



Buzzacott's Professional Practices Group Winter Newsletter

This edition focuses on the changes to Partnership Taxation - Finance Bill 2014:

- **Key questions**
- **Disguised employment of LLP members**
- **Mixed partnerships**

Changes to Partnership Taxation – Finance Bill 2014

Following last Summer's consultation period, draft legislation covering changes to partnership and LLP taxation was unveiled in two stages during December. The new rules have attracted a great deal of commentary, in part because they are far more wide ranging than anticipated and seem likely to catch commercially motivated arrangements.

We summarise the new rules below, but first some key questions that partnerships and LLPs are asking:

Should we be concerned?

Yes - if you trade through an LLP and/ or your firm includes a combination of individual and non-individual members.

If we need to change our structure, how soon must we act?

Any changes will need to be made before 6 April 2014 to ensure that the new rules

will not apply. Subsequent changes could mitigate the long-term impact of the rules.

Are year ends before 6 April 2014 caught?

No.

What happens if our accounting year straddles 6 April?

The tax status of LLP members may change on 6 April – payments and benefits in kind may become subject to the PAYE rules from that date. Employers' NICs at 13.8% would also become payable. The profits of 'mixed partnerships' may need to be allocated between two notional periods – up to 5 April and from 6 April. Current arrangements should be appropriate until 5 April.

What action should we take now?

All, or almost all, LLP structures will need to be reviewed to ensure that members will not be deemed to be employees from

6 April 2014. Arrangements may need to be renegotiated with members where there is a concern that the member may be deemed to be an employee and this may take some time, so work should start now. Mixed partnerships will need to consider whether alternative arrangements will be needed to achieve the commercial benefits that are straightforwardly obtained at present.



Disguised employment of LLP members

Since the introduction of LLPs, HMRC has taken the view that any individual member of an LLP that is carrying on a business is self employed for tax purposes. This is not a view that has been shared by many advisers (or indeed the Employment Tribunals) and so the majority of LLP members have rights and obligations consistent with those that would apply to a 'traditional' partner. Unfortunately, it seems that even these rights and obligations may not now be sufficient to satisfy HMRC – from one extreme to another!

From 6 April 2014, if an individual member of an LLP meets the following three conditions, he will be deemed to be an employee of the LLP for all tax purposes:

- **Condition A - Payment for provision of services.** More than 20% of the remuneration 'reasonably expected' to be paid to the member is 'disguised salary' – broadly, to fall outside this condition the individual's

remuneration must be a share of the (whole) firm's profits and must be 'at risk'.

- **Condition B - Significant influence.** The member has no 'significant influence' over the affairs of the LLP.
- **Condition C – Contribution to the LLP.** The member's contribution to the LLP (broadly capital, excluding undrawn profits, tax reserves and similar amounts) is less than 25% of the 'disguised salary' that is 'reasonably expected' to be paid to the member

It is immediately obvious that these tests are significantly more onerous than the tests that apply for Employment Law purposes and also than those applying to a partner in a 'traditional' partnership. It is assumed that the limited liability bestowed by an LLP is the justification for this, although one could question the difference between an appropriately insured partnership and an LLP where all members are required to give personal guarantees to landlords and/or banks.

Members of non-UK LLPs are not subject to these tests.

It is important to note that from 6 April 2014 a member of an LLP could be employed for tax purposes but may not have the rights and protections afforded to an employee.

For an LLP member to remain self-employed after 6 April 2014, only one test must be 'failed' – in other words, to be deemed employed, a member must meet all three conditions.

In all but the smallest firms, it is likely that a great many members would meet the 'significant influence' condition. The management of most firms is devolved to a sub-group of members and only those individuals are likely to be able to demonstrate a significant influence. Changes may be possible to demonstrate the requisite influence, but care will be needed to prevent the firm becoming impossible to manage.

HMRC considers that Condition A (disguised salary) is the most significant test and for many firms this will also be a difficult test to 'fail', certainly without significant changes to the remuneration of a number of members. To fail the test, 20% or more of a member's 'reasonably expected' remuneration must not be 'disguised salary'; that is, it must be dependent upon the profitability of the whole firm. Guaranteed or non-refundable payments or amounts dependent only on the performance of the member or a part of the firm would count as 'disguised salary'.

Priority profit shares payable to a category of members will need careful consideration even if they are profit dependent - where there is a reasonable expectation that the profit will be sufficient to cover these amounts there will be a risk, but the risk might be reduced if these amounts rank alongside a first charge (salary) payable to all members.

The HMRC guidance does distinguish between refundable drawings as an advance against a profit share ('profit share') and non-refundable drawings ('disguised salary'), but does not tie this in with the 'reasonable expectation' test. However, the implication is that amounts that are refundable should there be insufficient profits, or a loss, will not be 'disguised salary'.

If Condition A is 'failed' then the member will not be deemed to be an employee, so all arrangements will need

to be reviewed and, where necessary, discussions held to see whether mutually acceptable changes can be introduced to maintain the status quo.

The final condition, Condition C, while conceptually the most straightforward ("you earn 4X, so you need to have capital of X"), could be extremely difficult for many firms, particularly those that achieve high profits on a relatively low capital base. However, there does not seem to be a requirement for a commercial need for capital and so this may be a 'safe harbour'.

To fail Condition C, a member must have (broadly) capital in the firm equivalent to 25% or more of the amount of 'disguised salary' that the LLP will 'reasonably expect' to pay him in that tax year, with pro rata adjustments for changes to remuneration (including on admission and retirement). This capital must be controlled by the LLP (typically only repayable on retirement) and must be truly 'at risk' – amounts funded by limited recourse or soft loans will not count.

Condition C will need careful negotiation, particularly if there are LLP members with low capital who are not at risk of re-categorisation because they have either 'significant influence' or proportionately low 'disguised salary'.

LLPs will need to review arrangements now and document the basis for their conclusions on the tax status of each member

Reviews will then be needed on admission of new members or on changes to the arrangements with a member which might affect his tax status.

LLPs which find that they have significant PAYE and NIC exposures as a result of these changes and which cannot restructure as an LLP may need to consider a corporate structure with shareholdings for senior employees so that dividend payments can be utilised to avoid some NIC liability.

Mixed partnerships

Mixed partnerships are partnerships or LLPs where there is a combination of individual and non-individual members. Non-individual members are, simply, any members who are not individuals and so include partnerships, LLPs, companies and trustees.

Two strands of 'abuse' were identified by HMRC and are tackled by the draft legislation:

- **Excess profit allocations.** These changes apply where a non-individual member is either allocated the 'deferred profits' of an individual member or an individual member has the 'power to enjoy' profits allocated to a non-individual member.

These arrangements were typically used to reduce, to corporation tax rates, the cost of working capital for firms or the tax immediately payable on profits that were not immediately payable to individuals (and indeed may never be paid to those individuals). Unfortunately, this planning is viewed as unfair by Government.

The provisions will be addressed in more detail below.

- **Excess loss allocations.** These changes are specifically targeted at tax avoidance arrangements, often involving capital allowances, whereby individual investors fund a trade and

are allocated all the early years' losses, but then retire from the business or for other reasons do not receive an allocation of future profits.

Where such tax avoidance arrangements exist, the individual investors will not be able to make use of any losses allocated to them.

Excess profit allocations

Where the deferred profits of an individual member are allocated to a non-individual member, the individual will be taxable on the amount so allocated (and the non-individual will not). It is accepted that this could result in a clear iniquity in circumstances where the individual is prevented from having immediate access to the profit. Similarly, an individual member will be taxable (and the non-individual will not be taxable) on profit allocations to a non-individual member in excess of an appropriate notional profit.

Broadly, an individual will have power to enjoy the profits if he is connected with the non-individual member (other than as a consequence of their being business partners) or if he or someone connected with him can enjoy the profits. Therefore, genuine third party mixed partnerships will not be caught by these new rules.

Transfer pricing analysis could therefore become critical even in cases where the firm would otherwise be outwith the UK's anti-avoidance rules in this area and service companies may still have a part to play in planning for partnerships, both in terms of reducing the cost of capital, but also to spread ownership and allow profit sharing by dividends.

These rules are wide ranging and hard hitting, such that much of the recent planning in this area will no longer be effective.

Upcoming seminar on Thursday 16th January 2014

Tax Round-Up For Professional Practices

This seminar will concentrate on tax and financial planning from the perspective of firms and individuals.

We will be offering guidance on what to do in the run-up to the year end with a focus on the Finance Bill 2014 and, specifically, 'disguised remuneration'. It is particularly relevant for partners and finance directors in partnerships and LLPs, including those firms whose structure may feature a corporate partner or member.

The seminar qualifies for 1.25 hours CPD and will focus on the following topics:

- Update following the Finance Bill 2014;
- Changes to the taxation of LLPs and Partnerships;
- LLPs and self-employment;
- Future of tax planning for LLPs and Partnerships.

Speakers at this event include Alastair McQuater (Tax Partner). Registration is from 4:30pm for a 5:00pm start. The session will finish at 6:30pm with refreshments and networking.

To register please visit our website: www.buzzacott.co.uk/events

Upcoming MBL seminar in London and Manchester

Partnerships & LLPs - Important Legal & Tax Changes for Professional Service Firms

MBL seminars
4 February 2014 - London
12 February 2014 - Manchester

Changes to the way in which limited liability partnerships (LLPs) are taxed were announced in the 2013 Budget and are due to come into force on 6 April 2014. This course will help you to gain a greater understanding of the issues and the action needed before 6 April 2014.

Alastair McQuater, Tax Partner is a guest speaker at this event.

For more information or to register, please visit the MBL Seminars website.

Please note MBL seminars are not held at our Buzzacott office.

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