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Joining the firm?

Salaried partner or employee?

When is a partner not a partner? When he's an employee. When is a salaried partner an employee? When he's not a partner, of course.

Or when the Employment Appeal Tribunal says he's not. The EAT has decided two recent cases concerning solicitor salaried partners – in opposite ways.

The status of "salaried partner" or "fixed share partner" has been very useful for law firms. Clients like to deal with partners, so salaried partners are given the title as a badge of confidence by the firm, without all the financial consequences of admitting an equity partner.

Firms treat salaried partners in different ways. At one end of the scale, there is the person who is clearly an employee, but who is held out to the public as a partner. He has a contract of employment, he is paid under PAYE and he takes no significant part in the firm's overall management. He gets no profit share but is indemnified against any losses. At the other end is the fixed-share partner who takes a full part in partnership decisions, gets paid only if there are profits to distribute, perhaps contributes capital to the firm, and often has a small share of profit, which might be linked to individual or team performance. In between are a variety of other arrangements, often poorly thought through, which try to treat the person as an employee whilst making him self-employed for tax purposes. The documentation often looks like an employment contract, with varying degrees of lip-service to the partnership ideal.

In *Stekel v Ellice*[1] Megarry J. said that a salaried partner on a fixed salary, not dependent on profits, could still be a true partner, at least if he was entitled to a share in the profits on a winding-up. The relationship is a question of fact, and is not determined by what the parties call it.

[1] [1973] 1 WLR 191

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Employment protection Self-employed status can be attractive to the salaried partner who is taken outside the PAYE system. But it is a lot less attractive when the relationship ends, and salaried partners may be tempted to claim employment rights when they are dismissed, as Jeremy Briars did recently in *Williamson & Soden v Briars*[2]. He won comprehensively. The Employment Appeal Tribunal upheld the Tribunal's ruling that there was no doubt that Mr Briars was an employee for the purposes of the definition in the Employment Rights Act (ERA)[3]. The question was not whether he was truly a partner within the definition of the Partnership Act 1890[4], but whether he was an employee within the ERA definition. He had made a seamless transition from employed status with very little change in his role or terms. He received a fixed salary, not dependent on profits, plus a small profit share. He did not share in losses. The documents did not demonstrate acceptance of the heavy burden of partnership. And perhaps most importantly, he was subject to the control and direction the equity partners in a manner appropriate to an employee rather than a true partner.

It is often said that someone who has been treated as self-employed and has reaped the tax benefits could not easily convince a tribunal that he was in fact an employee when it suited him. But this point was not even mentioned in the judgment in *Williamson & Soden*, despite Mr Briars having been treated as self-employed for tax purposes for about six years.

Tiffin v Lester Aldridge LLP[5] went the other way. There, the fixed share partner had signed documents and received a benefits package that more clearly pointed to partnership; he received a small profit share, and he was entitled to a small share of surplus on a winding-up; he had limited votes at partners' meetings, and he contributed a small sum as capital. The Tribunal and EAT both found that Martin Tiffin was a partner, and not an employee. There was no minimum share of profits, surplus or voting required.

The position in an LLP ought to be slightly different. Whether or not two or more people are in partnership is a test of the relationship: as a matter of fact, are the partners carrying on business in common with a view of profit? In an LLP, though, the question of who is a member of the LLP is more defined: a member is a subscriber to the incorporation document or someone admitted by and in accordance with an agreement with the existing members[6]. There should be no room for arguing that a member of an LLP, recorded as such and registered at Companies House, is not in fact a "true" member of the LLP. But it seems you can be both a member and an employee of an LLP: "A member of [an LLP] shall not be regarded for any purpose as employed by the [LLP] unless, if he and the other members were partners in a partnership, he would be regarded for that purpose as employed by the partnership."[7]

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[2] [2011] UKEAT 0611_10_2005

[3] ERA 1996 Section 230: an individual who has entered into or works under a contract of service

[4] PA 1890 sections 1 and 2: carrying on a business in common with a view of profit, and receipt of a share of the profits is prima facie evidence that he is a partner, but does not of itself make him a partner; and the remuneration of a servant (employee) by a share of the profits does not of itself make the servant a partner.

[5] [2010] UKEAT 0255_10_1611

[6] Limited Liability Partnerships Act 2000 section 4

[7] Limited Liability Partnerships Act 2000 Section 4(4)

That looks odd, and it is. True partnership and employment are mutually exclusive, it seems; so if he and the other partners were truly *partners* in a partnership, he could not be an employee; though if they were not truly partners, and he was just called a partner, he could be an employee. What does the section add? Is it not effectively saying that a member of the LLP can never be an employee? Apparently not. In *Tiffin v Lester Aldridge* and in *Kovats v TFO Management LLP*[8] the section was assumed to mean the opposite of what it says: that if he and the other partners would *not* have been partners in a partnership, he could be an employee. In *Kovats* the EAT specifically recognised the possibility that a person could be both a member of the LLP and an employee.

Tax benefits But there is one important difference in an LLP. A member of an LLP is always taxed as self-employed, even if he is, in law, an employee. His taxation status does not depend on whether he is an employee within the meaning of the ERA, but on whether he is a member of the LLP. For income tax purposes, in a trading LLP all the activities of the LLP are treated as carried on in partnership by its members.[9] There is no exception for members who are also employees. So we have a potential category of salaried partners (members) in LLPs who are employees for employment protection purposes, but taxed as self-employed. This is very useful, as it allows firms to confer the taxation benefits of LLP membership (and gain exemption from employer NICs) without any real pretence at making the salaried partner a true partner. So long as he is admitted as a member in accordance with the LLP members' agreement, and perhaps has a small profit share (so that the membership is not a sham or blatant tax avoidance), he can have a contract that resembles an employment contract, and be subject to control and supervision as an employee, without losing the beneficial tax treatment. The potential for tax planning here is considerable, and we could see increasing use of LLP member status intended mainly to save tax.

By the same token, the taxation status of an LLP member ought to be irrelevant to his status for employment rights purposes, though this point does not seem to have been considered in *Tiffin* or *Kovats*. In a Partnership Act partnership, unlike an LLP, the tests for employment rights and tax purposes are the same, so a person treated as an employee for employment rights purposes should also be subject to PAYE.

Restrictive covenants It is said that post-termination restrictions will be harder to enforce against employees than partners, and that restrictions on employees must be narrower in scope if they are to be reasonable. But in fact it is the position and role of the individual that affects the enforceability of the covenant, not his status as employee or partner. Covenants have been enforced against senior employees[10] which might well not have been enforceable against junior partners. In all cases there must be a legitimate interest to protect and the restriction must be no more than is reasonable to protect it, but it is relevant to look at the respective bargaining power of the parties, their mutuality of obligation, and the extent to which the individual would have expected to benefit from the goodwill protected by the covenant.

[8] [2009] UKEAT 0357_08_2104

[9] Income Tax (Trading and Other Income) Act 2005 section 863

[10] eg in *Thomas v Farr PLC* [2007] EWCA Civ 118

Having the salaried partner sign new covenants in the same form as the equity partners may well help, both in demonstrating the reasonableness of the mutual obligations and in showing that the partner is a true partner.

What lessons can be learned from the cases? Many salaried partners will be employees, with employment protection rights, if no special effort is made to ensure that they are genuine partners. To make them genuine partners, consider making their remuneration depend on the availability of profits, so they share in risk; having them bear a small share of losses, and/or share in capital profits; having them contribute capital; making them parties to the main partnership or LLP agreement; giving them a benefits package appropriate to a partner; giving them votes at partners' meetings; and generally treating them as far as possible as partners.

In a partnership, if those things (or many of them) are not done, the firm is at risk of being charged PAYE if HMRC alleges that the individual is not a partner, so it may be safer to operate PAYE from the start. In an LLP you are on safer ground from a tax perspective, so long as the salaried partner has been admitted as a member in accordance with the members' agreement and the membership is not a sham or an artificial step for the purposes of tax avoidance.

The overall look and feel of the relationship and the documents is important. When reading *Williamson & Soden v Briars* and *Tiffin v Lester Aldridge,* it strikes you that the Tribunal's first impression was important. Jeremy Briars' engagement looked like employment; Martin Tiffin sounded like a partner. Displacing that initial impression is going to be difficult.

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