Tolley's Tax Digest

Partnerships: the changes in FA 2013, FA 2014 and FA 2015

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Detailed, expert guidance examining:

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- loans and benefits to participators;
- mixed partnerships;
- salaried members;
- incorporation of partnerships;
- anti-avoidance provisions;
- corporate partnerships and entrepreneurs' relief;
- and much more.

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Introduction

[1.1]

For many years the taxation of partnerships has been something of a poor relation in the tax code. While the mechanisms for assessment of partnerships and similar compliance issues are reasonably detailed, very little practical assistance is granted by the tax code on how to tax partnerships and a number of relatively ad hoc practices have arisen. Indeed, the entire scheme of taxation of partnership capital gains is governed by a Statement of Practice that has been with us for several decades (Statement of Practice D12) and, strictly, should be viewed as an extra-statutory concession (or several ESCs). So it came of something of a surprise to many people that there were major changes, first in Finance Act 2013 and then in Finance Act 2014 affecting the taxation of partnerships, with further changes to entrepreneurs' relief affecting partnerships in FA 2015.

This *Tax Digest* is intended to review the new rules for partnerships in the context of loans or other benefits to participators in FA 2013, the rules for salaried members and for mixed partnerships in FA 2014, and the new relating to partnerships and entrepreneurs' relief in FA 2015.

Loans and benefits to participators

Loans to participators: the background

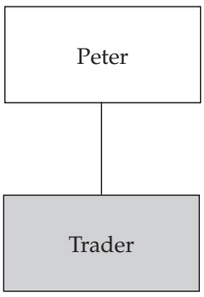
[2.1]

The loans to participators rules have been with us for as long as corporation tax and are designed to prevent the avoidance of tax by taking loans from companies, rather than dividends or salary.

Example 1

This demonstrates the mischief being targeted.

Figure 1



If Peter takes a salary, he will pay income tax and National Insurance contributions, and the company will also pay National Insurance contributions. If he takes a dividend, Peter will pay income tax and the company will effectively pay further corporation tax, as no deduction is due for dividends. However, absent any other legislation, Peter could take a loan from the company and there would be no income tax or National Insurance contributions due.

The loans to participators legislation prevents this form of abuse by imposing a tax charge on the company for as long as any loan remains outstanding. Furthermore, in most cases, Peter will also be a director of the company and there may be a charge under the benefits legislation, too, if no interest, or interest at a rate less than HMRC's official rate, is paid.

Loans to participators: the basics

The charge to corporation tax

[2.2]

The charge arises where a close company makes a loan or advance of money to an individual who is a participator in the company, or to an individual who is an associate of such a participator (CTA 2010 s 455(1)). Where such a loan is made, the company is required to pay an amount equal to 25% of the loan or advance, as if it were an amount of corporation tax chargeable on the company for the accounting period in which the loan or advance is made (CTA 2010 s 455(2)). This mechanism of charging ensures that the sum concerned is treated in all ways as if it were a corporation tax charge on the company, so that there is no need for separate compliance procedures, etc. The tax is generally due and payable nine months and one day after the end of the accounting period (CTA 2010 s 455(3)).

For these purposes, a loan or advance is also deemed to arise whenever a participator incurs a debt to the close company or a debt due from that person to someone else is assigned to the close company (CTA 2010 s 455(4)).

Definitions

Close company

[2.3]

A close company is a company controlled by five or fewer participators or by any number of directors who are participators (CTA 2010 s 439(2)). Alternatively, if five or fewer participators, or any number of director participators, are entitled to receive the greater part of the assets of the company were it to be wound up, the company is also close (CTA 2010 s 439(3)).

Participator

[2.4]

In general terms, a participator is a shareholder in a company, and we rarely have to look further than that.

However, the legislation extends the definition well beyond mere shareholders. Apart from shareholders, participators include any person having a share or an interest in the capital or the income of a company (CTA 2010 s 454(1)). The definition specifically includes any person with shares or voting rights in the company, anyone with a right to distributions by the company, loan creditors of the company, anyone with a right to amounts paid to loan creditors by way of premium or redemption, and anyone who can secure that the company's income or assets can be applied to that person's benefit (CTA 2010 s 454(2)). Furthermore, a participator includes anyone who has a right to acquire any of the rights referred to above (shares, voting rights, rights to distributions or amounts payable to loan creditors).

So the concept of a participator includes anyone with the sorts of rights that might be associated with a shareholding, even if they do not hold shares, and the sorts of rights associated with being a loan creditor, even if they are not actually loan creditors, and also includes rights which they may be entitled to acquire. Tying this together with the definition of a close company means that a company could be close, by virtue of rights which people who are not currently shareholders may be entitled to acquire in the future, so great care must be taken in the review of whether a company is close in considering any future rights. That said, of course, in 99% of cases we will simply be looking at the company and the holders of its ordinary shares and the situation will be relatively straightforward.

Associate

[2.5]

The loans to participators legislation also covers loans to associates of participators, which is another widely drawn concept. At its simplest, an associate of a participator includes any relative or business partner (CTA 2010 s 448(1)(a)). Relative means a spouse or civil partner, parent or remoter forebear, child or remoter issue, or any sibling (CTA 2010 s 448(2)). While widely drawn, this definition of a relative does not include uncles and aunts, cousins, in-laws, etc.

An associate also includes the Trustees of any settlement in relation to which the relevant person was a settlor, or in relation to which any relative of the relevant person was a settlor (CTA 2010 s 448(1)(b) or (c)). And if the relevant person is interested in any shares or obligations of a company which is subject to a trust, the Trustees of that settlement are his associates (CTA 2010 s 448(1)(d)).

If the participator is a company with an interest in shares or obligations of a company subject to a trust, then any other company with an interest in those shares or obligations is also its associate (CTA 2010 s 448(1)(d) and (e)).

If the person concerned has an interest in the shares or obligations of a company that is part of a deceased person's estate, the personal representatives are associated with that person. And if the relevant person is a company with an interest in shares or obligations of a company subject to an estate, any other company with an interest in those shares or obligations is an associate of the original company (CTA 2010 s 448(1)(f) and (g)).

Once again, these definitions are widely drawn and it is important to understand how they operate, but in the vast majority of cases, we are usually looking at whether, for example, there has been a loan to a close relative, such as a child or spouse, of a shareholder in a close company.

Timing and amounts of charge

[2.6]

The charge under CTA 2010 s 455 is 25% of the amount loaned or advanced. However, where all or part of the loan has been repaid, or released or written off, relief is given from the tax charge (CTA 2010 s 458(2)).

To the extent that the repayment or release has been made prior to the due and payable date, the tax, in effect, never becomes due or payable. While, strictly, a claim must be made for the relief to be due (CTA 2010 s 458(3)) within four years from the end of the financial year (NB not from the end of the accounting period) in which the repayment or release occurs, the usual practice is only to pay the relevant tax charge on the due and payable date, based on the amount outstanding at the end of the accounting period concerned less any amounts subsequently repaid. It is assumed that HMRC accept this as being an effective claim for relief.

This gives rise to the very common practice whereby directors will draw sums for living expenses throughout the accounting period and, once the accounts have been drawn up, bonuses or, more usually, dividends will be declared in such an amount as to clear the outstanding debt, so no, or less, tax is due and payable under CTA 2010 s 455(2). It was also not unknown for short-term loans to be taken out from a bank, sufficient to repay the loan just before the date nine months after the accounting period, which was immediately reversed nine months and two days after the end of the accounting period so that the bank loan could be repaid. This form of 'bed and breakfasting' was closed off by amendments in FA 2013 (in CTA 2010 ss 464C and 464D, but the details are beyond the scope of this *Tax Digest*).

Example 2

In Example 1, we saw that Peter took a loan of £100,000 from his company, which was close as he is the only shareholder. Let's say that this occurred in the accounting period ending 31 December 2014. The tax of £25,000 is due and payable on 1 October 2015.

However, when the accounts were prepared, the company had made a profit of £130,000, so a dividend of £100,000 was declared and credited to Peter's loan account with the company, wiping out the deficit. The accounts were prepared by the end of June 2015 and the dividend was formally declared and the relevant accounting entries made on 15 July, at the Annual General Meeting, which Peter attended at the company's accountants' office.

In respect of the year to 31 December 2014, therefore, no amounts were outstanding by 1 October 2015 and no corporation tax was due under CTA 2010 s 455(3).

Example 3

In an alternative scenario, when the accounts for the year to 31 December 2014 were prepared it was discovered that, due to an unexpected bad debt, the company's profits for the year had only been £80,000 after corporation tax, all of which was paid to Peter as a dividend, as before. In this case, however, £20,000 of the debt remained outstanding at 1 October 2015 and the company is due to pay £5,000 under CTA 2010 s 455(3).

If the loan or advance is repaid or written off more than nine months after the end of the accounting period, relief is given nine months and one day after the end of the accounting period in which the repayment or write-off occurred (CTA 2010 s 458(4) and (5)).

Example 4

Following the events in Example 3, Peter had drawn a further £100,000 in the year to 31 December 2015. It was noted that the profits for that year, after corporation tax, exceeded £150,000, so a dividend of £150,000 was formally declared to Peter at a general meeting during July 2016.

As a result, firstly, the company did not have to pay a further £25,000 under CTA 2010 s 455(3) on 1 October 2016, as there were no further net loans to participators in the year to 31 December 2015. Secondly, the company can now claim relief in respect of the £20,000 outstanding in respect of the year 31 December 2014. However, in this case, the repayment has occurred after the date on which the tax due in respect of the loan or advance in the year to 31 December 2014 occurred (i.e. on or after 1 October 2015), and has occurred in the company's accounting year ending 31 December 2016. So relief for that extra £20,000, i.e. repayment of the £5,000 tax, will not be given until 1 October 2017. In practical terms, of course, the amount concerned is usually set off against the corporation tax liability also due and payable on that date (in respect of the year ended 31 December 2016).

Remember, also, that the claim must strictly be made by 31 March 2021, i.e. within four years of 31 March 2017, being the financial year in which the loan was repaid.

Extension of loans to participators rules

The previous position

[2.7]

Prior to the announcement on Budget Day 2013, it was widely held that the loans to participators rules did not apply where the loan was made to a limited liability partnership (LLP) which a participator of a close company was also to be a member of.

In Figure 2 we see a commercial scenario we were asked to look at some years before the change of the legislation. Flopsy, Mopsy and Cottontail are the three equal shareholders of Coney Trading Ltd. They run a light engineering business from a small industrial unit on an out-of-town industrial park. Over a period of about six months, the units on either side of them became vacant and available to buy. Flopsy, Mopsy and Cottontail were considering expansion of their business and, with property prices relatively low at the time and their business being quite buoyant, they decided it would be a sensible investment to acquire these premises, and use them either for that future expansion or to rent out. However, in order not to taint the status of Coney Trading Ltd as a trading company, they decided to acquire the properties separately, through an LLP. They therefore set up Coney Property LLP, funded it with a loan from Coney Trading Ltd, and acquired the premises.

We took the view, in common with many advisers looking at similar situations, that a loan to a participator, given the definition of both participators and associates, did not include a loan to an LLP. The main thrust of the argument was that the LLP is a separate legal entity, being a body corporate, and it is not to be identified with the individuals or other legal persons who from time to time make up its membership. Had Flopsy, Mopsy and Cottontail formed an ordinary partnership (under the Partnership Act 1890), which is not a body corporate and does not have status as a legal person, it would have been more likely that, from a legal viewpoint, the loan by the company would be treated as a loan to its participators, on the basis that the legal approach would also be to look through the partnership to its members. But the status of the LLP as a body corporate and separate legal person meant, in our view, that the loan by the company was not, therefore, a loan to its participators.

The FA 2013 changes

[2.8]

HMRC say that they have always held a different view. And that view was legislated in FA 2013, so that for loans or

advances made on or after 20 March 2013, the date of the Budget announcement, the loans to participators rules were extended so that they now apply to loans to an LLP or other partnership, one or more of the partners in which is an individual who is a participator in the company or an associate of an individual who is a participator in the company (CTA 2010 s 455(1)(c)). There are two points that are immediately noteworthy.

- The loan in Figure 2, involving Flopsy, Mopsy and Cottontail, is not caught by the new rules, as the loan or advance was made well before 20 March 2013. Of course, if a further loan were to be made, this would be caught by the new legislation. If substantial amendments were made to the terms of the current loan, it is possible that these would, in and of themselves, constitute the making of a new loan, which might be caught by the new rules.
- The other important feature is that HMRC have, to some extent, focused on pre-20 March 2013 loans to LLPs and challenged these as being loans to participators. While this has not become a campaign by HMRC, so far as we are currently aware, it is important to remember that HMRC insisted and continues to insist that the extension of the loans to participators rules to encompass loans to LLPs is no more than clarification of the rules and is not, in their view, any form of extension. In other words, HMRC considers that loans to LLPs were always caught.

Planning

[2.9]

See **Figure 2** below.

The effect of the new rule will be to charge an amount under CTA 2010 s 455(3) in the circumstances shown in Figure 2, where the loan was made on or after 20 March 2013. The obvious planning, of course, would be form another limited company, rather than an LLP, to make the acquisition. Loans to another close company are not caught by the loans to participator rules generally although, in some cases, a charge might be imposed by CTA 2010 s 459 (which is outside the scope of this *Tax Digest*).

Problem areas

[2.10]

See **Figure 3** overleaf.

A major concern about the new rules arises if we inspect Figure 3. In this case, Flopsy, the relevant participator has a one third holding in the close company but only a small interest in the LLP. The loan is made on commercial terms and under purely commercial arrangements and the other members of the LLP are not members of the company. But they are associates of the relevant individual who is also a member of the close company, as they are Flopsy's business partners (CTA 2010 s 448(1)(a)). So a completely commercial loan made by a close company to a generally unrelated LLP will be caught by these arrangements in cases where, as here, a person is a minority participator in the company and a minority member of the LLP. This does seem to us to be a somewhat draconian result, and one which is arguably unrelated to the mischief that these rules are meant to prevent.

Figure 2

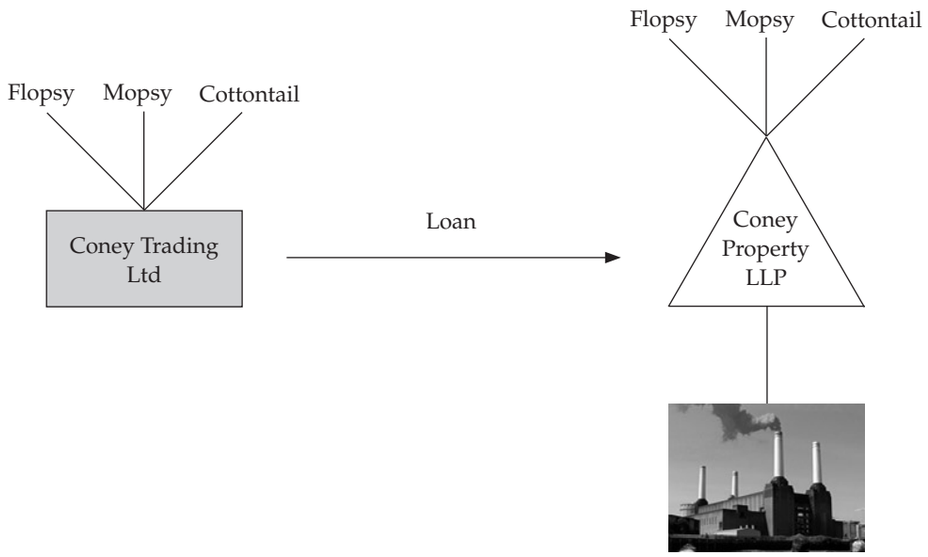
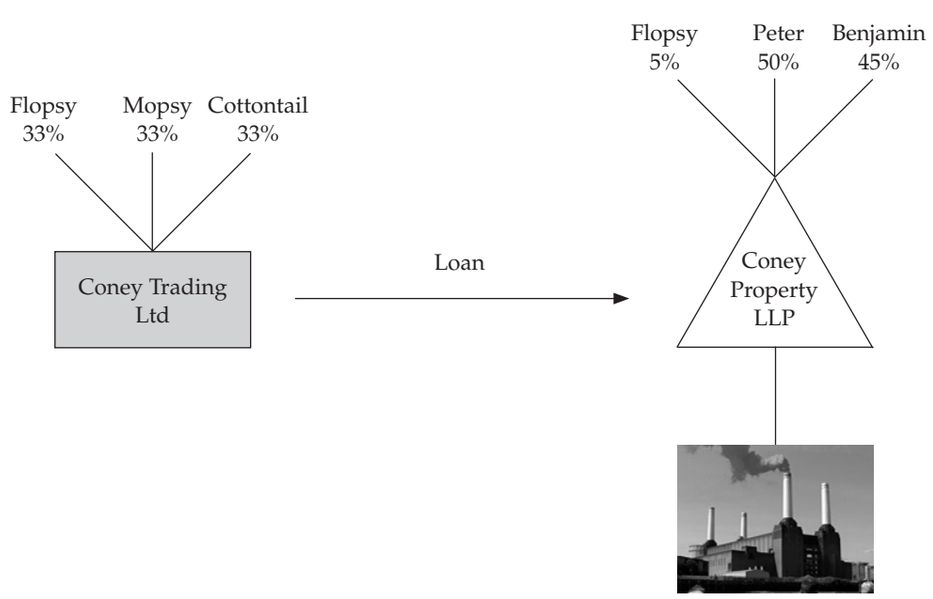


Figure 3



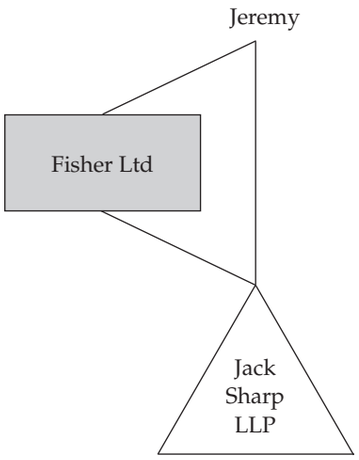
Benefits to participators

Background

[2.11]

Another new rule came into force on 20 March 2013 which is not specifically targeted at partnerships. However, in the discussion documents relating to this new legislation, the main example given by HMRC of what they saw as abusive behaviour was shown in Figure 4.

Figure 4



Here, we have a typical situation where an individual, Jeremy, forms a company, Fisher Ltd. Together, they then form Jack Sharp LLP. There are many sensible commercial reasons for these structures. For example, the individual might wish to have the protection of limited liability status in law. There is no such thing as a limited liability sole trader, so the only way to achieve this is to form a partnership with another person and, in many cases, this is best achieved by the use of a company which is already wholly owned by the relevant individual.

Another commercial reason in the professional world might be the ability to use the logos and designations of a professional body. For example, until recently, if the individual was a member of the Chartered Institute of Taxation, then the LLP would be entitled to refer to itself as a firm of chartered tax advisers and use the CIOT logo. However, if the individual was in partnership with another individual who had no professional qualifications, the LLP was not entitled to use the logo or designation. So there are strong commercial reasons for setting up these structures.

The mischief HMRC was concerned about can be explained by assuming that the intended split of partnership profits was 20% to Jeremy and 80% to Fisher Ltd. If the LLP made £100,000 profit in a period, Jeremy would be entitled to draw £20,000 of the profits and the company would be entitled to draw £80,000. HMRC was concerned about situations where Jeremy might draw, say, £30,000 and the company not draw any profits. While the company has effectively funded Jeremy's overdrawn account, by not drawing its own profits, there is clearly no loan to a participator, as the company has not made a loan or advance to Jeremy, and nor has Jeremy incurred a debt to the company. He may have incurred a debt to the partnership, but that is not the same thing. So HMRC took the view that this sort of scenario should be the subject of a charge similar to that in CTA 2010 s 455, and the relevant legislation is now in CTA 2010 s 464A.

The FA 2013 legislation

[2.12]

The new rule requires a close company to be party to tax avoidance arrangements, as a result of which a benefit is conferred on an individual who is a participator in the company or an associate of such a participator (CTA 2010 s 464A(1)). The rules apply whether that benefit is conferred directly or indirectly. Tax avoidance arrangements are arrangements whose main purpose, or one of the main purposes, is the avoidance or reduction of a charge under CTA 2010 s 455, or the obtaining of relief or increased relief from tax on that section, or any other tax advantage for the participator or associate (CTA 2010 s 464A(6)). So it can be seen that the charge is very widely drawn, and is certainly not restricted to the scenario outlined in Figure 4.

Indeed, one might argue that that scenario is not caught by the new rules as it might be perfectly acceptable for Jeremy to overdraw from the LLP and one might argue that Fisher Ltd is not, itself, party to the arrangements. It is not clear how this argument would sit with HMRC, who would almost certainly dispute the position, but neither is it clear that the example they gave of the mischief that they were trying to prevent is resolved by this new legislation.

If the benefit itself either gives rise to a tax charge on the company under CTA 2010 s 455, or alternatively gives rise to an income tax charge on the individual (as would be the case for salary or dividends), then there is no application of this new rule (CTA 2010 s 464A(2)).

Otherwise the charge is essentially identical to that of CTA 2010 s 455, being 25% of the value of the benefit conferred 'as if it were an amount of corporation tax chargeable on the company for the accounting period in which the benefit is conferred' (CTA 2010 s 464A(3)). There is no explanation as to how the value of the benefit is to be determined, although in most cases we assume that the benefit will be in the form of cash or amounts otherwise easily identified. The tax is due nine months and one day after the end of the relevant accounting period (CTA 2010 s 464A(4)), again the same as under s 455.

As might be expected, relief is to be given if the company is paid in respect of the benefit ('the return payment'), so long as the company gives no consideration for the return payment (CTA 2010 s 464B(2)). If the return payment is made prior to the due date for the corporation tax under CTA 2010 s 464A, the return payment reduces or eliminates the charge. If the return payment is made later than the due date, a repayment of tax paid is due nine months and one day after the end of the accounting period in which the appropriate payment is made (CTA 2010 s 464A(4) and (5)). The relief must be claimed within four years of the end of the financial year in which the return payment is made (CTA 2010 s 464B(3)).

Scope of the legislation

[2.13]

The way in which the concept of conferring a benefit is so widely drawn that it has led to concerns as to how wide this charge might be. For example, the author was made aware of a case where a company was considering reducing its capital and returning cash to shareholders. This is a capital transaction and one which is in no way connected to or indeed similar to the mischief that HMRC identified in relation to the benefits to participators rules. Nevertheless, the agents were worried that the cash return to the shareholders might constitute a benefit to which this legislation applied. In our view, this is a misplaced concern. We would suggest that a better answer is that a benefit under CTA 2010 s 464A must follow the principle of *ejusdem generis*. That is, given the way in which the legislation was enacted and the positioning of the legislation within the Act, a benefit under CTA 2010 s 464A is restricted to benefits that have some similarity to loans to participators under CTA 2010 s 455.

In other words the benefit must be something that, perhaps, confers a temporary financial benefit on the participator, might involve some apparently unwarranted extraction of cash from the company, and is capable of being reversed or returned or repaid. Of course, since this legislation is very new, we cannot be certain that this will be the line that HMRC would restrict themselves to.

Mixed partnerships

Background

[3.1]

This legislation was enacted in FA 2014 as part of a major attack on what were seen as structures to avoid tax in partnerships. In this case, the mischief relates to the allocation of profits between partners in a 'mixed partnership', being a partnership where the membership includes both individuals and non-individuals. The intention is to prevent tax avoidance by the allocation of profits to a non-individual partner that pays less tax, so reducing the overall tax bill of the partnership. The rules do, however, permit allocation of profits to non-individual partners where it is commercially pertinent to do so, although the rules are, arguably, unnecessarily complex.

A typical example of the mischief aimed is shown in Figure 4. If Jeremy owns Fisher Ltd and Jeremy and Fisher Ltd form a partnership, the normal rule would allocate the profits between the two on the basis of their profit sharing agreement (ITTOIA 2005 s 850). Suppose that the company makes £100,000 profit, to be allocated 60% to the company and 40% to Jeremy. Jeremy will pay income tax on £40,000 at a maximum tax rate of 20%, as well as paying Class 4 National Insurance contributions. The company will pay corporation tax at 20% (from 1 April 2015) on £60,000,

with no National Insurance contributions. Furthermore, if Jeremy extracts funds from the company by way of dividend, he will only pay tax at an effective rate of 25% on taking out the £60,000 and, again, no National Insurance contributions.

In contrast, if the entire £100,000 had been allocated to Jeremy, he would have paid some of his income tax at the higher rate of 40%, as well as more Class 4 National Insurance contributions. So the allocation of profits to the company has clearly saved tax and, unless there is a commercial justification for the company receiving those profits, the new legislations aims, instead, to treat Jeremy as being the recipient of the entire profits.

HMRC guidance

[3.2]

HMRC published guidance on these new rules on 27 March 2014, which can be found at www.gov.uk/government/publications/mixed-membership-partnership-aifms-and-asset-disposal-rules-legislation-day-technical-note-and-guidance. This guidance supersedes the version originally published with the draft Finance Bill clauses in December 2014, but does not yet appear to have been incorporated into any of the HMRC Manuals.

The guidance contains HMRC's views of the way the legislation is intended to operate and has many examples, some of which are used in this *Tax Digest*. Remember, however, that HMRC's views of the meaning and operation of the legislation may not always be correct. Do not be afraid to view the guidance critically and to challenge HMRC's approach, where you consider it necessary.

Entry conditions

[3.3]

For this legislation to apply the following conditions must be satisfied.

- a partnership must make a profit as computed under ITTOIA 2005 s 849;
- an individual, A, must have a profit share or no profits allocated to him for the period under ITTOIA 2005 s 850;
- a partner that is not an individual, B, also has a profit share for that period; and
- one of two conditions, X or Y, is met (ITTOIA 2005 s 850C).

A non-individual for these purposes is effectively defined as any partner of the firm that is not an individual (ITTOIA 2005 s 850C(6)). In Figure 4, the non-individual partner is a company, and tax is clearly avoided by virtue of the company having a lower tax rate. It is also possible for the non-individuals to be, say, a trust, although for there to be a tax saving the trust would *prima facie* have to be resident outside the UK, as UK trusts generally pay tax at higher marginal rates than individuals.

Conditions X and Y will be discussed in detail below but, broadly, consider whether the profits allocated to B are a deferred profit of A or whether A has power to enjoy those profits.

The effect of the legislation applying is that A's profit share is increased, on a just and reasonable basis, by the amount that one might reasonably consider to be A's deferred profit allocated to B, or profits allocated to B that A has the power to enjoy (ITTOIA 2005 s 850C(4)). If B is subject to UK income tax or corporation tax, B's profit share is reduced by a corresponding amount (ITTOIA 2005 s 850C(5) and CTA 2009 s 1264A) depending on whether B pays income tax or corporation tax.

Condition X

[3.4]

Condition X very simply requires that it be reasonable to suppose that B's profit share includes or comprises amounts that represent deferred profits of the individual member or members and, as a result, the profit share for the individual or individuals is reduced, as is the overall tax bill (ITTOIA 2005 s 850C(2)).

Deferred profits

[3.5]

While the concept of a deferred profit of the individual appears quite straightforward, it is further defined as including 'any remuneration or other benefits or returns' which would be provided to A but has been deferred including remuneration, etc. which would only accrue to A on the meeting of conditions whether or not these might ever be met (ITTOIA 2005 s 850C(8)(a)). This means, for example, where profits are held by a corporate member of a partnership to be distributed in due course to the individual partners, as and when their profit share has been determined, perhaps in the light of future events, it is not possible to defer the taxation of those profits in this way (except for special rules for alternative investment finance managers (AIFMs), see 3.22).

Taking a very simple case, in Figure 4, any profits allocated to Fisher Ltd are likely to be deferred profits for Jeremy to call on in due course. In which case, the profits will all be treated as being Jeremy's.

HMRCs guidance (at Example 1) refers to a deferred remuneration scheme, involving Kate, who is a member of XYZ LLP. She is awarded a bonus that is conditional upon the successful outcome of a project she has been involved

in. In the interim, the bonus is initially allocated to XYZ Corporate Member Ltd. HMRC's view is that this is a deferred profit arrangement, to which the new rules will apply, so that the profit is treated as Kate's profits immediately. The fact that the award of the profit share is conditional upon a future event does not alter the position.

What is somewhat worrying is that there does not seem to be a mechanism whereby Kate can claim back any tax if the profit share is not eventually awarded to her. If her profit share in a future period is reduced in a commensurate manner, the position might unwind that way. Otherwise, it may be necessary to claim an adjustment on the basis of cases such as *CIR v Gardner Mountain and D'Ambrumenil Ltd* 29 TC 69 or the more recent Upper Tribunal decision in *Martin v Revenue and Customs Commissioners* [2014] All ER (D) 01 (Oct), [2014] UKUT 429 (TCC).

It is also possible for profits to be allocated to a corporate member that represent the deferred profits of more than one member, possibly all the members of the partnership, with a view to allocation at a later date. These will be allocated to the individuals on a just and reasonable basis in such cases, on the basis that these profits, too, satisfy condition X (ITTOIA 2005 s 850C(8)(b)).

HMRCs Example 2 demonstrates this in the hypothetical Y LLP, with 50 individual members and a corporate member. In the first part of the example, it is suggested that the profits allocated to the corporate member will be tracked according to each individual's profit entitlement for the year and those profits will be made available to them to draw when they retire. In such cases, the tracked amounts will be chargeable on them under ITTOIA 2005 s 850C(4) under the new rules.

In the second part of the example, the amount any partner can take on retirement will be a matter for discussion at that time. In that case, the profits must be allocated for assessment on the individuals on a just and reasonable basis, as required by ITTOIA 2005 s 850C(8)(b).

Reduction of tax

[3.6]

It is important to remember the requirement that the overall result must be a reduction in the overall tax charge. Specifically, the 'relevant tax amount' must be less than it would have been, as a result of the deferred profit arrangements (ITTOIA 2005 s 850C(2)(b)). The relevant tax amount is the sum of the tax that would have been paid by the individual and non-individual members on their income as members of the firm (ITTOIA 2005 s 850C(9)). We assume that this does not take National Insurance contributions into account, as these are not generally considered to be tax.

As noted, this means that partnerships involving UK trusts are unlikely to be caught, simply because UK trusts invariably pay income tax at the highest possible rate, currently 45%, so it is unlikely that there would be any tax saving.

Similarly, even with a corporate member, as in Figure 4, allocating profits to Fisher Ltd may not trigger Condition X. If the partnership is making a profit of less than £52,985 (at 2015/16 rates), any allocation of profits to Fisher Ltd would actually increase the tax bill, as the overall income tax charge, taking into account the personal allowance (£10,600) and the basic rate band (£31,785), comes out to less than the 20% rate of corporation tax. And if there are more individual partners involved in a profit deferral arrangement, the numbers increase. So it is important to check the numbers before assuming that Condition X applies. If Condition X does not apply, because there is no overall tax saving, then Condition Y cannot apply, either, as it has an identical requirement (see 3.8).

Condition Y

[3.7]

Generally, if Condition X is not in point, Condition Y must be considered (unless, as mentioned above, there is no overall tax saving).

Entry conditions

[3.8]

Condition Y has four components (ITTOIA 2005 s 850C(3)):

- B's share must exceed the 'appropriate notional profit'. The 'appropriate notional profit', which is the aggregate of the 'appropriate notional return on capital' and the 'appropriate notional consideration for services' (ITTOIA 2005 s 850C(10));
- A must have the power to 'enjoy' the profit share attributed to B;
- it must be reasonable to suppose that the whole or part of the profit share allocated to the non-individual is attributable to the fact that the individual or individuals can 'enjoy' those profits; and
- the profit shares of the individuals and the overall tax charge must be lower than they would be if A could not 'enjoy' the profit share of B (this is identical to the requirements of Condition X, see 3.6).

The essence of Condition Y is to permit a non-individual member to have a profit share related to the commercial contribution that it makes to the earning of those profits. In genuine arm's-length cases, as we shall see, it is likely that there will be no restriction on the profits allocated to the non-individual member.

Appropriate notional return on capital

[3.9]

As noted above, the 'appropriate notional profit' is the aggregate of the 'appropriate notional return on capital' and the 'appropriate notional consideration for services'. The appropriate notional return on capital is defined as being the return on capital which the non-individual member could reasonably expect for their contribution to the partnership, calculated by reference to the time value of money at a commercial rate of interest, and taking all the circumstances into account (ITTOIA 2005 s 850C(11)(a) and (12)). We must subtract any amounts actually received by the non-individual in respect of that contribution. In other words, the profit share that can be allocated to the non-individual member is a reasonable rate of interest on the capital less any interest actually paid by the firm as such.

The contribution to the firm to be taken into account is given by ITA 2007 s 108 (ITTOIA 2005 s 850C(13)), and is the amount of capital which the non-individual member has contributed, less amounts previously received or drawn back, amounts that B draws out or receives back within five years of the time we are looking at, amounts that the member is entitled to receive or draw back whilst still a member of the firm, or amounts which may be reimbursed to the firm. This effectively forces the non-individual member to have a capital account with the partnership, alongside any current account it may have, on which it is not entitled to draw, in order to establish a contribution on which a reasonable rate of return might be allocated.

HMRCs example on this point (Example 3) is also not terribly helpful. It refers to a company, B Ltd, that has invested £10,000 in ABC LLP and is not paid any interest on this amount. ABC LLP apparently is able to borrow from the banks at an interest rate of 2%, because it is a good borrower, so HMRC tells us that 2% is an appropriate commercial rate of interest to apply to the capital contribution from the company, so that the appropriate notional return in this context to the corporate member would be £200 per year.

With respect, this is an absurd answer. It is highly likely that a loan to an LLP by the banks is, for example, secured on personal assets of the individual members, or indeed on assets of the partnership itself, and it is generally given on very formal and prescriptive terms, in return for the relatively low rate of interest (anyone in business during 2014 or 2015 would consider this an absurdly low rate of interest). In contrast the contribution by the company to the firm is likely to be unsecured, not payable within any particular period of time albeit notionally probably repayable on demand, such that it might be perfectly reasonable to suggest a much higher rate of interest on the basis that the risk associated with an unsecured loan with no specific repayment terms is much greater.

In this case, we would certainly propose that HMRCs example is simply incorrect on any sensible analysis.

Appropriate notional consideration for services

[3.10]

The 'appropriate notional consideration for services' is the arm's-length consideration which the non-individual would receive for any services that it provides to the firm during the relevant period, on the assumption that it is not a partner in the firm, less any amounts actually received for such services (ITTOIA 2005 s 850C(15) and (16)). HMRC's guidance suggests that this will usually only involve the cost to the non-individual in providing those services plus a modest mark-up, although they clearly also accept the possibility of an arm's-length charge for services.

In HMRC's Example 5, we have a corporate member of a farming LLP which has a general trade of leasing equipment to farms. HMRC accepts that the appropriate notional consideration for services provided by that company as a member of the partnership would be the arm's-length consideration that it would charge third parties for the same services provided to them. This must be the correct answer.

In Example 6, HMRC has a farming partnership where the corporate member of the partnership owns some of the land from which the farming trade is carried out. No other services are provided in the example, and no rent is actually paid. It is accepted that the appropriate notional consideration for services would be the arm's-length rent for the land.

If a market value rent were being paid, this would be the company's recompense for the use of the land and there would be no appropriate notional consideration for services.

The author had a similar example arise when the legislation was first published, where two siblings were farming some land in partnership with their father's Will Trust, where the same question came up. So HMRC's example when the guidance was eventually published was helpful. Having said that, the non-individual in that case was a UK resident trust. This means that there was no reduction in the tax bill by virtue of sums allocated to the trust, as it pays income tax at the highest possible rate on consideration received, so the new legislation would not have been invoked, in any case.

Where services are also provided by a member of the firm as well as by the non-individual, the services are to be ignored (ITTOIA 2005 s 850C(17)).

HMRC's Example 4 has ABC LLP with B Ltd as a corporate member providing advertising services for the LLP. The work is actually carried out for B Ltd by an individual, A, who is also a member of the partnership. In these circumstances, the contribution is ignored and there is no appropriate notional consideration for services.

The contrast with Example 5, above, is that the services in Example 5 are genuinely provided by the company, which has a real trade apart from its membership of the partnership.

Power to enjoy

[3.11]

Condition Y only applies if A has the power to 'enjoy' B's profit share. There are several parts to this test.

Connection

[3.12]

A can 'enjoy' B's profit share, if A is connected with B (ITTOIA 2005 s 850C(18)(a)), within the meaning of the standard definition of connection in ITA 2007 s 993. For these purposes, ITA 2007 s 993(4), which states that persons are connected if they are in partnership, is ignored. Clearly, given the nature of these provisions overall, all members of mixed partnerships would be connected with each other by virtue of ITA 2007 s 993(4), so, unless we are required to ignore the provision in looking at whether persons are connected for these purposes, A would always have the power to enjoy these profit shares under such circumstances!

Looking at Figure 4 again, Jeremy is connected with Fisher Ltd, on the basis of controlling the company (ITA 2007 s 993(6)), and is thus defined as having the power to enjoy the company's profits. HMRC's Example 10 is identical.

Example 5

Conversely, we came across a scenario (which mirrors HMRC's Example 11), where two dentists decided to go into partnership. Prior to that, one of them, Jemima, operated as a sole trader and the other operated through a limited company, Puddleduck Ltd. Clearly, if they went into partnership, they would be a mixed partnership, with an individual and a company carrying on a dental practice. However, at least in the context of connection, since Jemima is not connected with Puddleduck Ltd, there is no question of this test of enjoyment applying to this partnership.

Arrangements to secure corporation tax treatment

[3.13]

The second enjoyment test is whether A is party to arrangements which have a main purpose to secure that B's profit share is chargeable to corporation tax, not income tax, or is subject to the corporation tax rules rather than the income tax rules (ITTOIA 2005 s 850C(18)(b)). Arrangements, as always in these sorts of provisions, 'includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable)' (ITTOIA 2006 s 850C(19)).

HMRC's guidance explains that this is targeted at schemes designed to allocate profits to corporate partners that can then access specific reliefs to reduce their corporation tax liabilities, such as R&D allowances, amortisation of goodwill, etc. The guidance does not contain any examples, although it does state that this provision does not postulate any economic connection between the parties.

It is noticeable that this provision is very widely drawn. If we refer to our Example 5, both will be party to arrangements to ensure that an appropriate proportion of the profit accrues to Puddleduck Ltd. But, of course, we are only likely to be looking at this test if the amount of profit allocated to Puddleduck Ltd is in excess of the appropriate notional profit, which is itself unlikely.

Enjoyment conditions

[3.14]

Finally, we need to see if any part of B's profit share is subject to any of the enjoyment conditions (ITTOIA 2005 s 850C(18)(c)). These are (ITTOIA 2005 s 850C(20)):

(a) any part of B's profit share is dealt with by any person has to be calculated at some time to enure for the benefit of a, whether or not in the form of income;

(b) the receipt or accrual of B's profit share to increases the value of asset of A or for A's benefit;

(c) A receives or is entitled at any time to receive any benefit provided or to be provided (directly or indirectly) out of B's profit share;

(d) A may become entitled to the beneficial enjoyment of B's profit share, if one or more powers are exercised by a person;

(e) A can in any way control the application of B's profit share, directly or indirectly.

In the above enjoyment tests, A is to be read as including any person connected with A (apart, of course, from B) (ITTOIA 2005 s 850C(21)).

These enjoyment tests are taken directly from the legislation relating to the transfer of assets abroad. They essentially refer to any way in which A is advantaged or potentially advantaged by the receipt or accrual of profits to the non-individual member of a partnership.

For example, in Figure 4:

- any profit received by or accrued to Fisher Ltd increases the value of that company, which is an

asset owned by Jeremy, satisfying ITTOIA 2005 s 850C(20)(b);

- Jeremy could exercise his power at any time to vote a dividend from the company, so satisfying section ITTOIA 2005 s 850C(20)(d); and
- as the 100% shareholder, Jeremy can control the application of Fisher Ltd's profit share, satisfying ITTOIA 2005 s 850C(20)(e).

Conversely, looking at our Example 5, above, Jemima has no interest in or power over Puddleduck Ltd, so she satisfies none of the enjoyment conditions.

HMRC's Example 14 is helpful in explaining when the enjoyment conditions would not apply.

We have an LLP comprising three individuals and X Plc. One of the individuals owns shares in X Plc as part of a share portfolio, and other received shares under an incentive scheme when she used to work for X Plc. There are no arrangements by which those individuals can benefit from the profit share of X Plc and it would not be reasonable to suppose that the small shareholdings by those individuals have in any way influenced the profit share that X Plc is allocated.

It might be true to say that profits allocated to X Plc have the potential to increase the value of the shares held by the two individuals, but the example highlights the fact that this must still link in with the other tests for condition Y to apply. In other words, is it reasonable to suppose that the profits are allocated to X Plc because the individuals had any power to enjoy those profits? Clearly not, as their small shareholdings would not give them such power over X Plc. Therefore, the guidance states that HMRC would not consider condition Y to apply in these circumstances.

Counteraction

[3.15]

To counteract the mischief targeted by these provisions, A's profit share must be increased by the amount that it is reasonable to suppose was allocated to B as either A's deferred profit, or attributable to A's power to enjoy the excess over the appropriate notional profit. The increase in A's profit share is determined on a just and reasonable basis (ITTOIA 2005 s 850C(4)). There can be no double counting, so that it is not possible to increase A's profit by an amount of deferred profit and again because that profit exceeds the appropriate notational profit. And the amount of increase in A's profit share by virtue of its power to enjoy cannot exceed the excess over the appropriate notional profit for B.

Also to avoid double taxation, if B is an income tax payer its taxable profits under ITTOIA 2005 ss 850-850B are to be reduced by amounts that are just and reasonable to take into account the increase in profits to A (ITTOIA 2005 s 850C(5)).

Where B pays corporation tax, CTA 2009 s 1264A has the same effect in adjusting the profits calculated under CTA 2009 ss 1262-1264, making such adjustments as are just and reasonable to take into account the increase of profits charged on A under ITTOIA 2005 s 850C(4).

If the accounting periods of the company are not co-terminus with that of the partnership, adjustments of the corporation tax profits are to be made for all accounting periods in which the relevant period of account falls (CTA 2009 s 1264A(2)(b)).

Anti-avoidance: cases involving non-individual partners

[3.16]

There is a separate set of provisions (at ITTOIA 2005 s 850D), which apply where a partnership consists only of non-individuals, with the persons who might otherwise have been partners acting through those non-individuals. Typically, this would be a partnership of companies each wholly owned by an individual who one might assume would otherwise have been a partner, directly.

Gateway provisions

[3.17]

These provisions apply if (ITTOIA 2005 s 850D(1)):

(a) an individual, A, personally performs services for the firm at any time during a period of account;

(b) if A had been a partner throughout the period of account, A would have had a profit under the calculation under ITTOIA 2005 s 849;

(c) a non-individual partner, B, has a share of that profit, calculated according to ITTOIA 2005 s 850 and, if relevant, ITTOIA 2005 s 850A (ITTOIA 2005 s 850D(7));

(d) it is reasonable to suppose that A would have been a partner in the firm but for the new rules at ITTOIA 2005 s 850C;.

(e) one of conditions X or Y is met.

It is assumed that condition (d), above, is met if A is a member of a partnership associated with the firm during the relevant period of account (ITTOIA 2005 s 850D(8)). An associated partnership is one which is a member of the firm or is a member of another partnership which is associated with the firm (ITTOIA 2005 s 850D(9)).

In the above provisions, partnership includes a limited liability partnership (ITTOIA 2005 s 850D(10)).

Avoidance of ITTOIA 2005 s 850C

[3.18]

The crucial point is ITTOIA 2005 s 850D(1)(d), the requirement that it be reasonable to suppose that A would have been a partner directly, had it not been for the mixed partnership provisions at ITTOIA 2005 s 850C. This has a number of interesting consequences. First, any partnership set up in this way before the provisions were enacted, or at least before any of the detail was announced, cannot be caught. A person cannot be said to have set up a structure, as described by ITTOIA 2005 s 850D, in order to avoid anti-avoidance rules that did not exist at the time the partnership was set up.

Since the legislation came into force on 5 December 2013, albeit only with effect from 6 April 2014, we believe this means that structures in place by 5 December 2013 are grandfathered.

This is borne out by HMRC's Example 29, where the individual members of a firm decided to replace themselves with wholly-owned corporate members, instead. HMRC suggests that, even though implementation was not until 12 December 2013, the agreement to do so prior to the publication of the new rules means that ITTOIA 2005 s 850D could not be invoked.

We have also come across a number of commercial structures, often relating to various kinds of fund management, which are invariably partnerships made up only of companies, often wholly owned by brokers or small grounds of brokers. This seems to be the standard commercial structure for a number of these fund management arrangements. Even if such a structure were set up today, we suggest that these structures are set up purely for the commercial benefits, and not because of the existence of the provisions at ITTOIA 2005 s 850C. Therefore, again, we suggest that ITTOIA 2005 s 850D would not apply to such structures.

Conditions X and Y

[3.19]

Conditions X and Y are identical to the eponymous conditions in ITTOIA 2005 s 850C (ITTOIA 2005 s 850D(2), (3), (12) and (13)).

Counteraction

[3.20]

For the purposes of ITTOIA 2005 s 850D, A is treated as being a partner in the firm throughout the relevant period of account and is, unsurprisingly, to be treated as having a share of the partnership profit as it is reasonable to suppose is attributable to profits allocated to B representing A's deferred profit or profits which A has the power to enjoy, again on a just and reasonable basis (ITTOIA 2005 s 850D(4)). Again, there is to be no double taxation, such that A can only be allocated a maximum of the excess profits allocated to B over the appropriate notional profit and cannot be charged on both that and an amount of those profits treated as being deferred profits of A. A's profit share calculated in this way is charged to income tax under the income tax rules for the tax year in which the relevant period of account of the partnership ends.

Also to avoid double taxation, if B is an income tax payer its taxable profits under ITTOIA 2005 ss 850-850B are to be reduced by amounts that are just and reasonable to take into account the increase in profits to A (ITTOIA 2005 s 850D(5)).

Where B pays corporation tax, CTA 2009 s 1264A has the same effect in adjusting the profits calculated under CTA 2009 ss 1262-1264, making such adjustments as are just and reasonable to take into account the increase of profits charged on A under ITTOIA 2005 s 850D(4). If the accounting periods of the company are not co-terminus with that of the partnership, adjustments of the corporation tax profits are to be made for all accounting periods in which the relevant period of account falls (CTA 2009 s 1264A(2)(b)).

Preventing double taxation

[3.21]

Clearly, without any further provisions, it is possible for a mixed partnership to have allocated profits to a company, but for the individual member of that partnership to have paid income tax in respect of those profits. If that individual then extracted profits from their company, this would probably be charged to income tax as a distribution from the company.

There are, however, provisions in place to prevent such double taxation (ITTOIA 2005 s 850E). These provisions apply if there has been allocation of profits to the individual member or members under ITTOIA 2005 ss 850C(4) or 850E(4), there is an agreement in place in respect of that part of the non-individual's profit share, as a result of that agreement a payment is made to the individual, or any other person, out of that excess profit share, and the arrangements do not have a main purpose of obtaining a tax advantage for any person (ITTOIA 2005 s 850E(1)). In such cases, as far as the income tax payer is concerned, the amount paid is not income and is not a distribution. The company cannot take this sum into account, however, in calculating any profits or losses or deducting it from any income (ITTOIA 2005 s 850E(2)).

As always, arrangements include any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable) (ITTOIA 2005 s 850E(3)).

Interestingly, while 'arrangements' is defined, 'agreement' is not. The wording, however, is similar to that for

payments for group relief (CTA 2010 s 183), and HMRC has been known to insist that there be some evidence of an agreement to make such payments before accepting that a payment for group relief is to be ignored for tax purposes. So, if taxpayers decide to follow this approach with mixed partnerships, a formal agreement might be advisable.

Commencement

[3.22]

The new legislation officially came into force on 5 December 2013, but essentially only affects tax liabilities for periods of account beginning on or after 6 April 2014, subject to the transitional provisions .

The mixed partnership rules at ITTOIA 2005 ss 850C and 805D have effect for periods of account beginning on or after 6 April 2014, with appropriate impact in respect of ITTOIA 2005 s 850E and CTA 2009 s 1264A (FA 2014 Sch 17 para 12(1)).

If a period of account of a firm straddles 6 April 2014, the period must be split into two notional accounting periods, and the new legislation applied to the period from 6 April 2014 to the end of the period of account (FA 2014 Sch 17 paras 12 and 13(3) and (4)).

Mixed partnerships: solutions

Incorporation

[3.23]

The most common solution has been to incorporate the business, usually into the existing corporate partner. Prior to announcements made on 3 December 2014, it was often the case that people would, in fact, sell their business to the newly incorporated company, rather than using then incorporation relief at TCGA 1992 s 162. This would then create a debt outstanding from the company, representing the value of the business transferred in. If that business was a trade, the vendor (i.e. the individual members of the partnership) would only pay capital gains tax at 10%, assuming they qualified for the entrepreneur's relief. However, to the extent that the assets sold for the company constitute goodwill, entrepreneur's relief will no longer be available, following the changes in FA 2015 (see Part 5, below).

As a result, most incorporations have used the incorporation relief at TCGA 1992 s 162. Incorporation by transferring the rest of the trade or business to the existing corporate member might not be seen as strictly qualifying for relief under TCGA 1992 s 162, as that provision strictly requires that the whole of the business be transferred to a company, which cannot be possible if the company already owns part of the business. HMRC responded to the Chartered Institute of Taxation on this point, however, in May 2014, just after the legislation came into effect. They 'would, subject to all the other conditions being satisfied, accept that section 162 can apply to the individual members where an LLP transfers its business to the corporate member in exchange for shares in the corporate member. Section 59A(1)(b) [TCGA 1992] treats any dealings by the LLP as those of its members so the transfer of its business by an LLP will be treated as a transfer by its members'.

This advice specifically related to LLPs. However, we note that TCGA 1992 s 59(1)(b) is worded in a very similar way, in respect of ordinary partnerships, to TCGA 1992 s 59A, which applies to LLPs. We would anticipate, therefore, that HMRC would take a similar view in respect of the incorporation of such partnerships.

The only difficulty we have occasionally come across is where the partnership includes property or, indeed, is perhaps a property investment partnership. In those cases, it is important to ensure that the relevant conditions in FA 2003 Sch 15 are satisfied to prevent a charge to Stamp Duty Land Tax arising.

In a sense, this legislation is almost worthless, as the vast majority of cases that we have dealt with have involved mixed partnerships with companies, and the incorporation of those partnerships. So we have these lengthy provisions to stop avoidance by allocating profits to a corporate member, which simply have the effect of driving the partnership into incorporation, so that 100% of the profits are allocated to the company! If this is the future of anti-avoidance legislation, to drive people into lower tax solutions, then one cannot help feeling that HMRC has somewhat missed the point.

Do nothing

[3.24]

Other clients have decided to leave things as they are, except that the individual will be taxed on the profits of the partnership, and extract funds later from a corporate partner, relying on ITTOIA 2005 s 850E so that no subsequent tax charge arises. As noted above, we would always advise that a formal agreement be put in place between the corporate member and the individual or individuals, so that HMRC cannot challenge the efficacy of such arrangements, on the basis that there is no agreement.

Amend partnership agreement

[3.25]

In other cases, the partners have simply agreed to amend the partnership agreement, so that the corporate member has no rights to profits in the partnership. There is no requirement in the Limited Liability Partnership Act 2000 for a person who is a member of an LLP to also be entitled to share in the profits or capital of that partnership. This point is a little more difficult for ordinary partnerships, as the partnership exists only so long as the relationship between the parties described in s 1(1) of the Partnership Act 1890 is in place: 'persons carrying on

a business in common with a view of profit'. If the corporate member no longer has any rights to share in any profits, gains or capital of the partnership, and is completely inactive, and contributes no capital to the partnership, can it be said that the company and the individual are carrying on a business in common? This is a difficult legal point, but if they cannot, then a partnership between a company and an individual would effectively dissolve if the corporate member's share is reduced to nothing. So it might be better either to incorporate the business completely, or to incorporate an LLP, first, before reducing the company's share to nil.

Excess loss allocation

[3.26]

This part of the mixed partnerships rules is designed to prevent the excess allocation of losses to high taxed individual partners, rather than to low taxed non-individual partners. Again, of course, it is obvious that this is largely directed at partnerships including companies, as the allocation of losses to individuals could save tax at up to 45%, in contrast to the 20% rate for corporation tax. HMRC's guidance explains: 'In a typical case, arrangements are made between a company and wealthy individuals, where the individuals will contribute funding to a business venture in return for the losses generated in the early years of the partnership, perhaps through capital allowances. The losses will be less valuable to the company than to the individuals, who are taxable at higher income tax rates. When the business becomes profitable, the individual members will have their contribution returned and they will withdraw from the partnership.'

The main provisions

[3.27]

The main provision for trading losses is at ITA 2007 s 116A. Put simply, this rule states that if in a tax year, an individual, A, makes a loss in trade as a partner in a firm and A's loss arises wholly or partly, directly or indirectly in consequence of, or otherwise in connection with, relevant tax avoidance arrangements, then no relevant tax relief may be given for A's loss (ITA 2007 s 116A(1) and (2)).

Definitions

[3.28]

Relevant tax avoidance arrangements are arrangements to which A is a party, and the main, or one of the main, purposes is to secure that the trading losses are allocated or otherwise arise in whole or in part to A, rather than to someone who is not an individual, so that A will obtain the relevant loss relief. (ITA 2007 s 116A(3)).

References to A are to include references to A and other individuals, too, so it is about transferring the trading losses from a non-individual member to the individual member or members of a partnership. That said, the legislation also states that it does not matter if the non-individual is not, in fact, a partner in the firm, or indeed is an unknown person or does not exist (ITA 2007 s 116A(5)). We understand that this is directed at some of the more aggressive tax planning schemes.

Relevant loss relief means sideways relief, carry forward loss relief (ITA 2007 s 83), terminal loss relief (ITA 2007 s 89) and capital gains relief. And arrangements means any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable). Both of these definitions are at ITA 2007 s 116A(6).

The provision applies to professions as well as to trades (ITA 2007 s 116A(7)).

Example and impact

[3.29]

HMRC's manual only has one example (Example 24) explaining how the restriction might apply. The suggestion is an LLP with 100 individual members and one corporate member. The individual members each introduce £40,000 and the corporate member provides £60 million, giving a total of £100 million. (This is quoting directly from the example, as the arithmetic is clearly incorrect and it should probably show each individual contributing £400,000.)

The example goes on to show the LLP spending £100 million on an asset that qualifies for 100% allowances in the year of acquisition, albeit with a significant income stream into the future. The partnership agreement provides that the profits or losses of the first year are all allocated to the individual members, and for subsequent years all or most of the profits or losses are allocated to the corporate member. The example suggests that this is an arrangement simply to ensure that the losses arising from the acquisition of the asset and the tax write-down are all allocated to the individuals, in which case the new legislation applies.

The effect is to deny relief for those losses for the individuals concerned.

It also appears from the way the legislation is written, and the interaction with the general rules for allocating profits and losses, that any losses that are purportedly transferred to the individual members in these circumstances are, in fact, completely lost, on the basis that the losses have been formally passed to the individuals, under the partnership agreement. So the non-individual member cannot reclaim the losses that are not to be used by the individuals and use them itself, as there is no mechanism for them to be allocated to that non-individual.

Loss allocations in property businesses

[3.30]

There is an identical rule preventing excess loss allocation to partners who are not individuals in a UK property business

or an overseas property business in a mixed partnership. The legislation, in ITA 2007 s 127C, is almost exactly word-for-word the same as ITA 2007 s 116A, apart from replacing references to trading losses, etc. with references to losses in a UK property business or an overseas property business.

In this provision, relevant loss relief refers to carried forward property loss relief (ITA 2007 s 118) or property loss relief against general income (ITA 2007 s 120).

Commencement

[3.31]

The new legislation officially came into force on 5 December 2013, but essentially only affects tax liabilities for periods of account beginning on or after 6 April 2014, subject to the transitional provisions.

Both sets of new rules apply for losses of 2014/15 and later years. Where a period of account straddles 6 April 2014, the losses of that period are to be apportioned on a time basis and the Excess Loss Allocation Rules will apply to that proportion of the loss arising on or after 6 April 2014. If this method of apportionment gives an unjust and unreasonable result, another method that provides a just and reasonable result can be used, instead (FA 2014 Sch 17 para 14).

Alternative Investment Fund Managers (AIFMs)

[3.32]

AIFMs were required, for regulatory reasons, to leave funds within the partnership prior to allocation to individual members. These sums were subject to performance conditions, and cannot be accessed until and unless the conditions are satisfied.

Historically, this was achieved by having a corporate partner where the unallocated profits were 'parked' until they could be allocated. This now has tax implications, given the mixed partnership rules explained above. New rules have been enacted to deal with this issue, although the simplest approach would surely have been to give AIFMs a derogation from the mixed partnership rules. The detailed treatment of AIFMs is outside the scope of this *Tax Digest*, but we include the following précis. The rules are at ITTOIA 2005 ss 863H to 863L and apply for tax years 2014/15 onwards.

Unallocated profits are allocated to the firm, which is treated as if it were a partner. Those profits are excluded from the profits chargeable to income tax on the individual partners and charged to income tax at the additional rate, currently 45%. The profits to which this provision applies must represent variable remuneration, being either deferred or upfront remuneration vesting in the form of instruments with a retention period of at least six months, and it must be awarded in accordance with the 'Guidelines on Sound Remuneration Policies under the AIFMD' issued by the European Securities and Markets Authority on 3 July 2013 (ESMA/2013/232).

The AIFM firm has to elect for the new rules to apply within six months of the end of the first period of account for which the election is to have effect.

Once the remuneration vests on the relevant individual partner, the partner is treated as receiving those sums as remuneration in the year in which they vest, so long as the person is still carrying on an AIFM trade, although not necessarily as a partner in the AIFM firm. The person is then treated as receiving the allocated profit net of tax, plus the tax on those profits that has been paid by the AIFM firm by the time of vesting, and credit is then given for that income tax in determining the partners' personal income tax liabilities for the year.

If the allocated profit vests in an individual partner when they are no longer carrying on the AIFM trade, they are treated as receiving income, but not trading income, equal, again, to the amount of profit allocated and the tax on that profit, so far as paid by the AIFM firm. Once again, credit is given for the tax already paid.

Class 4 NICs are only chargeable on vesting.

The legislation is silent as to the treatment if the remuneration never vests in the partners, perhaps because performance targets are not met. HMRC's guidance states that such non-vesting is ignored for both tax and NIC purposes. No further income tax is payable by the firm, but none is repayable, and no Class 4 NIC can be collected.

Disposals through partnerships

[3.33]

These rules are directed at avoidance where assets or income streams are effectively disposed of tax free by the use of partnerships. The detailed treatment of these is outside the scope of this *Tax Digest*, but we again include a précis.

There are new rules applying to disposals of income streams and to disposals of assets.

Disposals of income streams through partnerships

[3.34]

The new rules are in ITA 2007 ss 809AAZA and 809AAZB for income tax payers and apply to arrangements made on or after 6 April 2014. For corporation tax payers the new rules are in CTA 2010 ss 757A and 757B and apply where arrangements are made on or after 1 April 2014. The two sets of rules are essentially identical and are similar to the existing rules for the disposals of income streams by individuals.

The income tax rules apply if:

- there are arrangements involving a person who is within the charge to income tax (the transferor) and another person (the transferee);
- there is a disposal of a right to relevant receipts by the transferor to the transferee;
- that transfer is wholly or partly by or through a partnership; and
- at any time the transferor is a member of the relevant partnership or of a partnership associated with it, and the transferee is a member of the relevant partnership or of a partnership associated with it (although they do not have to be members of those partnerships at the same time).

There must also be a main purpose behind at least one of the steps effecting the disposal that is the obtaining of a tax advantage for any person. These provisions do not apply, however, if the transferor is the spouse, civil partner, brother, sister, ancestor or lineal descendant of the transferee. However, the spouse/civil partner exemption only applies if they are living together.

A partnership is associated with another partnership if it is a member of that partnership or a member of a partnership associated with that partnership and references to transferor and transferee include persons connected to either of these.

If the disposal of relevant receipts by the transferor satisfies all these conditions, then the relevant amount is treated as income of the transferor and is charged to income tax in the same way as the relevant receipts would have been chargeable to income tax or brought into account as income, but for the disposal.

As noted, the corporation tax rules are more or less identical, applying to persons within the charge to corporation tax on income, and so on.

Disposals of assets through partnerships

[3.35]

The new rules are in ITA 2007 ss 809DZA and 809DZB for income tax payers and apply to arrangements made on or after 6 April 2014. For corporation tax payers the new rules are in CTA 2010 ss 779A and 779B and apply where arrangements are made on or after 1 April 2014. The two sets of rules are essentially identical.

The income tax rules apply if Conditions A and B are met. Condition A is that in consequence of or in connection with arrangements involving a person within the charge to income tax (the transferor) and another person (the transferee) there is, in substance, a disposal of an asset by the transferor to the transferee, by or through a partnership. Again, the transferee and the transferor must both be members of a relevant partnership or a partnership associated with it, although not necessarily at the same time. Again, there has to be a main purpose of obtaining a tax advantage and there is the same exception for spouses, civil partners and other relatives.

Condition B is that it is reasonable to assume that, had the transferor disposed of the asset directly to the transferee, the relevant amount would have been chargeable to income tax as income of the transferor or brought into account in calculating their profits for income tax purposes.

If these conditions are satisfied, then, once again, the relevant amount is treated as income of the transferor, chargeable to income tax or brought into account as income in calculating their profits as they would have been had the disposal not occurred.

As noted, the corporation tax rules are more or less identical, applying to persons within the charge to corporation tax on income, and so on.

Salaried members

Background

[4.1]

The other major change to partnership tax legislation in FA 2014 was the new rules relating to so-called salaried members of LLPs. These are also only relevant to LLPs and the problem largely arises because a person who is a member of an LLP cannot also be an employee of that LLP (LLPA 2000 s 4(4)). In HMRC's view, this position has been abused at 'both ends of the spectrum'.

At one end, it is understood that large numbers of low paid employees, such as the office cleaning staff of a large office cleaning company, might have formed themselves into LLPs. This absolves the main company from the responsibility of having large numbers of employee, of being required to operate PAYE, etc. At the same time, those members of the LLP were being hired by the company to do exactly the same work and being paid in exactly the same way at the same hourly rate. So there was very little economic difference in their positions.

The main difference as far as the cleaners was concerned was that no tax was deducted from their pay, their National Insurance contributions were lower as self-employed people, and they only had to account for tax and National Insurance contributions twice a year. The company, of course, did not have to account for employer's National Insurance contributions, as well as not having to operate the PAYE system. So there was not just a deferral of income tax, but an absolute loss of tax in the reduced National Insurance contributions. Furthermore, in this scenario it

seems highly likely that a proportion of these low paid workers would not, in fact, have saved sufficient funds to pay the tax bills twice a year, so there was probably a further absolute loss of tax through that lack of funds, too.

At the other end of the spectrum, HMRC was concerned that the high paid partners in many larger partnerships, and HMRC specifically pointed to professional partnerships, such as accountants and lawyers, were effectively highly paid employees and not partners on any sensible economic analysis. At first glance, one might ask why this is any different from a general partnership (i.e. a partnership that is governed by the Partnership Act 1890). But the partners in a general partnership have unlimited liability for the losses of the partnership. So if HMRC challenge the status of a partner in a partnership that is not an LLP, regardless of how much that person might look like they are in fact an employee of the partnership, their legal relationship with the partnership and the other members is that all of their personal assets are at risk if anything goes wrong with the partnership as a whole. This is such a fundamental difference from the relationship between an employer and an employee that HMRC was not generally able to assert that that person should be treated as an employee.

In contrast, of course, the whole point of an LLP is that the partners have limited liability in respect of the debts or losses of the firm, limited generally to the amount of capital they have contributed to the partnership or any amounts they have promised to contribute in a winding-up. Generally speaking, that contribution does not extend to being the whole of their personal assets, so the major distinguishing feature that was often found between being an employee and being a partner is not, generally speaking, present in LLPs.

HMRC also point out that the Partnership Act 1890 has the effect of requiring the relationship between the parties to be considered in determining whether or not there is a partnership. Specifically, s 1(1) of that Act states that a partnership is the relation that subsists between persons carrying on a business in common with a view to profit. In contrast, to become a member of an LLP, you merely have to subscribe to membership with a view to carrying on a lawful trade. That is, none of the 'normal' characteristics of partnership need to be present.

Overall, these reasons combine to explain why HMRC has enacted this new legislation.

HMRC guidance

[4.2]

HMRC published guidance on these new rules on 27 March 2014, which can be found at www.gov.uk/government/uploads/system/uploads/attachment_data/file/298724/Partnerships_Salaried_member_rules.pdf. This guidance supersedes the version originally published with the draft Finance Bill clauses in December 2014, but does not yet appear to have been incorporated into any of the HMRC Manuals.

The guidance contains HMRC's views of the way the legislation is intended to operate and has many examples, some of which are used in this *Tax Digest*. Remember, however, that HMRC's views of the meaning and operation of the legislation may not always be correct. Do not be afraid of viewing the guidance critically and to challenge HMRC's approach, where you consider it necessary.

Structure of the legislation

[4.3]

The structure of the new legislation is conceptually simple. There are three conditions, A, B and C, which must be met by an individual, M, who is a member of a limited liability partnership that carries on a trade, profession or business with a view to profit (ITTOIA 2005 s 863A(1)). If that person, M, satisfies all three conditions, they are to be treated as being an employee of the LLP under a contract of service, and any rights or duties as a member of the LLP are to be treated as rights or duties under that contract of service (ITTOIA 2005 s 863A(2)).

The corporation tax legislation is also amended (by the insertion of new CTA 2009 s 1273A) to ensure that, for corporation tax purposes as well, the salaried member is treated as being employed by the LLP under a contract of service, and his rights and duties as a member of the LLP are treated as rights and duties under that contract.

While this is very straightforward in application, it is not obviously fair. It will be appreciated that these are purely tax provisions, which means that you may have a partner in an LLP being taxed as if they were an employee, but since they are still actually a member of an LLP, they are subject to the terms of the LLP agreement. They do not therefore have any of the normal protections afforded by law to employees.

Our overall experience is that relatively few people are actually affected by this legislation (although, to be fair, our experience is unsurprisingly related much more to the professional services end of the spectrum), but, anecdotally, we have heard that a small number of people who are caught by this legislation have resigned from the LLP of which they were members, in order to become employees again, so that they would have access to the legal protections available to employees.

Condition A

[4.4]

Condition A is met if, at the relevant time, it is reasonable to expect that at least 80% of the amount payable to M

during the 'relevant period' under 'relevant arrangements' in respect of their performance of services in their capacity as a member of the LLP will be 'disguised salary'.

Disguised salary

[4.5]

Disguised salary is defined as being amounts which are fixed, or which are variable but not by reference to the overall profits or losses of the LLP, or which are not, in practice, affected by the overall amounts of those profits or losses (ITTOIA 2005 s 863B(3), step 2).

Looking at this a slightly different way, to avoid satisfying condition A, it is important that the individual concerned should expect to receive remuneration as a member of the LLP calculated so that more than 20% of their income could reasonably be expected to be based on those overall profits. At first glance, a test applied by reference to the overall profits of a partnership looks like a reasonable measure of whether somebody has a relationship that looks like a partnership, taking a share of the risks and rewards of that partnership business. Indeed, being remunerated according to a share of the profits of a partnership is a prima facie indication of being in partnership under PA 1890 s 2(3).

But it is not clear why HMRC insist that the test can only be failed by reference to the overall profits of the partnership, and not by reference to profits of various divisions of the partnership. For example, we could imagine a partner in a national firm in, say, the Leicester office. That person's remuneration may all be by reference to shares of profits, but there may be components made up of a share of the overall profits of the Leicester office, a share of the Midlands regional profits, a share of the profits of, say, the tax discipline regionally and/or nationally, and a final component that may be related to the overall profits of the partnership. In this case, even though the person is remunerated only by reference to the profits of various parts of the business, it is only the component related to the overall profits of the business nationally that counts towards the more than 20% required to fail condition A.

Example 6

We are aware of a national firm that awards its partners points for their various roles within the firm, and for their performances within those roles. The total profits for a year are then divided by the total number of points that have been issued to the partners to come up with the partner remuneration in the form of pounds per point. For example, if I hold 150 points and the profits of the firm are such that each partner receives £2,000 per point, I will receive £300,000. In this case, it is clear that every partner is remunerated by reference to the overall profits of the firm. (This is similar to HMRC's Examples 10 and 12).

In contrast, HMRC's Example 27 involves W LLP, which operates sites offering 'hand car washes'. The individuals who wash the cars are members of the LLP, not employees. Member D washes cars at one of these sites. Member D is paid on a piece work basis, so that the more cars washed, the more he receives. His income is based on his work, not on the success of the business as a whole, so Member D receives a disguised salary and Condition A is satisfied.

In HMRC's Example 28, XYZ LLP decides to expand into a new business area. A new member, P, is recruited to run the new business area. As it is expected that the new business area will initially make a loss, P will receive a guaranteed profit share of £100,000 plus a percentage of the turnover of the new business area.

Neither the guaranteed payments (which may be called 'guaranteed profit share') nor the payment based on a percentage of the turnover of that business area is based on the profits of the LLP as a whole. Condition A is satisfied for the duration of the remuneration arrangements, whatever level of income he receives.

HMRC also provides a number of examples to demonstrate other aspects of disguised salary, such as payments based purely on personal performance, guaranteed payments, and so on.

Relevant arrangements and the capacity test

[4.6]

The disguised salary must be paid under relevant arrangements, being arrangements for payments to be made to M by the LLP in respect of M's performance in their capacity as a member of the LLP (ITTOIA 2005 s 863B(2)). In other words, the disguised salary must be part of M's remuneration for being a member of the LLP, which imposes a capacity test. Thus, a person must fail condition A, and cannot be a salaried member, if they are receiving remuneration but are not providing services to the LLP, and are not expected to, or where remuneration is paid by the LLP to them in a capacity other than that of a member.

Arrangements, as always, includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable) (ITTOIA 2005 s 863B(5)).

In HMRC's Example 5, X used to be an active member of JKL LLP but effectively retired a number of years ago. In recognition of his contribution, however, he remains a member of the LLP and is allocated a profit share annually. Since this is not amounts paid in respect of his services as a member of the LLP, because he is not providing any services, he necessarily fails condition A.

Similarly, HMRC's Example 6 shows how the same argument applies to somebody who is paid to commute a

period of garden leave. One again, such a payment would clearly not relate to the provision of services as a member of the LLP, so condition A is failed.

HMRC's Example 7 demonstrates the necessity for the remuneration to derive from the services provided to the LLP. An LLP is formed between a family and a local developer to develop some land. Kate is a member of the family, and also a member of the LLP, but the LLP agreement does not require her to do any work for the LLP. Her profession is as an architect, and the LLP engages her to provide professional services as an architect to draw up plans for the LLP, for which she charges an arm's length fee under her normal professional terms of engagement. Whilst she is providing services to the LLP, she is clearly not providing services as a member of that LLP. Therefore, condition A is not engaged.

Similarly, HMRC's Example 8 has an individual renting land to a farming LLP of which he is a member. The LLP pays an arm's length rent to him for the use of the land. These amounts are not paid in respect of any services he provides to the partnership as a member of the partnership, and condition A is, once again, not engaged.

Furthermore, HMRC also highlight that, were that person to otherwise be determined to be salaried member, the rental income would also not comprise part of their earnings from the employment, as it arises from the entirely separate source of renting the land.

Benefits

[4.7]

The condition specifically refers to amounts to be paid to the member of the LLP. HMRC states in their guidance that this means that any benefits provided by the partnership to the members of the LLP will be disregarded in this respect. However, if the person concerned is determined to be a salaried partner, any benefits supplied will be taxed as the benefits of an employee, in the normal way.

Relevant time and relevant period

[4.8]

Condition A is a forward-looking test, as is clear from the phrase 'reasonable to expect' in the description of the condition. Expectation clearly implies that one looks at the beginning of a period and asks what the likely outcome is during that period.

Initially, we are required to consider condition A at the following times (each of which is, accordingly, a relevant time (ITTOIA 2005 s 863B(3)):

- if relevant arrangements are in place, on 6 April 2014 or at the later date when the individual concerned becomes a member of the LLP (ITTOIA 2005 s 863B(1)(a));
- at any later time when relevant arrangements are put in place or modified (ITTOIA 2005 s 863B(1)(b));
- where condition A has previously been considered and the relevant arrangements do not end and are not modified by the end of the relevant period, we must also revisit the position at the end of the relevant period.
- Condition A then requires us to determine the relevant period, which is the period from the relevant time to the time when it is reasonable to expect that the relevant arrangements will end or be modified (ITTOIA 2005 s 863B(3), at step 1).

We are then required to look at the level of disguised salary that it would be reasonable to expect, under the relevant arrangements, during the relevant period.

Simplifying this slightly, we are required to make a determination in respect of condition A when a person becomes a partner (it is clearly too late to be considering 6 April 2014), when the remuneration arrangements for that partner are put in place or modified or when it might reasonably be anticipated that the existing arrangements would expire, and we need to make a reasonable prediction of how that member will be remunerated over the relevant period.

HMRC's guidance is helpful in explaining that this means that the 'relevant period' can be more than a year (and, by inference, presumably can be less than a year, too).

HMRC's Example 2 has John being a member of an LLP which entered into an agreement to develop a property over three years. John will receive a fixed profit share of £100,000 for each of the first two years and be paid 50% of the profit from the development, when it matures in year 3. This latter amount is expected to be £500,000.

The relevant period is therefore the three years during which these relevant arrangements subsist. Clearly, looking forward from the beginning of this agreement, the fixed element of John's remuneration is only £200,000 out of an anticipated £700,000, which is much less than 80%, so condition A is failed.

The forward-looking nature of the test is also emphasised by the fact that the position is not affected if, in the event, the development project fails and, for example, John receives nothing in year 3. Despite the fact that he only received the fixed elements in years 1 and 2, condition A is failed by virtue of what it was reasonable to expect at the beginning of the relevant period, and not with hindsight during or at the end of the relevant period.

The concept of the relevant period ending when it is reasonable to expect that the relevant arrangements will end or be modified (in ITTOIA 2005 s 863B(c)) is also

illustrated by this example. While there is no reference to any subsequent amendment of the agreement, or any new partnership agreement, clearly the relevant arrangements will expire at the end of the development, so this must also be the end of the relevant period, as defined.

Condition B

[4.9]

Condition B requires that the mutual rights and duties of the members of the LLP, and of the partnership and its members, do not give the member significant influence over the affairs of the partnership (ITTOIA 2005 s 863C). This is, once again, interpreted by HMRC as meaning significant influence over the affairs of the partnership as a whole. They were very open during the process that they expected this to be a condition that would be satisfied by the vast majority of partners in large professional services firms and that they would only expect a relatively small number of people on the national executives of such firms to fail this condition. Conversely, it is probably reasonable to assume that most small partnerships would easily fail this condition, on the basis that it would be very hard for HMRC to argue that, say, all five members of an LLP did not have significant influence over the affairs of that LLP.

It is clear from HMRC's guidance that they consider that a partnership requires a group of people to be carrying on a business in common with a view to profit, referencing PA 1890 s 1(1), despite the fact that this is clearly not a requirement of the LLPA 2000. Nevertheless, one might argue that it is a reasonable indicium of partnership and one relevant to the current test.

HMRC's Example 32 has a mother and father carrying on a farming business in partnership, to which they admit their son. However, they omit to amend the partnership agreement, so one has to look at the actual facts of the case to determine whether the son has significant influence over the affairs of the partnership, too.

In Example 33, they propose a partnership of ten members, all of whom have equal rights and responsibilities, and accept that all ten of those partners are likely to fail condition B.

Example 7

We came across an interesting situation in practice, three individuals had been friends for many years and had always met for breakfast one day a week at a café down the road from the offices where they worked. They eventually set up their own accountancy practice together, as the three founding partners, but continued to meet for breakfast once a week, as they always had. Now that they were running a business together, they tended to discuss business strategy at these weekly breakfasts.

Over a number of years they have invited two other people to join the partnership. They were considered equal partners in most respects but they had never been invited to join the weekly breakfasts, as this was largely a matter between friends. They asked us about condition B (although it was not clear that either conditions A or C were a problem, in any case), and we suggested that they could do one of two things: they could either invite the two new partners to join them for their weekly breakfast, or they could instigate a proper weekly partners' meeting to which all five partners were invited, in order to demonstrate, in either case, that condition B was failed for all five partners and not just the three founding partners.

HMRC's guidance gives some helpful indicia as to the sort of decisions that partners would be involved with if they have significant influence over the affairs of the business. These include matters such as:

- appointment of new partners;
- deciding the firm's areas of business;
- strategic decisions; and
- business acquisitions or disposals.

There are several more but HMRC also make the point that these are merely indicia, just some guidance of aspects that HMRC considers to be appropriately significant.

Since the test requires somebody to have significant influence, HMRC also accept the possibility that somebody might, *prima facie*, have no official role but might still have considerable influence. They give the example of a semi-retired person who founded the firm and whose views are frequently, or even invariably, followed by the current partners, notwithstanding her lack of any official standing.

HMRC also accepts that it is the real influence that must be considered, not merely what is stated to occur in the partnership agreement or similar documents. They give a number of examples where the underlying facts are at odds with the legal documentation, and stress, rightly, in our view, that it is the actual position that must be considered in the context of condition B, not merely the formal legal agreements or status of partners.

Condition B is silent as to when the test needs to be applied. HMRC's guidance suggests that this matter must be considered either on 6 April 2014, when the legislation came into force, or at the date that a person becomes a partner, and then again when the arrangements change. But this is not a legislative provision, which is not entirely satisfactory.

Consider, for example, the fact that it does not say that the person has to have significant influence throughout a

particular period, or example. So it is unclear what happens if a person who is, for example, on the management board of the firm, therefore fails condition B at a particular point in time, but later in the year decides to step down, such that they no longer fail condition B. In the absence of specific legislation on this point, one can only infer that HMRC would expect (assuming that that person satisfies conditions A and C), that the moment the person starts to satisfy condition B, they become a salaried member and must be remunerated accordingly.

Condition C

[4.10]

Condition C measures the partner's capital at risk in the partnership and compares it to the likely disguised salary in a period. Specifically, Condition C is satisfied if at the relevant time, M's contribution to the LLP is less than 25% of the disguised salary which it would be reasonable to expect the LLP to pay to M for M's performance during the relevant tax year of services in M's capacity as a member of the partnership (ITTOIA 2005 s 863D(1) and (2)).

Disguised salary takes the same definition as it does for Condition A (ITTOIA 2005 s 863D(2)).

Essentially, therefore, we are saying that a person will be treated as a partner for tax purposes, even if they have substantial disguised salary for a period, so long as the amount of capital they have at stake is at least 25% of the reasonably expected amount of disguised salary for the tax year. It is, if you like, playing to HMRC's perception that one of the indicia of partnership is that one has some permanent financial stake in the business. This is, of course, not entirely a commercial view of the way partnerships operate. Certainly, almost every partnership that we are aware of will extract as much cash as possible, as early as possible, while having an eye to cash-flow, commercial needs, etc., as it is generally considered prudent to extract the cash as quickly as possible in case of any future problems within the business.

Contribution to the LLP (i.e. capital at risk)

[4.11]

M's contribution is any amount of capital contributed to the LLP, as well as any share of the LLP's profits (calculated in accordance with generally accepted accounting practice) that is added to the partnership capital (ITTOIA 2005 s 863E(2)-(4)).

From this amount, we must deduct any amounts that M has previously drawn out or received back, any amount that M may be entitled to draw out or receive back when a member of the LLP, or any amount that M may be entitled to require another person to reimburse to them (ITTOIA 2005 s 863E(6)), and references to drawing amounts out or receiving them back are to be taken as references to doing so directly or indirectly (ITTOIA 2005 s 863E(7)).

Given the distinction between amounts contributed as capital and amounts which can be drawn upon, etc., it is clear that this provision effectively requires the relevant members to hold separate capital and current accounts, so as to distinguish between the two.

HMRC's Example 42 is helpful. This shows a sum of £10,000 contributed as capital in accordance with the LLP agreement and £50,000 described as a long-term loan, carrying interest, but otherwise held on identical terms to the capital contribution, so that the money cannot be drawn upon unless and until the partner retires from the business. There are also sums of £30,000 described as a short-term loan, £25,000 undrawn profits and £25,000 as a tax reserve account. The guidance states that the first two of these, being held on very similar terms, are clearly capital as defined, and the other sums are not. Therefore, the individual concerned has £50,000 as their contribution to the LLP.

We note that many LLP agreements provide for sums to be contributed as capital by members when they join the LLP, and also potentially for members to be liable for certain sums in the event of the LLP being wound up. However, there is no reference in Condition C to any amounts to which the member might become liable when the LLP is wound up. This may be because HMRC has deliberately chosen to arrange for the condition to refer to sums actually contributed to the LLP, not sums which might be contributed to the LLP.

When is condition C determined?

[4.12]

The question of whether Condition C applies is to be determined (ITTOIA 2005 s 863D(3) and (4)):

- on 6 April 2014 (when the legislation came into force) or at any later time at which the person becomes a member of the LLP;
- at the beginning of each tax year;
- if there is a change in the person's contribution to the LLP during a tax year;
- if there is some other change of circumstances which might affect whether Condition C is satisfied.

Once Condition C is determined to be satisfied, or not, it is to be treated as being satisfied or not satisfied until the subsequent time at which it is to be re-determined (ITTOIA 2005 s 863D(5)).

Anti-avoidance

[4.13]

There is an anti-avoidance provision, so that a member cannot temporarily increase their capital contribution at, say, the beginning of the tax year, in order to fail Condition C. If this is done, it must also be reasonable to expect that

the condition will not be met for the remainder of the tax year, in order to fail condition C (ITTOIA 2005 s 863D(6) and (7)).

An increase in the contribution includes the initial contribution or any deemed contribution that is to be made within two months of joining the partnership (ITTOIA 2005 s 863D(12)) (see 4.15, below).

It is, having said that, quite hard to see how this could arise. If an amount contributed on, say, 6 April does fall within the definition of capital, then it cannot be withdrawn. Alternatively, if it can be withdrawn then, surely, it does not fit within the definition of M's contribution?

Joining and leaving LLPs

[4.14]

There is a further provision to ensure that the amount of capital taken into account is reduced in accordance with the proportion of any given tax year during which the person concerned is not a member of the LLP. This is most likely to arise in the year in which a person either joins or retires from the LLP. The essence is to reduce the amount of the contribution taken into account in determining whether Condition C is met. For example, if a person joins a firm halfway through a tax year, then only half of their capital contribution would be taken into account in considering Condition C and comparing that capital contribution to their disguised salary for the year.

More technically, if there are excluded days in a tax year, the contribution to the LLP is multiplied by the fraction (D - E)/D, where D is the number of days in a relevant tax year and E is the number of excluded days (ITTOIA 2005 s 863D(8)).

In the year that a person joins an LLP, excluded days are the days in the tax year before that person joins the LLP (ITTOIA 2005 s 863D(9)). If a person leaves an LLP during the tax year ('if… it is reasonable to expect that M will not be a member of the LLP for the remainder of the relevant tax year'), any day after the person leaves the LLP is an excluded day (ITTOIA 2005 s 863D(10)). And if the person's contribution increases during the tax year, so that they newly fail condition C, the excluded days are the period before Condition C ceases to be met (ITTOIA 2005 s 863D(11)).

An increase in the contribution includes the initial contribution or any deemed contribution that is to be made within two months of joining the partnership (ITTOIA 2005 s 863D(12)) (see 4.15, below).

Date of contribution

[4.15]

The legislation came into force from 6 April 2014, despite still being debated by Parliament and not having been granted Royal Assent, which caused certain commercial difficulties. While this was, obviously, a one-off problem, HMRC accepted that it might take a short period of time for newly-appointed partners to arrange appropriate borrowing in order that they could make adequate capital contributions. As a result, the legislation permitted a three-month delay, so that contributions had to be made by 5 July 2014 (effectively a three-month transitional period).

For future contributions, Condition C takes into account contributions that will be made within two months of being appointed a member of the LLP. To qualify for this favourable treatment, the member must have given an undertaking (although not necessarily a legally enforceable one) to make the contribution (ITTOIA 2005 s 863F(1)). In such cases, that person is effectively treated as having made the contribution for the purposes of condition C, even if they have not. But this treatment only subsists during that two-month period (ITTOIA 2005 s 863F(2)).

If the person makes the contribution during the relevant period, Condition C does not have to be reconsidered (ITTOIA 2005 s 863F(3)). If the whole or any part of the contribution is not made within the relevant period, Condition C is to be reviewed, from the beginning of the relevant time, i.e. the tax year or from when the person became a member, on the basis that the contribution has not been made, or has only been partly made.

This could, of course, therefore lead to the position that, the person intended to make a contribution but was unable to do so, so that Condition C is retrospectively seen to have been met. It is to be hoped that this situation does not occur in practice, as it would presumably mean that, for example, if Conditions A and B were also met, it would be the case that the company should, retrospectively, have been operating PAYE for that two-month period. This might be relatively easily rectified, and it is to be hoped that HMRC would not consider this an appropriate occasion for charging penalties on the company.

Anti-avoidance

[4.16]

There are three anti-avoidance rules within the salaried members legislation. Each of them refers to arrangements of one type or another. In each case, the word arrangements includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable) (ITTOIA 2005 s 863G(5)).

General anti-avoidance provision

[4.17]

The first anti-avoidance rule effectively tells us to ignore any arrangements which have their main purpose, or one of their main purposes, to ensure that these salaried

members rules do not apply to one or more individuals who are members of the LLP (ITTOIA 2005 s 863G(1)). This is a very sweeping anti-avoidance rule, but HMRC accept that arrangements intended to ensure that the individual or individuals become, in effect, genuine partners, will not trigger the anti-avoidance legislation. In other words, if people change their behaviours in a way which HMRC consider to be appropriate, this will be accepted. What they are concerned about is the possibility of people entering into artificial arrangements simply to get out of the legislation, without changing their commercial or financial status vis a vis the LLP itself or the other members.

Anti-avoidance for non-individual members

[4.18]

This legislation only applies to individuals who are members of an LLP. So there is another anti-avoidance provision, similar to that for the mixed member partnership rules, to prevent a person sidestepping the salaried member rules by operating through a corporate or other non-individual member of the partnership, and not being a member of the partnership themselves (ITTOIA 2005 s 863G(2) to (4)).

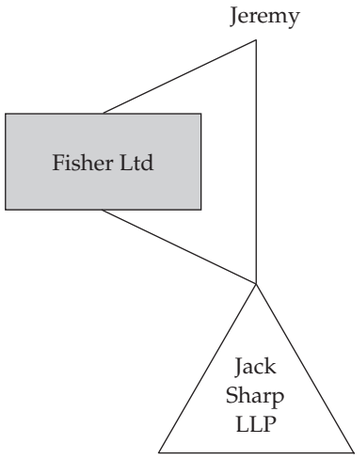
Essentially, this rule applies if an individual performs services for an LLP but is not a member of that LLP, and the arrangements under which the services are performed involve a member of the LLP that is not an individual, with the intention (i.e. the main or one of the main purposes) of ensuring that the salaried member rules do not apply, then this rule takes effect. There must also be a sum of money arising to the non-individual which would have arisen directly to the individual, had that person been a member of the partnership, and would then have been treated as employment income under the main rule.

If this rule applies, then the amounts concerned are deemed to arise directly to the individual as employment income under the main rule, and is not to be treated as the income of the individual on any other income tax basis (for example, as distributions from a corporate member).

Precedence of mixed membership rules

[4.19]

The salaried member legislation does not apply where an individual would otherwise be a salaried member because of arrangements that have a main purpose of securing that the mixed membership partnership legislation does not apply (ITTOIA 2005 s 863G(4A)). In essence, this seems to prioritise the mixed membership rules. HMRC's guidance does not provide any examples, so let us look, again, at Jeremy and Fisher Ltd.



Example 7

Suppose Jeremy were to fix his profit share at £200,000, at a time when Jack Sharp LLP is making £500,000 a year profit. This would *prima facie* bring him into the salaried members regime, and the LLP would have to treat him as an employee. But in that case, he cannot be treated as an individual who is a member of a mixed membership partnership, because he cannot be both an employee and a partner. So the other £300,000 profits would flow to Fisher Ltd and the mixed member rules would not apply.

Thus ITTOIA 2005 s 863G(4A) prevents the salaried members regime from applying, so that the mixed member rules can apply, instead.

Deductions

[4.20]

The relevant rules for deductions are amended to permit deductions for the expenses paid by the partnership in respect of a salaried member's deemed employment under these rules. In other words, if a statutory deduction in respect of deemed salary, income and NICs was not available, the rules have been changed to make sure that those amounts are deductible.

For trading profits, the new rules are at ITTOIA 2005 s 94AA, for income tax payers, and at CTA 2009 s 92A, for corporation tax payers. For the profits of a property business, there are appropriate amendments to ITTOIA 2005 s 272, for income tax payers, and to CTA 2009 s 210, for corporation tax payers.

Finally, the rules for companies with an investment business are amended in relation to their management expenses by

the insertion of CTA 2009 s 1227A, so that the management expenses are treated as referable to the accounting period in which they are paid.

Returns

[4.21]

A salaried member is treated as an employee of the partnership, not as a member, so they are not included in the partnership return. Obviously, if they become a salaried member during a period, or cease to be one, their details will need to be included in the return, as if they had joined or left the partnership, as appropriate.

Commencement

[4.22]

The rules apply from 6 April 2014, except for ITTOIA 2005 s 863G(4A) (see 4.19), which came into force on 13 July 2014, when the Finance Act 2014 received Royal Assent.

Solutions

[4.23]

The most frequently asked questions in our practice have been about how to prevent these rules applying. There is no once-size-fits-all approach, but we have been able to advise in a number of areas. Generally, the advice has either been that the relevant partners are not salaried members, anyway, or we have advised on ways in which they can change their relationships with the LLP or its members to fail one of the three conditions.

In smaller partnerships it might well be possible to adjust the profit-sharing arrangements within a partnership, particularly in marginal cases. So if a member of an LLP was likely to receive fixed remuneration as, say 85% of her total package, this figure could be adjusted down to, say, 75%, with 25% based on the total partnership profits. This level of restructuring would probably be more difficult with larger partnerships. Having said that, anecdotally, we understand that one of the larger accountancy firms did, in fact, completely change its remuneration structure in order to ensure that all of its partners failed condition A!

In general terms, as we have seen, HMRC will accept that a small- to medium-sized partnership will fail condition B in respect of all of its members. Conversely, we understand that they consider the majority of partners in the larger professional partnership to satisfy condition B and it would be virtually impossible to change that. The difficulty, of course, lies in understanding where the dividing line is between their example with ten partners, and a partnership with, say, 100 partners. The important issue here, however, will be to ensure that, if the members of the LLP genuinely all have the appropriate level of influence, that this is properly documented, both in terms of their contractual arrangements with the LLP and in terms of their actually being able to wield that influence, where appropriate. It will only be in relatively marginal cases, such as that described in Example 6 above, where the partnership governance arrangements will be such that they can be changed in order to fail condition B.

We understand that condition C has been the area of most activity, particularly with the larger professional partnerships. Essentially, it is a 'well known fact' that those LLPs have required their more junior members, i.e. the non-equity partners who do not share in the overall profits of the firm sufficiently, to make a greater permanent contribution to the partnership, in order to fail condition C. This would also be a perfectly feasible solution for smaller partnerships, of course, although our experience has been that the majority of smaller partnerships, in fact, fail condition A, so that they are far less likely to be the target of these new rules.

Incorporation of partnerships

Background

[5.1]

In the Autumn Statement on 3 December 2014, the Chancellor announced two surprise new measures to restrict tax reliefs available to businesses on incorporation. One was to restrict the availability of entrepreneurs' relief when transferring goodwill on incorporation. The other will restrict the availability of tax deductions for amortisation of goodwill transferred to the successor company on incorporation. The legislation is FA 2015 s 42.

While these measures are not strictly targeted at partnerships, many partnerships decide to incorporate and these new rules will have an impact on the tax arising on incorporation.

There are three mechanisms for incorporating a business. If you transfer your business to a company in return for an issue of shares, you could claim incorporation relief under TCGA 1992 s 162, so that the gain that would have accrued on the disposal is instead deducted from the base cost of the shares. Or assets can be gifted to the company, using the business asset gift relief under TCGA 1992 s 165. Neither relief was affected by the Finance Act 2015 changes.

The third mechanism is to sell a business to a company. If the business was a trade, the owner(s) of the business would have expected to claim entrepreneurs' relief and pay only 10% capital gains tax on the disposal. The main advantage of selling a business to a company is that this leaves a debt due to the transferor, which allows tax-efficient profit extraction from the company as the debt is repaid. HMRC's view is that such sums should be extracted from the company by more 'normal' means, such as dividends or salaries, so this

provision 'removes an unfair advantage' (according to the tax information and impact note (TIIN)) and 'supports the government's objective to have a fair tax system' (from the explanatory notes to the draft legislation).

To be fair, this was always considered to be a fairly generous relief, especially where the trade comprise substantial goodwill, as the corporation tax profits could then be depressed by the amortisation of that goodwill (under CTA 2009 s 739).

Capital gains on incorporation

[5.2]

From 3 December 2014, to the extent that a person transfers goodwill when incorporating a business, entrepreneurs' relief will no longer be available, under new TCGA 1992 s 169LA.

Denial of entrepreneurs' relief

[5.3]

Where there is a qualifying business disposal involving the transfer of a business directly or indirectly to a close company, the transferor is a related party in relation to the company, and the transferor is not a retiring partner, the goodwill is not a relevant business asset for entrepreneurs' relief purposes, so the 10% CGT rate is not available in respect of its disposal (TCGA 1992 s 169LA(1) and (4)). In practice, this means that it is unlikely that businesses with substantial goodwill will be incorporated using this method, and people will revert to using the incorporation relief.

Whether a person is a related party in relation to a company is defined by the corporation tax rules for intangible fixed assets, in CTA 2009 Part 8. The most relevant rule for partners incorporating a trade will be that a participator in a close company is a related party in relation to that company (CTA 2009 s 835(5)), as the partners will generally become the shareholders of the company, on incorporation (TCGA 1992 s 169LA(2)).

Definitions

[5.4]

In these rules, the meaning of 'participator' and 'associate' are given by CTA 2010 ss 448 and 453. 'Arrangements' means any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable) (TCGA 1992 s 169LA(8)).

A company that is not UK resident, but would be a close company if it were UK resident, is treated as a close company for the purposes of these rules (TCGA 1992 s 169LA(5)).

Retiring partners

[5.5]

The original draft legislation did not make any provision for partners who might be retiring at the point of incorporation. The draft legislation would have prevented a retiring partner from claiming entrepreneurs' relief on what would be, to him, a genuine arm's length disposal of his interests in the trade. HMRC recognised that this was not fair and made some amendments.

A retiring partner is defined as someone who is a member of the partnership immediately before the disposal of the goodwill to the company, but who will not be a participator in the company or in a company that has control of or holds a major interest in the company. There must also not be any arrangements under which that partner could become such a participator (TCGA 1992 s 169LA(3)(a)). The exception also requires the retiring partner to be a related party in relation to the company by virtue of being an associate of the relevant participators (TCGA 1992 s 169LA(3)(b)) but only because they are also members of the partnership from which he or she is retiring (TCGA 1992 s 169LA(3)(c)). In order words, if the retiring partner is associated by some other way to those participators, such as being related to them, the exception will not apply.

At first glance it does appear as though the unfairness that had been identified is resolved. However, this is not entirely true. Imagine a father and son in partnership, where they decide that the father will retire and the son will incorporate the business into a company. *Prima facie*, the father would appear to be a retiring partner as he is not going to become a participator in the company. However, the reason he is a related party in relation to the company is not just because he is associated with his son as a business partner; he is also associated with his son as a relative (CTA 2010 s 448(1)(a) and (2)(b),(c)). Therefore, in a commercial arrangement with no intention to avoid tax or to get any unfair advantage, the father is denied entrepreneurs' relief because his son wishes to continue the business in a corporate form. This seems exceptionally unfair and very much only a partial answer to the problem that was identified to HMRC.

Anti-avoidance

[5.6]

If there is a disposal of goodwill, as part of a qualifying business disposal, and there are arrangements with a main purpose of ensuring that these rules do not apply, then those relevant avoidance arrangements are ignored, and the rules apply, anyway (TCGA 1992 s 169LA(6) and (7)).

Commencement

[5.7]

These provisions apply to qualifying business disposals made on or after 3 December 2014.

Solutions

[5.8]

If individuals in partnership wish to incorporate the business, the obvious solution is going to be to use the reliefs at TCGA 1992 s 162 or, if preferred, s 165, as the legislation now denies entrepreneurs' relief for a direct sale or indirect sale to the company for consideration.

For retiring partners, where there is a connection other than that of pure partnership, it might partly depend on what is meant by a disposal of goodwill 'directly or indirectly to a closed company'. If we consider the father and son relationship at 5.5 above, prior to the change in the rules, the father and son would both have sold their share of the partnership to the company. The company therefore would owe them both money and would repay out of post-tax profits over time. Under the new legislation, the difficulty is that the father cannot sell his share of the business to the company and claim to be a retiring partner under the legislation, because he is related to his son, the other partner.

One possible solution, therefore, would be for him to sell his share of the business to his son, first. The son could then incorporate the business by whatever mechanism he considers appropriate, and repay his father out of the proceeds of owning the company (salary and dividends). This feels, however, slightly ad hoc and somewhat unsatisfactory. And we cannot be certain that this will not be seen as an indirect sale of the trade to the company by the father.

It may be more appropriate to incorporate the business from a partnership for other reasons, such as the SDLT relief available for incorporation of a partnership, which would not apply if it were a sole trade being incorporated. It might, therefore, be better for the father and son to incorporate the business and for the father to sell his shares to the son after, say, a year, when he will qualify for entrepreneurs' relief. This will, of course, require more advanced planning than might previously have been the case.

It is also possible that, in due course, HMRC will realise that this shoddily concocted legislation needs amendment to permit a genuinely retiring partner to claim entrepreneurs' relief, regardless of any other relationship he might have with the ongoing business owners.

Changes to goodwill amortisation relief

[5.9]

On incorporation, by whatever mechanism, the goodwill transferred into the company should appear on the balance sheet at market value, as acquired goodwill on a business acquisition. The amortisation or impairment of that goodwill is generally allowable for tax purposes under the accounts-based tax rules for corporate intangibles in CTA 2009 Part 8.

This advantage was removed in respect of transfers of intangible assets to connected companies on or after 3 December 2014. While the treatment of the goodwill is outside the scope of this *Tax Digest*, a brief overview is appropriate.

Denial of amortisation relief on incorporation

[5.10]

The new provisions apply where goodwill or similar assets (referred to as 'relevant assets') are acquired by a company from an individual who is a related party in relation to the company, or from a partnership where at least one member is a related party in relation to the company.

A 'relevant asset' means goodwill, customer information, customer relationships, unregistered trademarks or other signs and licences in respect of any of the above assets, relating to the business or part of the business that is transferred to the company (CTA 2009 s 849B(2)). So the legislation does not just apply to goodwill (although it will be the most common case) but also to these other assets which are considered, by HMRC at least, to be closely related to the goodwill. For example, an unregistered trademark is considered part of the goodwill of a business, as highlighted in *Iliffe News and Media Ltd v Revenue and Customs Comrs* [2012] UKFTT 696 (TC), [2013] SFTD 309.

In the simplest case, the rules deny any deductions for amortisation or impairment of the goodwill (CTA 2009 s 849D(1)). Any debit arising on realisation of goodwill is to be treated as being a non-trading debit (CTA 2009 s 849D(2)). So if the goodwill is realised at a loss, the debit appears to be allowed for corporation tax purposes, but as a non-trading debit the availability to set it against other profits of the company, particularly in prior accounting periods, is restricted.

It is also unclear whether the debit would be by reference simply to the accounts debit or to the unamortised tax figure, but we assume the latter.

Incorporation after third-party acquisition of relevant assets

[5.11]

The legislation recognises that goodwill, etc. transferred on incorporation could have been acquired in previous arm's-length transactions. So there are rules to ensure that appropriate relief for amortisation of such assets is available.

The assets must have been acquired by the transferor in an arm's-length transaction from a genuine third party (CTA 2009 s 849B(7)). And there must not be a main purpose of obtaining a tax advantage (CTA 2009 s 849B(7)).

In such cases, CTA 2009 s 849C ensures that some deductions are allowed in the company for amortisation, etc., by applying a factor (the appropriate multiplier, 'AM'), to the deduction, D, in the P&L account (CTA 2009 s 849C(2)). D is determined by ignoring any previous application of CTA 2009 s 849C.

AM is a fraction whose numerator is the 'notional accounting value' of the goodwill, as if GAAP-compliant accounts had been drawn up by the transferor immediately prior to transfer of the business to the company, on the assumption that the business was a going concern (CTA 2009 s 849C(6)-(8)). The denominator is the total goodwill recognised by the company, whether capitalised or recognised in determining profit and loss without being capitalised (CTA 2009 s 849C(6)).

This is not a favourable calculation, as the notional accounting value will usually be the amortised cost of the goodwill arising on previous third-party business acquisitions, whereas the capitalised expenditure in the company's accounts might well be substantially greater. So any enhancement to previously acquired goodwill prior to incorporation is not recognised by this calculation.

On realisation, any debit (again, ignoring previous applications of CTA 2009 s 849C) is also multiplied by AM to determine the proportion that should be treated as a non-trade debit. The rest, relating to goodwill originally acquired from third parties, is treated normally.

Commencement

[5.12]

These rules apply to accounting periods starting on or after 3 December 2014 and apply to transfers of assets on or after that date, unless a contract for the transfer had become unconditional before the relevant date (FA 2015 s 26(5)).

Where an accounting period straddles 3 December 2014, it is to be treated as if it were two separate accounting periods for the purposes of these rules (FA 2015 s 26(7)).

If the transfer was before 24 March 2015, only a direct transfer of assets is caught by the new legislation (FA 2015 s 26(6)). For transfers on or after that date, both direct and indirect transfers are caught (FA 2015 s 26(5)).

Impact of these rules

[5.13]

A criticism of the new rule is that it will apply even where the company and the unincorporated business are not under the same economic ownership. Clearly, the target is where a partnership is incorporated and the shareholders of the company are the same as the members of the LLP. In essence, the business is under the same economic ownership, so the new rules prevent the members of the LLP claiming entrepreneurs' relief and prevent the company reducing its corporation tax profits by the amortisation or impairment of the goodwill and related assets. This is the new 'fair' result.

But what if the LLP's business is sold to a third-party company in return for shares in the company? The entrepreneurs' relief point may not matter, if the vendors can claim incorporation relief. But is it fair that the corporation tax deductions for amortisation of goodwill should be denied to the purchaser, which is buying a business at arm's-length?

You might argue that this is not a related party transaction, as we are not transferring the goodwill to a company of which we are participators, as we do not become a participator until the transfer. However, that is not HMRC's view, or the First-tier Tribunal's, as demonstrated by *HSP Financial Planning Ltd v Revenue and Customs Comrs* [2011] UKFTT 106 (TC), [2011] SFTD 436, where the incorporation of a business into a company owned by one of the employees, i.e. not owned by the owners of the business, was held to be a related party transaction for these purposes, because there was a commitment for the company to issue controlling shareholdings to the transferors. So the new rules might inhibit commercial transactions, as the vendors will either be forced not to take a shareholding in the company, or the company will pay less for my business, because it will not get the benefit of the amortisation.

Corporate partnerships and entrepreneurs' relief

Background

[6.1]

The requirements for the availability of entrepreneurs' relief on disposal of shares in a trading company are relatively straightforward. The shares must be disposed of by an individual who is an officer or employee of the company, and who holds 5% or more of the share capital of that company, together with at least 5% of the voting power. These conditions must all have been satisfied for one year to the date of disposal.

HMRC has become aware of a number of structures put in place in order to effectively allow individuals with a lower shareholding to access the entrepreneurs' relief. One such structure obviously involved some form of corporate partnership. In Figure 5A overleaf, we see a company with a large venture capital stake and four members of the management team each with 3% of the company's shares, so that they do not qualify for entrepreneurs' relief on a disposal of that company. Conversely in Figure 5B overleaf, the trade is now carried on in partnership between the original company, owned wholly by the venture capitalists, and by a separate company owned 25%

Figure 5A

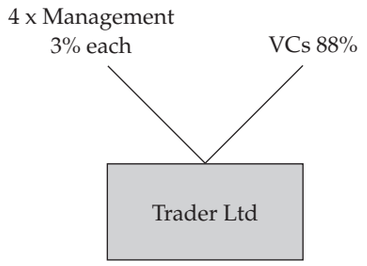


Figure 5B

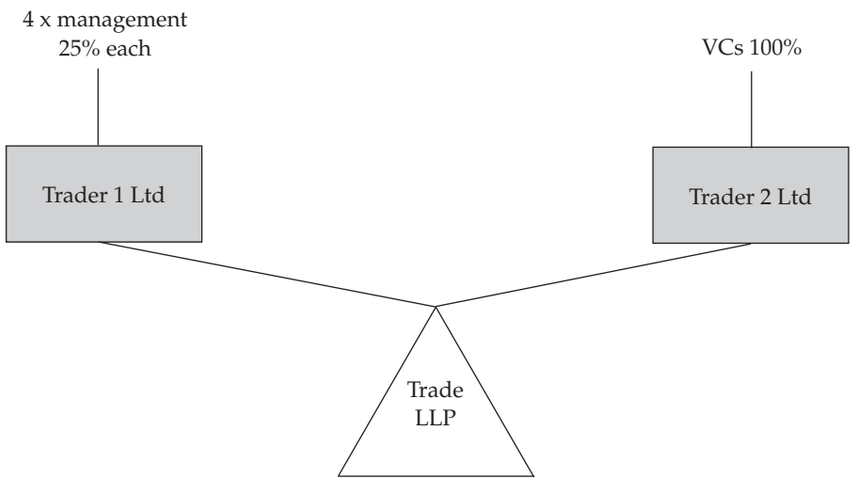
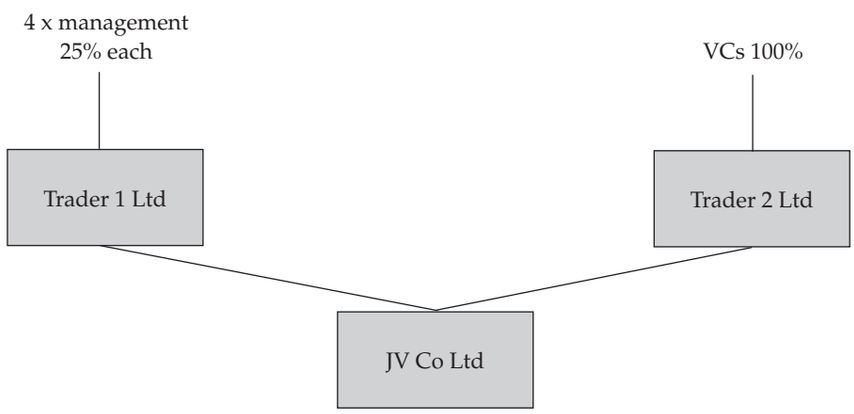


Figure 5C



each by the management team. The argument is that both companies are trading together, therefore both of them are trading companies, and the individual members of the management team hold sufficiently large a stake as to qualify for entrepreneurs' relief.

New legislation

[6.2]

This was clearly considered offensive by HMRC (although it has taken them seven years either to spot the problem or to decide to do something about it). As a result, the legislation has changed so that, if we are trying to determine whether a company that carries on a trade in partnership is a trading company, the activities carried on by that company as a member of the partnership are to be treated as not being trading activities (TCGA 1992 s 169S(4A)(b)).

Similarly, if we are looking at whether a group of companies is a trading group, activities carried on by any group company as a member of a partnership are to be treated as not being trading activities (TCGA 1992 s 169S(4A)(c)).

The overall result is that the companies in Figure 5B will not be treated as trading companies and the individual members of the management team will not qualify for entrepreneurs' relief. This is, of course, an absurd situation, as the legislation has this effect even if there is no avoidance, these are genuine commercial arrangements, and the management team would otherwise have qualified for entrepreneurs' relief.

Commencement

[6.3]

The new legislation comes into force from the date of the original announcement, 18 March 2015.

Solutions

[6.4]

In cases where, in effect, entrepreneurs' relief was being claimed where people only had a small minority holding in the business, the correct answer might be to do nothing, on the basis that they are a proper target for anti-avoidance legislation. However, for genuine commercial structures where there is no avoidance, but the new anti-avoidance legislation happens to catch those structures, it will be necessary to reconsider whether some form of reconstruction of the trade might be necessary.

Unfortunately, the obvious restructuring, to make the partnership a joint venture (see Figure 5C), instead, will not work. At the same time as denying entrepreneurs' relief to corporate partnerships, the relief was also denied to joint venture companies (TCGA 1992 s 169S(4A)(a)).

This is the unfortunate side effect of both widely drawn anti-avoidance legislation, which is rushed into force and hence not given proper scrutiny either by Parliament or the relevant professional bodies. It is to be noted that the legislation was announced on 18 March 2015, the Finance Bill was published on 24 March and received Royal Assent on 26 March 2015.

It is also interesting to question the policy point behind the original requirement that a person hold 5% of the shares in the company, which is the source of this particular planning. It is certainly the case of entrepreneurs' relief would be available to a person who leaves a partnership even if they did not have a 5% share in that partnership, so it is difficult to understand why a higher threshold is put in place for the owners of trading companies.

One possible solution depends on the fact that, while a shareholding in a company must be at least 5% in order to qualify for entrepreneurs' relief, there is no similar rule in respect of partnership shares. If we look at Figure 6A overleaf and compare it to Figure 5A, one possibility would be for the members of the management team to become members of an LLP alongside Trader 2 Ltd. The LLP can carry on the trade. The management as members of the company will need to ensure that they do not fall foul of the salaried members tests (see Part 4) but should not be affected by the mixed partnership rule, given the commerciality of the structure (see Part 3). This may not be entirely satisfactory for the management team, however, on the basis that all of their income will be immediately chargeable to income tax, rather than being potentially deferred into dividends. And access to entrepreneurs' relief depends on a purchaser buying the partnership out, as a whole.

An alternative solution is at Figure 6B overleaf where the management team provides services through their management company to the trading company owned by the venture capitalists. It is important to ensure that this does not form a de facto partnership (persons in business together with a view of profit, PA 1890 s 1(1)) but, otherwise, there is no obvious reason why such a service company structure should not work. Again, the issue arises on the eventual disposal of the trade. A purchaser that needed the management team might be willing to buy both companies, allowing the management team to access entrepreneurs' relief in respect of their activities. But a purchaser wanting the trading activities only, might choose not to buy the management company if it did not want the management team. So the management company would need to ensure that their company is remunerated adequately for the work it does, so that if the main trading company is sold, the management team can liquidate the management company and claim entrepreneurs' relief on extracting the proceeds.

As yet, these are speculative proposals and we do not know how they will be viewed by HMRC.

Figure 6A

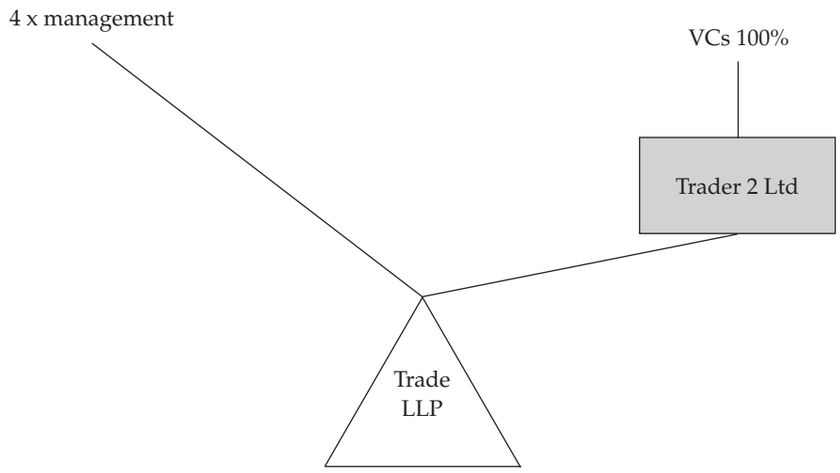


Figure 6B

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