Tax Clampdown Hits UK Hedge Fund LLPS

Changes in UK taxation rules coupled with restrictions on employee remuneration in the AIFMD could lead to higher costs and some complications for hedge fund limited liability partnerships (LLPs)

About the Author

Daniel Lewin is a Tax Partner in Kaye Scholer's London office. He advises corporate, institutional and private clients on the U.K. and international tax aspects of a wide variety of transactions including financings, acquisitions and divestitures, joint ventures, investment structures, derivative transactions and employment matters, usually with an international element. Daniel is a member of the Alternative Investment Management Association (AIMA) Tax Committee, which works closely with HM Revenue & Customs and HM Treasury on all aspects of the taxation of hedge fund groups on behalf of the alternative investment fund industry. He can be reached at ***daniel.lewin@kayescholer.com****.*

This article originally appeared in *Hedge Funds Review* on August 12, 2013.

HM Revenue & Customs (HMRC), the UK tax authority, published a consultation document in late May focusing on two aspects of the taxation of partnerships and in particular limited liability partnerships (LLPs), one of the preferred structures for hedge fund management companies.

The two aspects covered are "disguised employment" and "profit and loss allocation schemes".

The consultation is currently at the centre of discussions between the UK Treasury, HMRC, the Financial Conduct Authority (FCA) and the Alternative Investment Management Association (Aima), which is representing the hedge fund industry interests.

The vast majority of financial services firms established as LLPs will be affected by the changes. The proposals are of significant concern to the investment management industry and in particular the hedge fund sector where most UK businesses are set up as LLPs.

There are clear statements from the tax authority that new measures will be introduced to counter what it perceives as unfairness in the UK tax system. Under the consultation, which ended August 9, the feedback is therefore in many instances limited to the design of the proposed anti-avoidance changes to the current tax rules.

> ***"There are clear statements from the tax authority that new measures will be introduced to counter what it perceives as unfairness in the UK tax system."***

Once finalised, the changes are intended to come into force from April 6, 2014 and in many cases will have significant adverse financial implications for businesses affected. Crucially, under the present proposals no grandfathering will be available for existing structures.

Partnership test

The first aspect of the consultation concerns "disguised employment". HMRC is 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 contribution (NIC) regime.

Importantly, unlike payments to employees, profit allocations to partners or members are not subject to employers' NICs, which are currently 13.8%.

Under the proposals an individual member of an LLP such as a hedge fund manager will be classified as a "salaried member" if she or he is regarded as "employed" under the employment tests set out in the tax authority's Employment Status Manual. Even if the person is not considered to be "employed" under the relevant rules, that person will still be classified as a "salaried member" if she or 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.

> ***"HMRC is proposing to remove the existing legislative presumption of 'self-employment' status for individual members of LLP**s."*

Arguably the consultation failed to take account of the first tax test that should be considered: whether the individual concerned is a partner under the partnership tests. Not only is the tax authority proposing to introduce significantly stricter partnership tests for UK LLPs than those that exist for all other types of partnerships, but the practical effect for many hedge funds will be that many partners, other than for example founders, are likely to be treated as "salaried members" and therefore liable to income tax at source and primary (Class 1) NICs.

The employer, the LLP, will then be liable to secondary (Class 1) NICs at 13.8% on all remuneration paid to the salaried members. Consequently, the cost of operating as a UK-based hedge fund manager through an LLP, as is very common, would increase substantially if the rules are adopted as they now stand.

Mixed partnerships

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 are of even greater concern.

Most hedge funds established as LLPs are set up with a corporate member, either because the fund's head office is overseas or to benefit from lower corporation tax rates for certain purposes.

For UK tax purposes a partnership or an LLP is transparent in most circumstances. It is the partners or members who are liable to tax on their share of the partnership's profits in the year in which the profits arise, as allocated under the partnership or LLP agreement.

As part of the proposals, the government is seeking to counter scenarios under which profit and loss allocations made by partnerships with "mixed partners", that is with individual and corporate members, are used to achieve a "tax advantage".

> ***"For UK tax purposes a partnership or an LLP is transparent in most circumstances."***

These anti-avoidance proposals are far-reaching and extend to standard working capital or deferral arrangements. In those scenarios money is typically initially allocated to a corporate member to benefit from the lower corporation tax rate, which is currently 20-23%.

HMRC considers these corporate member arrangements to contribute towards the "unfairness and market distortion" existing within the UK tax system. For instance, a corporate member used for working capital retention purposes of an LLP is deemed abusive if income is allocated to it to benefit from the lower corporation tax rate, leaving a greater amount available for reinvestment, compared with allocating income to individual members at higher income tax rates.

However, the same benefit, such as the use of the lower corporation tax rate of 20-23%, would be available to any business operating as a limited liability company. Therefore, it is difficult to understand here where the "evil" lies with LLPs.

> ***"HMRC considers these corporate member arrangements to contribute towards the "unfairness and market distortion" existing within the UK tax system."***

AIFMD rules

HMRC also acknowledges that certain investment managers are currently subject to or will become subject to regulatory rules on deferred remuneration, such as the FCA's Remuneration Code and the alternative investment fund managers directive (AIFMD).

Under the present AIFMD provisions, depending on the circumstances of the fund manager, up to 40-60% of variable remuneration of an individual member of an LLP must be deferred and/or received as fund equity and partially be at risk of forfeiture. So far investment managers who sought to align their remuneration practices with investor requirements or the AIFMD requirements have often used arrangements involving allocation of deferred amounts to a corporate member in some capacity in order to avoid double taxation if the deferred amounts were forfeited.

This is sensible tax planning.

The concern for the UK tax authority is that through appropriate structuring it is possible in certain circumstances to keep the applicable tax rate at the corporation tax level even when the individual member subsequently takes out the money.

This is also an area where the tax provisions have been abused.

While HMRC has been understanding of the concerns that arise if all deferred income is allocated and therefore taxable to individual members up front, many difficulties remain unresolved. The consultation was looking for feedback on this point.

Overall to achieve its fiscal aim of collecting additional revenue, the UK government has proposed complex and in part fairly extreme measures, reversing or tweaking areas of law that have been in existence for a long time.

The law of unintended consequences beckons. For example, what happens to an LLP member that suddenly becomes a "salaried member" or an employee? How does she or he fit within the existing, deferred partnership remuneration structure if no longer a "member"? Separately, the FCA's deferral rules are not expected to be finalised until later this year and should tally in with the tax rules.

The intention of the consultation about partnerships was to deter arrangements that seek a tax advantage, but not to affect persons entering into arrangements unmotivated by tax. However, the new tax proposals are so far-reaching it is difficult to imagine many LLP scenarios in which the new anti-avoidance rules would not apply. The almost draconian nature of some of the present proposals arguably creates some unfairness in the UK tax system itself.

> ***"What happens to an LLP member that suddenly becomes a 'salaried member' or an employee? How does she or he fit within the existing, deferred partnership remuneration structure if no longer a 'member'?"***

Unsurprisingly, many have suggested the tax authority delay implementation of the present "profit and loss allocation scheme" proposals and instead target those areas where the tax authority sees particular abuse with specific anti-avoidance rules. In this respect the consultation document proposes to introduce a targeted anti-avoidance rule to counter "disguised employment" where changes are made by LLPs so as to meet the new tests in form but not substance.

The dialogue between HMRC, the UK Treasury, the FCA and Aima, as well as other representative bodies, continues.

Meantime, nearly all professional and financial services/investment firms set up as LLPs will need to review their profit arrangements and organisation and documentation.