

U.K. Tax Alert

February 24, 2014

U.K. Partnership Tax Changes

Slightly later than first advertised, Her Majesty's Revenue & Customs (HMRC) has now issued further guidance regarding the employment status of members of U.K. limited liability partnerships (LLPs).

The revised technical note and guidance can be found [here](#).

In summary:

General

- the new rules will apply from April 6, 2014, and will only impact U.K. LLPs. HMRC is adamant that, despite the short timeframes, the new legislation will not be deferred

The Conditions

- the three limbed test is retained. All three tests have to be passed for an individual to be regarded as an employee for all U.K. tax purposes. It follows that if only one of the three tests is failed, then an individual member will continue to be taxed as self-employed
- the three tests continue to be, broadly, "proportion of *disguised salary*" (Condition A); "significant influence" (Condition B); and "substantial capital at risk" (Condition C). To repeat, if an individual fails just one of these conditions, as they have significant influence, for example, then they will continue to be regarded as self-employed for U.K. tax purposes
- it may well be the case (see below) that Condition B will become the test which most alternative asset managers find practical to fail. It should certainly be the test that is considered first

Condition A

- the new legislation will include the 80:20 ratio for determining if a member is reasonably expected to receive "significantly wholly" *disguised salary*. Previously, this ratio was just to appear in HMRC guidance. Broadly, if 20% or more of an individual member's reasonably expected payments from the LLP are not disguised salary then they will fail Condition A. As a result, they will continue to be taxed as a self-employed individual
- an amount is *disguised salary* if it is either:
 - fixed
 - variable, but varied without reference to the overall amount of the profits or losses of the LLP; and/or

- not, in practice, affected by the overall profits or losses of the LLP
- *disguised salary* does not include drawings if it is reasonable to assume that they are sums on account of a separate amount that is not itself disguised salary. In other instances, drawings could, for example, be regarded as “not, in practice, affected by the overall profits or losses of the LLP”
- HMRC has now stressed that “. . . personal performance can be a factor in determining entitlement to a profit share.” This will be welcome news for managers who use personal performance, such as performance of a specific fund managed, as a means of dividing up the overall profits of their LLP
- HMRC states that “. . . if the member is to be rewarded on a basis that takes into account the overall profitability of the firm, then Condition A will not be met even if the reward also reflects personal performance or the performance of the division in which he or she works.” HMRC is at pains, however, to stress that ‘divisions’ of a business cannot be insulated from each other
- HMRC draws an analogy between the overall profits of the business and a cake. Provided an individual’s share of the cake depends both on the size of their slice and the total size of the cake, then what they are expected to receive should not be disguised salary
- guaranteed payments may continue to cause difficulty for individuals hoping to fail Condition A. Similarly, HMRC considers that caps might also cause amounts to be regarded as disguised salary
- worryingly, HMRC also states that:
 - “ . . . if the bonus pool mechanism. . . is not fixed at the beginning of the year (so no percentage of profit is earmarked), but is decided at the discretion of a remuneration committee, there is unlikely to be a reasonable expectation of the amount at the beginning of the year. . . ”

Such variable amounts would not then be included when establishing if a member is expected to receive payments of which at least 20% are not disguised salary. If HMRC cannot be dissuaded of this view, to take precedent into account for example, it may raise difficulties for those otherwise relying on failing Condition A

- in a departure from comments made verbally by HMRC, the guidance states that:
 - “If the profits of the U.K. LLP are calculated on a cost-plus basis, then Condition A is satisfied as the level of profits vary with the rewards to the members rather than the members receive a reward that varies with the profits of the LLP.”

Those alternative asset managers currently adopting a cost-plus basis of transfer pricing may well struggle to have individual members fail Condition A

Condition B

- individuals regarded as having “significant influence” will include those “. . . senior members . . . who may have little interest in day-to-day management. . . but their roles and rights mean that they can exert significant influence over the business as a whole”
- HMRC included in its revised guidance a list of matters which having a significant influence over might mean that Condition B is failed. However they make clear that merely being able to vote, or to express a view, on such matters would be unlikely, in itself, to constitute significant influence
- HMRC is likely to accept that individual members authorised, by the Financial Conduct Authority (FCA), as CF3 (chief executive function) or CF8 (apportionment and oversight function) do not meet Condition B. While CF4’s (partner function) will be considered on their facts, HMRC does add that:

“In cases where the firm’s activities consist wholly or almost wholly of regulated activities and the individual in question significantly contributes to the firm’s major decisions (management, strategic or investment-related), then it is likely that HMRC would accept that this constitutes significant influence for the purpose of Condition C.”

Condition C

- as regards “substantial capital”, a commitment in place by April 6, 2014, to contribute capital within three months of this date will be taken into account in determining whether Condition C is met. Where an individual becomes a member on or after April 6, a two-month period will be allowed to provide the capital, again subject to there being a commitment to contribute the capital from the day of becoming a member

And Finally...

- formerly active members, who continue to receive a profit allocation, should be outside the scope of the new rules
- provided that the tests are applied reasonably, they are not revisited with the benefit of hindsight if it is found that any of the assumptions were incorrect
- the non-statutory business clearance procedure¹ will apply following the enactment of the new provisions. Managers may therefore be able to take their particular fact pattern to HMRC if sufficient uncertainty arises.

¹ <http://www.hmrc.gov.uk/cap/nscg.htm>

Contact Information

If you have any questions regarding this alert, please contact:

Jon Hanifan

jhanifan@akingump.com

+44 (0)20.7012.9708

London

Jonathan Ivinson

jvinson@akingump.com

+41 22.787.4035

Geneva

Thomas Lloyd-Jones

tlloydjones@akingump.com

+44 (0)20.7012.9636

London

Tim Pearce

tpearce@akingump.com

+44 (0)20.7012.9663

London

Ian Patrick Meade

imeade@akingump.com

+44 (0)20.7012.9664

London

David M. Billings

dbillings@akingump.com

+44 (0)20.7012.9620

London