UK HM Revenue and Customs Propose Significant Clampdown in Consultation on the Taxation of UK LLPs and Partnerships

On May 20, 2013, HM Revenue and Customs (HMRC), the UK revenue authority, published a consultation document focusing on two aspects of the taxation of partnerships, and, in particular, UK limited liability partnerships (LLPs): disguised employment and profit and loss allocation schemes.

It is expected that a large number of professional (legal and accounting) and financial services firms established as LLPs, which, in many ways, are similar to US LLCs, will need to review their set-ups. Equally, the proposals will be of significant concern to the UK investment management industry, and in particular the private equity and hedge fund sectors, where most businesses are set up as LLPs.

Under the consultation, comments are invited by August 9, 2013. However, the feedback sought is in many instances limited to the *design* of the proposed changes to the current tax rules; there are clear statements from HMRC that the anti-avoidance measures *will* be introduced to counter perceived unfairness in the UK tax system. The changes, once final, are to come into force with effect from April 6, 2014.

Disguised Employment

The first aspect of the consultation concerns “disguised employment.” HMRC are proposing to remove the existing legislative presumption of “self-employment” status for individual members of LLPs. Under current law, individual members of an LLP are taxed as self-employed partners rather than employees, and are subject to a slightly more favourable income tax and National Insurance Contributions (NICs) regime. Importantly, profit allocations to partners or members are not subject to employers' NICs (currently 13.8 percent).

Under the proposals, an individual member of an LLP will be classified as a “salaried member” if s/he is regarded as “employed,” which will be determined by the employment tests set out in HMRC’s Employment Status Manual. Moreover, even if such member is not considered to be “employed” under the relevant rules in the manual, s/he will still be classified as a “salaried member” if s/he is on a fixed salary, does not bear real economic risk and is not entitled to share in the profits and surplus assets of the LLP on a winding up. Here, HMRC are proposing to introduce significantly stricter partnership tests for LLPs than those that have been in existence for other types of partnership in the past.

Going forward, a salaried member will be treated as an employee for UK tax purposes and therefore liable to income tax and primary (Class 1) NICs. As employer, the LLP will then be liable to secondary (Class 1) NICs (currently 13.8 percent) on all remuneration paid, causing significant economic consequences.

Profit and Loss Allocation Schemes

Of separate concern are HMRC's proposed and (in part) highly penal measures regarding profit and loss allocation scenarios and the impact on structures in which an LLP or other partnership has a corporate member.

For UK tax purposes, a partnership (or an LLP) is transparent in most circumstances, and it is the partners (or members) who are liable for tax on their share of the partnership's profits as allocated under the partnership or LLP agreement. As part of the proposals, the government is seeking to counter the scenario whereby profit and loss allocations made by partnerships with "mixed partners," i.e., individual and corporate members, are used to achieve a tax advantage. In principle, the introduction of *some* anti-avoidance measures would be understandable, given some of the overly aggressive abuse that has taken place in this area. However, the proposals are very far-reaching, and, for example, extend to standard working capital or deferral arrangements, as HMRC consider these to contribute towards the unfairness and market distortion existing within the UK tax system: for example, a corporate member used for working capital retention purposes of an LLP is deemed abusive (notwithstanding that the same benefit, the use of the lower corporation tax rate of 20-23 percent, would be available to *any* business operating as a company).

HMRC also acknowledge that certain investment managers are currently subject to, or in the future may be subject to, regulatory rules, e.g., on deferred remuneration, the Financial Conduct Authority's (FCA) Remuneration Code and the Alternative Investment Fund Managers Directive (AIFMD). To date, investment managers who sought to align their remuneration practices with investor requirements or the potential (and now incoming) AIFMD requirements have often used arrangements involving a corporate member in some capacity, so as to avoid double taxation. This is sensible tax planning. To HMRC's credit, this area appears to be one of the few where input is sought on measures that would achieve an equitable result, but the outcome is as yet unknown.

Overall, to achieve its aims, the government has proposed complex and partially extremely severe measures. The stated intention is not to affect those persons entering into arrangements that are not tax-motivated, but rather to deter arrangements that seek a tax advantage. The concern is that HMRC's proposals are so far-reaching that it is difficult to imagine many LLP scenarios in which the new anti-avoidance rules would not apply. Thus, the almost draconian nature of some of the present proposals arguably creates some unfairness in the UK tax system itself. As many LLPs involve a corporate member for remuneration or other purposes, it is hoped that, as a result of the consultation process, the damage will be limited.

Separately, it is interesting to note that HMRC will also introduce a targeted anti-avoidance rule notwithstanding the coming into force on July 1, 2013 of the much-heralded General Anti-Abuse Rule (GAAR). Overall, it is expected that nearly all professional and financial services/investment firms set up as LLPs need to review their profit arrangements and LLP set-ups and agreements.

Kaye Scholer will be making representations to HMRC.

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