

FOCUS ON

# Limited liability partnerships: partnership tax changes

Some significant changes to the taxation of Limited Liability Partnership are to be introduced in the 2014 Finance Bill. Nothing was announced in the March 2014 Budget which changes the Government proposals announced in December 2013.

Broadly, the two aspects that have become the subject of such scrutiny are the status of individual members of Limited Liability Partnerships and Partnerships with mixed memberships.

## The Salaried Members Legislation

Under the new proposed rules, members of LLPs will find themselves in an entirely different position to any other individual engaged for labour in the UK. Whereas the status of individuals working on their own account and partners in traditional partnerships will be treated as employed or self employed based upon the facts, looked at in the round, for members of an LLP the question of status will be determined on a formulaic basis.

An individual member of an LLP will be viewed as an employee unless he or she satisfies at least one of the three following criteria:

- At least 20% of the individual's profit share is directly linked to the profitability of the firm. This would appear to exclude not only any fixed salary but also any award to the individual that is based upon personal performance.
- The individual has significant influence over the affairs of the LLP. This means the affairs of the LLP as a whole and not influence over for example a particular department or service line.
- The individual has contributed financially to the LLP, a sum that exceeds 25% of the profit share that the individual receives that is either fixed or is related to personal performance.

One of the features of partnerships and LLPs is that there are myriad different profit sharing mechanisms. The legislation distils the categorisation of members of LLPs down to the three criteria above. This will inevitably result in what can best be viewed as anomalies. This is illustrated below.

## Example 1

Take a ten partner firm of solicitors operating as an LLP. There are two tiers of partners. Tier 1 partners contributed £50,000 capital and Tier 2 partners contribute £25,000. The profit sharing arrangements for the firm is divided into four elements for all partners:

1. Interest on capital
2. Fixed share
3. Variable share from a pool based upon personal performance
4. Residual profit share by reference to capital contribution

Taking a Tier 2 partner (A), who does not have significant influence over the firm's affairs, if one assumes interest on capital of £1,000, a fixed share of £120,000, a performance related share of £30,000 and a residual profit share of £25,000, this individual will be viewed as an employee: there is insufficient profit related profit share, the individual does not have significant influence and the capital contribution is insufficient. In contrast (B), if the profit sharing arrangements were such that interest on capital was £1,000, fixed share was £60,000, performance related £60,000 and residual £55,000, the individual would be accepted as self employed.



## Example 2

Joe is a partner in a firm of Chartered Surveyors operating through an LLP. He has contributed £50,000 of capital. He is not a member of the management committee of the firm. His profit share comprises a fixed share of £100,000, a discretionary award and a residual profit share. As a result of a success fee earned, Joe's discretionary award for the year is £200,000 and his residual profit share is £70,000, giving a total of £370,000. Joe's capital contribution is less than 25% of his combined success fee and discretionary award, his residual profit share is less than 20% of his overall profit share and he is not involved in the firm's management hence he is liable to be viewed as an employee.

Some of the results of the tests proposed by the draft legislation include:

- Members of smaller LLPs are less likely to be treated as employees than members of larger LLPs because they are more likely to be able to evidence that they can exert significant influence.
- The award of performance related rewards to a partner may move members of LLPs to employed status because their total reward comes to exceed four times their capital contribution.
- To maintain self employed status, fixed share elements should be minimised i.e. it may be possible to maintain profit shares as between partners with smaller fixed share elements.
- There will be plenty of circumstances in which an individual who is a member of an LLP will be viewed as an employee based upon the same facts, but in a general partnership, there would be no question that they would be viewed as anything other than self employed.
- Subject to the operation of the General Anti Abuse Rule, it would seem that the mechanistic approach proposed may result in being able to manage the self employed status of more junior members of LLPs as discretionary awards to more senior members should allow the residual profit share entitlements of the more junior members to be controlled.

The point at which consideration needs to be given to these tests is 6 April 2014 or for members joining the LLP after this date, at point of entry. It is then necessary to reconsider their contribution to the LLP at the beginning of each tax year and the other two tests whenever there is a change in circumstances. The HMRC guidance refers to taking a realistic view of the facts and identifying the real package on offer

Targeted anti avoidance provisions are proposed too under which steps taken for the main purpose of avoidance of categorisation as an employee and the insertion of intermediaries (such as a company) are to be ignored. Again, the practical application of, in particular, the first arm of the anti avoidance rules is not clear. However, notwithstanding these rules, consideration needs to be given now to the profit sharing arrangements of LLPs. Ideally this will be a commercial exercise not only in considering how profit sharing arrangements may better motivate members of the LLP and taking the opportunity of removing anomalies in the LLP agreement but also so as to ensure that members do not fall inadvertently to be treated as employees with the consequent PAYE operation requirements and benefit in kind consequences.

## Partnerships with Mixed Membership

It was apparent from the May 2013 consultation document that the Government were targeting the use of companies as members of partnerships deriving benefit from the significantly lower rate of corporation tax as compared to income tax.

The proposed mixed partnership rules propose the "just and reasonable" reallocation of profits for tax purposes from a corporate member to individual members where either the profits reflect what is termed the "deferred entitlement" of an individual member or members or where an individual member or members has the "power to enjoy" the profit. The objective is to tax the individual partners on the profit that they would have received had the profits not been allocated to the corporate partner.

There are differences between how the rules work as between deferred entitlement and power to enjoy cases. Where there is any case of deferred entitlement, that profit rests with the individual who has the deferred entitlement. In contrast, where there is power to enjoy, the profit that is reallocated to individual members is the excess of any profit allocated to the company over and above what is termed the notional profit. The notional profit is the profit share that would be produced based upon a reasonable return on the capital invested, coupled with a return for services provided (expected to be calculated by reference to cost with (at most) a modest mark up but excluding any services provided that involve other members of the partnership).

Where there has been a reallocation of profit to an individual, relief is provided for upon a subsequent payment of that profit to the individual i.e. because the profit has been subjected to income tax by reallocation, a subsequent payment is not viewed as an income receipt of any kind for the individual.

The mixed partnership rules beg very many questions. It is presupposed that it will be possible to establish a just and reasonable allocation of profits and that it will be apparent where the allocation of profits to a corporate partner reflects a deferred profit entitlement on the one hand or where there is power to enjoy on the other.

It is suggested that in practice this may be more difficult. Equally, whilst the apparent attempt to prevent double taxation is welcome, the guidance does not cater for circumstances in which profits are allocated to one individual partner "on a just and reasonable basis" but ultimately those profits come to be distributed to another individual neither on the basis of what relief would there be from taxation for the partner who ultimately receives the profit (apparently none) or how one deals with the inequity resulting from an individual having been taxed on profits that they have never received.

When looking at a normal case of a corporate partner owned by the individual partners of a partnership or LLP, these rules come into force with effect from 6th April 2014. They will apply to all periods commencing after this date. For periods which straddle this date, the period will be split so that the rules will be considered to apply to that part of the period of accounts which fall after 5th April 2014.

Whereas generally there is a 6th April 2014 commencement to the mixed profit share rules, immediate anti avoidance provisions applied from 5th December 2013 where there is a partnership of corporate partners owned by individuals who are not members of that partnership, but who work for the partnership. This applies for arrangements put in place on or after that 5th December date and operates to deem the individual to be a member of the partnership with the consequent application of the mixed partnership rules to profits allocated to the corporate member. The anti avoidance legislation appears to have been drafted to impact on arrangements put in place on or after 5th December 2013. However, it would appear reasonable to expect that this will be extended to cover arrangements in existence on or after 5th December 2013.

It will be important for partnerships that fall within these provisions to consider carefully the profit sharing arrangements that will prevail in respect of periods falling after 6th April 2014.

## The way forward

Because the structure of professional service businesses are so varied, it is difficult to make generalisations other than there is an absolute need to review structures (sooner rather than later) so as to understand the potential application of these new rules to any particular scenario.

## Key dates:

<b>May 2013:</b>	Government launches consultation document on partnership tax
<b>5 December 2013:</b>	Autumn statement announces the Government's partnership tax changes
<b>5 December 2013:</b>	Rules enforced for - Partnerships of corporate partners owned by individuals who are not members of that partnership, but who work for the partnership. This includes arrangements put in place after 6th December 2013.
<b>22 January 2014:</b>	Interim report from the Office of Tax Simplification on partnership tax changes makes no changes to the proposed new rules
<b>22 March 2014:</b>	Budget makes no announcement of changes to the proposed new rules
<b>27 March 2014</b>	Finance Bill published to include the partnership tax changes
<b>6 April 2014:</b>	Rule enforcement date for: <ul style="list-style-type: none"> <li>A "normal" case of a corporate partner owned by individuals of a partnership or LLP</li> <li>Salaried Members legislation</li> </ul>
<b>July 2014:</b>	Passing into law of the Finance Bill

## Contact

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