition, and taking into account all the circumstances and in particular the total economic rewards that are or could be available to the member in question, any risk or entitlement that is reasonable to regard as "insignificant" will be ignored. For these purposes, what is "insignificant" will be determined in light of all

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circumstances and in light of the total package of benefits derived from the partnership agreement, but in general an entitlement to a profit share that for practical purposes would never be more than 5 percent of any fixed entitlement is unlikely to be viewed as significant.

Salaried members will be subject to employee national insurance contributions (NICs), and their income tax will become collectable under Pay-As-You-Earn. The LLP will become liable for employee NICs at 13.8 percent.

It may be possible to manage the exposure of the disguised employment rules where individual members have the proposed minimum self-employment rights and take sufficient economic risks and have a sufficient entitlement to sharing in profits and assets. However, HMRC is proposing a targeted anti-avoidance rule (TAAR) "that will provide that in determining the tax status of the LLP member, no account would be taken of certain arrangements, the main purpose, or one of the main purposes, of which is to prevent the first or second conditions from being met." In addition, ignoring "insignificant" risk or entitlement will go some way to defeating artificial arrangements designed to circumvent the rules.

Corporate Member Planning

These proposals target structures where a partnership, including an LLP or a non-U.K. partnership, with a mixture of individual and non-individual partners, allocates profits or losses to a corporate member (or another member that does not pay U.K. income tax), and:

- where profits are allocated:
  - it is reasonable to assume that a main purpose of the partnership profit-sharing arrangements is to secure an income tax advantage for any person (this includes deferral of tax as well as a reduction in tax); and
  - a U.K. income tax paying partner has an "economic connection" with the corporate member (or other member that does not pay U.K. income tax) to which the profits are allocated, such that he/she can directly or indirectly benefit from the profits that are allocated; in which case
  - the profits allocated to the corporate member (or other member that does not pay U.K. income tax) will be treated as allocated for tax purposes on a just and reasonable basis to certain individual U.K. income tax-paying members; and
- where losses are allocated:
  - it is reasonable to assume that a main purpose of arrangements is to allocate a partnership loss to a partner in order for them to obtain a reduction in tax liability through income tax reliefs or capital gains relief; in which case
  - no income tax or capital gains tax relief will be given for the relevant partner's loss.

One example of a structure that HMRC is seeking to thwart is where individuals set up an LLP but include a corporate member who receives the bulk of the profits (the corporate members would pay tax at a lower rate on those profits than the individual members would have). The corporate member invests/retains the profits allocated to it in the LLP as additional partnership capital, which is in the future accessed by the individual members in a way that minimizes the tax charge.

The proposals also target profit transfer arrangements (broadly, where an individual partner subject to U.K. income tax transfers his/her right to profits to a partner that is not subject to U.K. income tax) where it is reasonable to assume that a main purpose of the profit transfer is to secure a tax advantage. Where the rules apply, the payment by the transferring partner is taxed as if it were partnership profit.

Commentary

The proposals have been a long time coming as HMRC announced some time ago its view that LLPs have been used to implement aggressive tax planning (sometimes poorly), and this has clearly been a source of aggravation.

In relation to the proposed new disguised employment rules, there may not be too much of a risk for LLP members if sufficient indications of self-employment have already been implemented, although the relative risks and rewards for each particular member have to be considered, as does the proposed TAAR. In particular, the amount of capital at risk is likely to be a live issue as it is well known that some LLPs only require a small amount of capital that may not even be paid in. As a general matter, we would recommend a thorough review of LLP documentation and related arrangements, and in some cases improvements can be made prior to the new rules coming into force, although we would not rule out some of the tests becoming disjunctive rather than conjunctive.

In relation to the corporate member planning, the timing of the proposals is interesting given that the Budget announced a general push for the U.K. to become a center of global funds' operations.

It is also interesting as a policy matter that HMRC is of the view that the imminent U.K. general anti-abuse rule may not catch certain schemes but that the TAAR should, because the schemes still represent "unacceptable tax planning" — a theme in today's politics.

In our view, there may genuinely be good reasons (and unfortunately no good alternatives) for financial services partnerships to implement long-term incentive planning, and it seems penal to us that such firms face a tax penalty as a result.

With the Alternative Investment Fund Managers Directive (AIFMD) due to come into force shortly, we expect strong representations from the asset management industry to HMRC to allow for some form of grandfathering or safe harbor (and maybe just permitting deferral if there is no tax advantage other than the deferral) where structures are seeking to create alignment of senior staff's incentives with fund investors' objectives. However, there is no doubt now that much close thought needs to be given to the motive behind any long-term incentive structuring, and perhaps managers will embrace AIFMD in a stronger way than they would otherwise have wished for. A wary eye must be kept though on this point, because HMRC appeared in its proposal document to be dismissive of many of the obvious regulatory reasons for such planning.

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