

Latham & Watkins Benefits, Compensation & Employment Practice Number 1625 | December 20, 2013

UK Tax Shake Up for Partnerships

In light of tax changes proposed for April 2014, partnerships may need to reconsider their members' classification and/or duties to maintain the most tax efficient positions.

The UK Government's recently published draft Finance Bill 2014 provisions are expected to impact significantly the taxation of partnerships — in particular 'salaried' members of limited liability partnerships (LLPs) formed under UK law as well as partnerships with 'mixed' members. These changes are expected to have effect from 6 April 2014.

The legislation, if introduced, would affect many different businesses, including those in the financial services and professional services industries.

This draft legislation is designed to address two main issues:

- **Disguising employment relationships** HM Revenue & Customs (HMRC) views certain salaried members of LLPs as disguised employment arrangements designed to reduce employment taxes, particularly National Insurance contributions; and
- **Allocation of profits and losses.** HMRC intends to address the tax-motivated allocation of profits and losses between individual and corporate members of all partnerships (not just LLPs).

In response to specific concerns that were raised during the consultation period concerning these new arrangements, the draft legislation also contains provisions for the taxation of deferred partnership remuneration payable to alternative investment fund managers (AIFMs) established as partnerships.

Taxation of LLP members

The presumption of self-employment of LLP members will be disapplied for salaried members of LLPs. Members will be treated as employees for the purposes of income tax, National Insurance contributions and corporation tax if all of the following three conditions are satisfied:

- The amounts received by that member are "*wholly, or substantially wholly, disguised salary*". This will be satisfied where the remuneration is either fixed or, if variable, is not varied by reference to, or is not in practice affected by, the overall profits or losses of the LLP. HMRC propose that when 80 per cent or more of the payments received by the member from the LLP are "*disguised salary*" this test will be met.
- The member does not have "*significant influence over the affairs of the partnership*". It is likely that all members of most large partnerships, or partnerships which are managed by management committees, will satisfy this test. By contrast, members of smaller firms may be better positioned to assert significant influence over the affairs of the partnership and may therefore be able to argue that they do not meet this condition.

- The member's capital contribution to the LLP is less than 25 per cent of their "disguised salary" in any given tax year.

If a member meets all three of these conditions, he or she will be treated as an employee for the purposes of tax and National Insurance contributions. That means the LLP, as employer, will be required to withhold tax and the employee's National Insurance contributions via pay-as-you-earn (PAYE) and will be required to pay employer's National Insurance contributions, currently calculated as 13.8 per cent of pay.

If a member does not satisfy any one of these conditions he or she should continue to be treated as self-employed partners for income tax and National Insurance contributions purposes. Notably, these conditions are quite distinct from the general test for employment under employment law.

In most large partnerships, individual members do not have significant influence over the affairs of the partnership. Similarly, many partners do not make significant capital contributions to the partnership. Therefore, in many situations, the first condition will be the most important test. Variable pay will only not count towards "disguised salary" if the pay varies by reference to the performance of the LLP. If a significant portion of a partner's pay varies by reference to his own performance, this will still be treated as "*disguised salary*".

Allocation of profits and losses in mixed membership partnerships

A partnership or LLP is transparent for UK tax purposes. Therefore, members are taxed on the profits of the partnership as and when they arise. If the member is an individual, he or she pays tax at income tax rates. Whereas if the member is a corporate entity it will pay corporation tax, currently significantly below the income tax rates applicable to individuals. In addition, a corporate member may also provide opportunities to defer the allocation of profit to individual members. If a partnership has only individual (non-corporate) members, they pay income tax when the profits arise, even if the payments out of the partnership to the members are deferred.

Under current law, for UK tax purposes, a partner's share of a firm's profits or losses is simply determined in accordance with that firm's profit-sharing arrangements. With respect to partnerships — which include both individual and non-individual (*i.e.*, corporate) members — this new legislation will reallocate profits to individual (non-corporate) members in certain circumstances, so that these profits become chargeable to income tax when the profits are earned, even if they are not allocated to the individual.

In order to be caught by this provision, the corporate member's profit share must be "excessive", and such share must be wholly or partly connected to either (i) the fact that either the individual member can enjoy the corporate member's share, or (ii) there are deferred profit arrangements. For example an individual member would be considered to have the power to enjoy a corporate member's profit allocation where that individual member is a shareholder of the corporate member.

Deferred remuneration for Alternative Investment Fund Managers

Pursuant to the Alternative Investment Fund Managers Directive (AIFMD) Remuneration Code, AIFMs are required to comply with certain deferred remuneration rules with respect to key staff.

Currently partnership members (including members of LLPs) are liable for tax on their share of the partnership's profits as these profits arise. However, in compliance with the AIFMD Remuneration Code, individual members of AIFM partnerships are restricted from immediately accessing their share of these profits. Consequently, there was a significant concern that the interplay of the rules on the taxation of

partnership profits and the deferred remuneration rules under the AIFMD Remuneration Code would give rise to unintended consequences.

The draft legislation aims to address this concern by introducing a mechanism whereby individual partners can allocate their portion of the firm's profits — which accounts for their individual deferred remuneration — back to the firm, and the firm then accounts for income tax on these amounts. When these amounts are ultimately paid to the relevant partners, the amounts will be treated as taxable income, but this will be set-off against the tax initially paid by the firm on these amounts.

Who will be affected?

The UK Government acknowledges that the effect of this legislation will be felt primarily by large professional partnerships, such as law firms, accountancy firms and other professional services LLPs.

By contrast, the majority of smaller, family partnerships likely will not be affected because either (i) they do not have members who will meet the de facto employee conditions, or (ii) they do not have corporate members to whom profits and losses have historically been allocated for tax purposes.

"Mixed" partnerships will need to give consideration to these proposed new rules. With regards to salaried members, LLPs should weigh up the additional administrative burden and employer's National Insurance contribution costs against the commercial feasibility of varying the individual members' terms, or the terms of the LLP agreement itself, in order to ensure these members genuinely participate in the management and economic risk of the firm. For some LLPs, accepting the 'employee' status of these salaried members may be the lesser of two evils.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Stephen M. Brown

stephen.brown@lw.com
+44.20.7710.1066
London

Sean Finn

sean.finn@lw.com
+44.20.7710.1000
London

Gretchen Lennon

gretchen.lennon@lw.com
+44.20.7710.4790
London

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