UPCOMING CHANGES IN PARTNERSHIP TAXATION

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Draft Finance Bill 2014 includes a series of changes to the taxation of partnerships.

One of the changes is, for example, a set of rules which applies a punitive tax treatment to individual members of partnerships with mixed membership comprising both individuals and non-individuals (typically, but not necessarily, a company). This could be seen as part of a growing trend in review by HMRC of the taxation of partnerships following on, for example, from the announcement in October 2013 restricting the application of UK: UK transfer pricing rules to service companies wholly owned by partnerships.

However, of the range of new rules, the aspect of most widespread application will be the new rules defining those individuals who will continue to be taxed as partners and those individuals who, alternatively, will be taxed as so-called "Salaried Members".

Who is a partner and who is a "salaried member"?

The new rules are scheduled to take effect from 6 April 2014. They apply only to members of an LLP constituted under the Limited Liability Partnerships Act 2000.

The consequences of falling within the newly legislated definition of Salaried Member are that the individual is to be treated, for corporation tax, income tax and NIC purposes, as being employed by the LLP thereby bringing the individual into taxation under ITEPA 2003 in respect of all earnings from that deemed employment. The individual's earnings would be subject to employer's and employee's NICs and, as employer, the LLP would be obliged to operate PAYE thereon. Correspondingly, the LLP would be entitled to a tax deduction for any expenses paid by it in respect of the employment.

The construction of the legislative tests of Salaried Member status: conditions A – C

An understanding of the draft legislation starts with a recap of ITTOIA 2005 s 863 which treats the activities of a UK LLP as carried on in partnership by its members. This section has always been interpreted by HMRC as requiring all members to be treated as partners for tax purposes irrespective of the substance of their rights and obligations. The new legislation overrides that general rule if all of the three conditions are met. If all three conditions are met then the member is a Salaried Member for UK tax purposes.

The conditions can be summarised as follows:

(a) the member provides services to the LLP and is remunerated for those services to the extent of 80% or more by way of "disguised salary" the quantum of which does not vary by reference to the overall profitability of the LLP; and
(b) the member does not have significant influence over the affairs of the LLP; and
(c) the member's capital contribution to the LLP is less than 25% of his "disguised salary".

Condition A

"Disguised salary" is remuneration which is:

- fixed; or
- if variable, varies without reference to the overall amount of the LLP's profits or losses; or
- is not, in practice, affected by the overall amount of the LLP's profits or losses.

The test requires a review of the member's remuneration arrangements in place at 6 April 2014, and at any relevant subsequent dates. If, based on all relevant circumstances in their totality, it is reasonable to expect that 80% or more is "disguised salary" then the individual meets the first precondition, Condition A, of Salaried Member status.

HMRC's rationale for the third leg of the definition of "disguised salary" is to capture fixed prior shares of profit which are only payable if the LLP makes sufficient profits. If, at the time the arrangements were entered into, or on 6 April 2014, it is unlikely that anything less than the fixed entitlement would be paid then HMRC's position is that the fixed prior share is "disguised salary". This will often be the case for junior partners with a fixed prior profit share entitlement.

An interesting borderline scenario concerns junior partner profit pool arrangements whereby, in addition to their fixed profit share entitlements, junior partners are entitled to participate in a "bonus" pool of profits and where their share of that pool is determined at the year end based upon their personal performance. HMRC's guidance notes provide some examples as to how the dividing line is to be drawn between employee-type performance bonuses and genuine profit share which is performance based. The key is always to revert to the legislative test of whether – looking at the totality of the arrangements – the "bonus" award varies by reference to the LLP's profit or not. This is what profit share does. If a firm has a good year then, all other things being equal, the profit share is higher than in a year in which the firm's profitability is less good.

Condition B

In applying Condition B, HMRC's guidance states that they will focus upon an individual's strategic management influence over the affairs of the firm as a whole. They make clear that it is insufficient, by contrast, to have influence over the running of one's own department or division. For firms with large numbers of partners, it is likely therefore that only those in management positions and a minority of others will be considered to have significant influence.

HMRC have refused to be drawn on exactly what percentage influence is "significant" or, therefore, the maximum number of partners within a firm before its size precludes the possibility that every member might be accepted as having significant influence. One of their examples indicates that 20 partners with equal influence might, in the right circumstances, each be said to have influence which was "significant". However each case, and each individual, will have to be reviewed on the facts.

Condition C

HMRC announced on 21 February that the legislative definition of "capital" was to change and, to date, the revised legislative definition has not been published. This is likely to be available as part of the Budget 2014 press releases.

Also on 21 February, HMRC helpfully announced that the rules would be altered to permit a form of "period of grace" whereby, even if increased capital was not in place by 6 April 2014, it would be taken into account so long as (i) there is an unconditional requirement in place at 6 April 2014 for the capital to be contributed and (ii) the capital is in fact contributed within three months of that date.

The Targeted Anti-Avoidance Rules ("TAAR")

HMRC's revised guidance also provides some further commentary on when they will invoke the TAAR which allows them to ignore certain arrangements in applying the tests. This is however likely to be an area of continued uncertainty until a bank of experience is established as to how HMRC intend to apply these potential wide-reaching rules.

Practical implementation

HMRC's guidance remains limited in terms of clarification of practical points of implementation should an individual fall within the Salaried Member rules. In particular, despite encouragement from a number of partnership tax commentators and businesses, they have declined so far to comment on some of the international tax complexities inherent in this type of "hybrid" status or on the employment-related securities implications if an LLP owns shares or on the application of PAYE in the transitional accounting period. It is to be hoped that further examples and guidance will be published in due course alongside the updated legislation.