HM Revenue
& Customs

# Partnerships: A review of two aspects of the tax rules

## Revised Technical Note and Guidance:

- *Mixed Membership Partnerships*
- *Alternative Investment Fund Managers*
- *Transfers of Assets & Income Streams Through Partnerships*

**27 March 2014**

# Contents



**On request, this document can be produced in Welsh and alternative formats including large print, audio and Braille formats.**

# 1. Overview

## A guide to this Chapter



## 1.1 Background

On 10 December 2013, HMRC published a Technical Note providing guidance on draft legislation on partnerships that was also published at Autumn Statement 2013.

HMRC invited comments on the guidance, and requesting further practical examples.

As a result of the examples and suggestions received from customers, HMRC published this updated Technical Note on 27 March alongside revised partnerships legislation and a separate note on Salaried Members. The Salaried Member legislation was first published on 7 March and remains unchanged.

The guidance published in this Technical Note and the Salaried Member Note will form the basis of guidance which will be published in HMRC's Business Income Manual after Royal Assent.

## 1.2 Who is affected by the legislation?

The rules in this note apply to partnerships and limited liability partnerships (LLPs). They also apply to foreign entities that are treated as partnerships for the purposes of UK Income and Corporation Tax.

## 1.3 The rules at a glance

This Chapter identifies the three elements of the legislation covered in this Technical Note. Chapter 2 provides interpretation and terms that are used in the note.

### *1.3.1 Tax-motivated allocation of business profits & losses in mixed membership partnerships (Chapter 3)*

The third Chapter of the note looks at the "mixed membership partnership" legislation. That is a partnership which has both individual members and non individual members (typically companies).

This legislation is being introduced to remove the tax advantages gained through tax-motivated:

i) profit allocations to non-individual partners; and

ii) loss allocations to individual partners.

The first element of this change will affect mixed membership partnerships where partnership profits are allocated to a non-individual partner in circumstances where an individual member derives a benefit from the allocation.

The second element will affect cases where partnership losses are allocated to an individual partner, instead of a non-individual partner, to enable the individual to access certain loss reliefs.

To prevent avoidance, certain provisions in the mixed membership rules came into force from 5 December 2013, the date when they were first published.

### *1.3.2 Alternative Investment Fund Managers (Chapter 4)*

This Chapter provides guidance on the legislation that provide for a collection mechanism for partnerships and LLPs that are alternative investment fund mangers (AIFM) in the context of the AIFM Directive (2011/61/EU).

### *1.3.3 Transfers of assets or income streams through partnerships (Chapter 5)*

This Chapter provides guidance on the legislation to counter the use of partnerships to dispose of income streams or assets without triggering a charge to tax on income.

The legislation applies to both the use of partnerships and LLPs.

The legislation applies if the main purpose, or one of the main purposes, of the disposal, or any of the steps by which the disposal is effected, is to secure a tax advantage in relation to the charge to income tax or the charge to corporation tax on income.

The legislation imposes a charge to tax on income on the person making the disposal.

# 2. Interpretation and Glossary

“AIF” means an alternative investment fund as defined for the purposes of the AIFMD.

“AIFM” or “AIFMs” means alternative investment fund manager or managers.

“AIFMD’ means the Directive on AIFMs (Directive 2011/61/EU).

“AIFM Regs” means the AIFM Regulations 2013 (S.I.2013/1773).

“CGT” means capital gains tax.

“CTA 2009” means Corporation Tax Act 2009.

“CTA 2010” means the Corporation Tax Act 2010

“Deferred remuneration”, “restricted profits” and “variable remuneration” are explained in sections 4.8 and 4.9.

“ESMA Guidelines” means the Guidelines on Sound Remuneration Policies under the AIFMD issued by the European Securities and Markets Authority on 3 July 2013 (ESMA/2013/232).

“FA 2004” means Finance Act 2004

“FCA” means Financial Conduct Authority.

“Instruments” is explained in Chapter 4 (section 4.12.1).

“ITA 2007” means the Income Tax Act 2007.

ITTOIA means the Income Tax (Trading and Other Income Act) 2005. All statutory references are to ITTOIA unless otherwise stated.

LLP means a UK Limited Liability Partnership formed under the Limited Liability Partnerships Act 2000 and LLPA means the Act.

NICs means National Insurance contributions.

“Partner” includes a member of a LLP who is not a “Salaried Member” (see the separate Technical Note published on 27 March 2014).

“Partnership” means any of a General Partnership, Limited Partnership, UK Limited Liability Partnership and any entity formed in a jurisdiction outside the UK that is treated as a partnership for UK tax purposes.

References to ”non-individuals” mean any person other than an individual and include an individual or individuals acting as trustee (see sub-section 3.3.4).

References to a partnership include an LLP.

“SPD12” means Statement of Practice 12 (CG57400)

“TCGA” means Taxation of Chargeable Gains Act 1992.

“TMA” means Taxes Management Act 1970.

“Vest” and ”Vesting” take the meaning as explained in Chapter 4 (sections 4.10 & 4.11).

# 3. Partnerships with Mixed Membership

## A guide to this Chapter



## 3.1 What is this about?

This guidance covers mixed membership partnerships. A mixed membership partnership is a partnership or LLP that has, as partners or members, both individuals and persons who are not individuals. Examples of non-individuals include companies or trustees.

One attraction of partnerships and LLPs is that they are seen as offering greater flexibility than other business structures, such as limited companies. Sometimes, however, the use of mixed member partnerships allows individual members to allocate profits and losses in a way that reduces tax liabilities. Draft legislation in Finance Bill 2014 will counteract these tax-motivated arrangements as set out below.

**Excess profit allocation**

Arrangements where an individual, or individuals, divert all or part of their profit share to a non-individual member or members, usually a company or companies, in order to reduce tax on their profit share.

The rules allow the profit sharing arrangements agreed by the members to be over-ridden so that individual members are taxed on the diverted profits.

The legislation does not apply to mixed membership partnerships in which the individual and non-individual partners are genuinely acting at arm's length and not intending to secure a tax advantage.

**Excess loss allocation**

Arrangements entered into with a view to an individual member, or members, being allocated losses of the partnership, instead of a non-individual, in order for them to be able to claim loss relief. The rules ensure that relief for the losses will be restricted in such cases.

This part of the note explains how these provisions work.

## 3.2 Excess profit allocation

### *3.2.1 Overview*

**Summary of when the legislation applies**

The legislation applies where the partnership or LLP makes a profit for tax purposes, a profit share is allocated to a non-individual partner (B) and either Condition X or Condition Y is met:

- Condition X is that the profits represent deferred profit of an individual member ("A"), or

- Condition Y is that B's profit share exceeds the appropriate notional profit and that individual partner (A) has the "power to enjoy" all or any part of B's profit share.

For further information on what is meant by "the appropriate notional profit" see sub-section 3.2.7 and "power to enjoy", see sub-section 3.2.8.

In both cases, it must be reasonable to assume that A's profit share is less than it would be apart from the profit deferral arrangements, or the circumstances that lead to the power to enjoy condition being met, and that, overall, less tax is paid because of the allocation of profits to the non-individual.

In the case of Condition Y, it must also be reasonable to assume that all or part of B's profit share is referable to A's power to enjoy.

**Summary of what the legislation does**

Instead of being taxed on their profit shares according to the usual tax principles, the partners' profit shares are adjusted for tax purposes so that:

- A is taxed on the profits that would have been allocated to A had the deferral arrangements not been entered into or that reflect A's power to enjoy, as determined on a just and reasonable basis.

- The non-individual is taxed on a smaller share to reflect the amount on which the individual is taxed.

Where Condition Y applies, the maximum additional profit that the individual can be taxed on is the difference between the appropriate notional profit (see sub-section 3.2.7) for the non-individual and the profit allocated to that non-individual (the non-individual's "excess profit").

For this purpose (and the purpose of reallocating profits), income tax rules are applied to the calculation of the non-individual's excess profit even if it is company.

If the profit shares of a number of individuals have been allocated to the same non-individual member, then the difference between the excess profit is reallocated amongst the individual partners on a just and reasonable basis.

### *3.2.2 Introduction – structure of this guidance*

Detail on when the legislation applies can be found at sub-sections 3.2.3 to 3.2.10.

The guidance on calculating the amount of profit that is re-allocated is at sub-section 3.2.11.

As reallocated profits are taxed on the relevant individual member(s), but the profits remain in the hands of the non-individual member, the legislation allows for the profits to pass from the non-individual member to the individual without further tax being due. For guidance on this, see sub-section 3.2.12.

Guidance on how this legislation interacts with the legislation on AIFMs can be found at sub-section 3.2.13.

There is anti-avoidance legislation which applies to prevent avoidance by using intermediary structures. The guidance on this can be found at sub-section 3.2.14.

Sub-sections 3.2.17 and 3.2.18 considers pseudo share schemes and international structures.

Guidance on commencement provisions is at sub-section 3.2.19.

### 3.2.3 When does the legislation apply? *(S850C (1)-(4))*

This section looks at when the excess profit allocation rules apply.

The legislation applies where:

- in a period of account, a partnership has a taxable profit;
- a share of the profit is allocated to a non-individual member;
- Condition X or Y is met.

Condition X is that it is reasonable to suppose that amounts representing A's deferred profit are included in B's profit share and in consequence both A's profit share and the relevant tax amount (see sub-section 3.2.10) are lower than they would otherwise have been.

Condition Y is that B's profit share exceeds the appropriate notional profit, A has the power to enjoy B's profit share and it is reasonable to suppose that the whole or any part of B's profit share is attributable to A's power to enjoy, and both A's profit share and the relevant tax amount are lower than they would have been in the absence of A's power to enjoy.

The terms, "appropriate notional profit", "power to enjoy", and "relevant tax amount", are explained in sub-sections 3.2.7, 3.2.8 and 3.2.10

### 3.2.4 Non-individual partners *(S850C (6))*

A non-individual partner is simply anyone other than an individual. As a result, the term non-individual partner includes companies and individuals acting as trustees.

The fact that one partner holds assets on trust for the partnership as a whole (for example, an individual member of the partnership holds leasehold land on trust for the partnership) does not make it a mixed membership partnership.

**Alternative Investment Fund Managers (AIFM)** (S863H)

Under the legislation dealing with the tax treatment of remuneration of members of AIFM firms in sections 863H to 863L, a partnership may elect to be treated as a partner in itself in order to pay tax on a member's remuneration on behalf of the member. If it does so, the AIFM firm is treated as an individual member of the partnership, not as a non-individual member for the purposes of the mixed membership rules.

For further information, see the AIFM guidance included in Chapter 4.

### *3.2.5 Condition X - Deferred profit arrangements (S850C(2))*

In brief, Condition X applies where amounts representing the individual member's deferred profit are included in the non-individual member's profit share (see sub-section 3.2.9).

Deferred profits means any profits of the individual member that are held back for whatever reason, and are initially allocated to a non-individual member, with the result that the tax paid in that period is lower than it would have been if the profits had been allocated to the individual.

Deferred profit arrangements include arrangements that include the possibility that events may mean that the individual may not actually receive the profits (Section 850C(8)).

***Example 1***

This example looks at a deferred remuneration scheme, where a bonus is initially allocated to a corporate member.

> *Kate is a member of XYZ LLP. She is awarded a bonus that is conditional upon the successful outcome of a project she has been involved in. The bonus is initially allocated to XYZ Corporate Member Ltd.*

This is a deferred profit arrangement; the fact that it is conditional upon a future event does not alter this.

The AIFMD and the FCA rules may prevent members of AIFMs which are partnerships from accessing their profit shares. Any such profits allocated to a corporate member of the partnership are deferred profits for the purposes of Condition X. There are special provisions for these profit shares which are explained in Chapter 4.

The profit deferral arrangements may operate in relation to a class of members rather than a particular individual, as set out in the example below:

***Example 2***

> *Y LLP has 50 individual members and a corporate member N Ltd. The 50 individual members are the shareholders in N Ltd. Profits allocated to N Ltd are injected as capital contribution into Y LLP; they are not paid out, by dividend or otherwise to the shareholders. However Y LLP keeps a memorandum note which tracks the longer-term entitlement of each of the individual members to a respective portion of each year's N Ltd profit allocation based on the partnership's profit sharing arrangements in that year. When an individual member retires from the LLP, he is paid out that cumulative entitlement and he ceases to participate as a shareholder in N Ltd.*

The profit share of N Ltd is attributable to each of the individual members in proportion to the entitlements tracked within the memorandum note and which will be paid out to them on retirement. The amounts represent the deferred profits of each individual which will be reallocated under section 850C(4).

If there were no separate memorandum, but the ultimate entitlement in relation to the profits allocated to N Ltd were to depend upon discussion at the time of the individual member's retirement, then each year's reallocation would be based on an assessment of how much of the total deferred profit allocated to N Ltd in that year is, on a just and reasonable basis, properly attributable to the individual. This would in practice mean that the total of N Ltd's profit for each year would have to be re-allocated amongst the individuals to whom the deferred profit arrangements were relevant.

### *3.2.6 Condition Y (S850C (3))*

Condition Y applies where:

- the non-individual member's profit share exceeds its appropriate notional profit (see sub-section 3.2.7 below);
- the individual member has the power to enjoy the profit share allocated to the non-individual member (see sub-section 3.2.8 below); and
- it is reasonable to suppose that the non-individual member's profit share is, in part at least, attributable to the individual member's power to enjoy it (see sub-section 3.2.9 below).

The fact that the Condition was not met in a particular period does not mean that it will not be met later even if the members of the partnership and ownership of the non-individual member remain the same.

### *3.2.7 Appropriate notional profit (S850C (10)-(17))*

For the legislation to apply, the profit share of the non-individual member has to exceed the appropriate notional profit (S850C(3)(a)).

The appropriate notional profit is made up of two elements:

- the appropriate notional return on capital; and
- the appropriate notional consideration for services.

**The appropriate notional return on capital** (S850C (11)-(12))

The appropriate notional return on capital is the rate which in all the circumstances in reasonably comparable to a commercial rate of interest on the non-individual's contribution to the firm.

The amount of capital contribution is based on the amount that the individual has invested as capital at that time.

The capital is the amount of money or other property that all the members have contributed, to the permanent endowment of the firm.

In addition to their capital, a member is likely to have what is sometimes called a current account. This account reflects the member's day-to-day balance with the firm reflecting things such as their entitlement to a profit share, tax account and drawings. The current account balance is not capital contributed.

An undrawn profit share is not capital, but the members can agree to convert it into capital just as they can agree to pay a further sum in as capital.

The legislation does not set a specific rate. The rate will vary as the appropriate commercial rate will vary from case to case and from time to time:

- The commercial rate will reflect the level of risk involved.

- Where the level of capital varies during the relevant period of account, the notional return must be calculated on these varying amounts.

The rate however must be limited to a reasonable rate of interest. It is not relevant that an equity return on the same investment might have been much greater.

If the member receives some other form of return on capital, other than a share of the profit (for example, a fee), then this is deducted in arriving at the limit on the notional return.

***Example 3***

This example shows that the notional return is based upon a **commercial** rate of interest.

> *B Ltd has invested £10,000 in the ABC LLP. It receives no return on this other than its profit share.*

ABC LLP is paying 2% on loans on the commercial market, reflecting its good credit rating. This represents a commercial rate, so B Ltd has an appropriate notional return on capital of £200.

**The appropriate notional consideration for services** (S850C (15))

This is the arm's length value of any services provided by that member for the period, less any other amount received for those services (for example, a service fee) that is not part of the profit share.

In most cases, this notional consideration should be no more than the cost to the company in providing the services plus a modest mark-up.

If any services provided involve other members of the partnership, then the value of these services is not included in arriving at the notional return (Section 850C(17)).

***Example 4***

This example shows how there is no notional consideration for services when the services involve other partners.

> *Continuing with the example 3 above, B Ltd is a member of ABC LLP and provides advertising services for ABC LLP. The work is carried out for B Ltd by A, who is also a member of ABC LLP. B Ltd provides no other services to ABC LLP.*

B Ltd is treated as providing no services as the only service provided involves another member of the LLP. Therefore, the appropriate notional consideration for services is nil.

As such, B Ltd has an appropriate notional profit of £200, consisting purely of its notional return on capital.

***Example 5***

This example shows that it is important to look at what service is actually being provided.

> *The members of Farm LLP are two individuals, A & B, and their company C Ltd. In addition to being a member of Farm LLP, C Ltd provides contractor services to farms in the area. C Ltd also leases equipment to farms, including Farm LLP.*
>
> *Farm LLP is a mixed membership partnership. C Ltd is providing services to Farm LLP, so the question is what is the appropriate notional consideration for services?*
>
> *C Ltd is being paid for contractor services on an arm's length basis directly by its customers. This is separate from any services that C Ltd provides to Farm LLP so is not taken into account under the mixed membership rules.*
>
> *In addition, C Ltd is providing the use of its equipment to Farm LLP. The arm's length value of this, using the amounts it charges to other farms as a comparable, is £10,000.*

C Ltd has an appropriate notional consideration for those services of £10,000. This is because it is providing equipment to Farm LLP.

***Example 6***

This example looks at where a corporate member provides the partnership with the use of an asset, such as land.

> *The members of Agri LLP are two individuals, H & J, and their company HJ Ltd. HJ Ltd owns some of the land farmed by Agri LLP, no rent is being charged by HJ Ltd.*

*Agri LLP is a mixed membership partnership. HJ Ltd is providing services to Agri LLP, so the question is what is the appropriate notional consideration for services?*

The appropriate notional consideration for services is the arm's length rent for the land.

***Example 7***

This example looks at where the partnership is paying rent but the terms have not been reviewed.

*The facts are the same as in example 6, except that a rent is being paid. This was set a number of years ago, and has not been reviewed.*

The appropriate notional consideration for services is the arm's length rent for the land less the rent paid.

***Example 8***

This example looks at where the partners themselves are also working for the corporate member.

*The HED LLP has as members D, E, F, G & H together with a corporate member HED Ltd. HED Ltd provides management services to the LLP which is carried out by H, E and D as directors of HED Ltd.*

Whilst the work was carried out by the directors of the company, these directors are also members in their own right. As the work was done by members the appropriate notional consideration for services is NIL. That the work was done in their capacity as directors of the corporate member makes no difference.

***Example 9***

This example looks at where the services are provided by members via a chain of intermediaries.

*The members of FM LLP are the individuals M, N and O and a corporate member X Ltd.*

*M, N &O are also employees of Y Ltd an offshore employer.*

*Y Ltd contracts with X Ltd to supply it with the services of M, N & O.*

*X Ltd is the managing member of FM LLP, with the work being done by M, N & O on secondment to X Ltd. X Ltd receives a profit share for acting as managing member.*

The question is what is the appropriate notional consideration for services?

The legislation looks at whether the work involves any member other than that corporate member. It does not look at the link between that member and the corporate member.

In this case, the work is actually done by individuals who are members of the FM LLP. As a result the appropriate notional consideration for services is NIL.

### ***3.2.8 The power to enjoy*** *(S850C(18)-(21))*

For Condition Y to apply, the individual (A) must meet the power to enjoy requirement in relation to the profit that has been allocated to the non-individual member (B).

This test is widely drawn and does not depend upon A deriving any direct benefit from the profits allocated to B. Nor does it require A to have any actual connection to B.

A has the power to enjoy B's profits if:

- the parties are connected, or
- A is party to arrangements a main purpose of which is to secure that B's profit share is subject to corporation tax rules rather than income tax provisions or
- any of the enjoyment conditions is met.

**Connected parties** (S850C(18)(a))

The individual has the power to enjoy the profits of the non-individual partner if they are connected persons within the definition at ITA2007/S993, other than simply being connected through being partners.

***Example 10***

This looks at a basic example of where an individual can enjoy the profits allocated to the company.

*A and A Ltd are the members of A LLP. A owns all of A Ltd.*

As A controls A Ltd, A and A Ltd are connected and, as such, A has the power to enjoy any profits of A LLP which are allocated to A Ltd.

***Example 11***

This example shows that being connected by being partners does not mean that the individual can enjoy the profits.

*A and B Ltd are the partners in the AB partnership. A has no interest in B Ltd, which is wholly owned by B, who is not connected to A.*

A and B Ltd are only connected by being fellow partners in the AB partnership. As they are only connected under ITA2007/S993(4) (as partners in the same partnership), A is not in a position to enjoy the profits under the connected person test. They are not connected and the excess profit allocation rules do not apply.

**Arrangements to secure corporation tax rather than income tax treatment** (S850C (18))

HMRC has seen a number of schemes that purport to maximise the amount of corporation tax reliefs that can be claimed by company members. The company member receives a profit share that means that, after claiming the corporation tax relief, little or no tax is due, whilst the individual partners pay income tax on lower profit shares. The intention is to reduce the overall tax paid by the partners.

Accordingly, the legislation applies where an individual is party to arrangements, one of the main purposes of which is to ensure that an amount is included in the non-individual's profit share and subject to corporation tax instead of income tax. This rule can apply even if there is no economic connection between the individual and the corporate member.

The legislation applies both where the intention is to ensure that the sum is taxed at corporation tax rates, rather than income tax rates, and also where the aim is to access a relief that is only available for corporation tax payers.

**Enjoyment conditions** (S850C (20))

These conditions look at whether the individual, or a person connected to the individual, is in a position to enjoy the benefit of the profit share allocated to the non-individual. The test is widely drawn but does not include all partnerships with mixed membership, as shown by the example below.

***Example 12***

This is an example of a farming partnership where the landlord is represented by a corporate member.

> *A farm in Scotland is run as a partnership between the tenant farmer and a limited company owned by the landlord, who is not connected to the tenant.*

This is a mixed membership partnership, but none of the enjoyment conditions is met.

***Example 13***

This example looks at where the enjoyment conditions are met but the profits are not currently being paid out.

> *A and his personal company A Ltd are both members of the MBX LLP. Profits that can be withdrawn are allocated to A. The profits that A does not need to withdraw, for example as the LLP needs the money to finance expansion, are*

*allocated to his personal company. In practice, A does not withdraw any money from A Ltd*

The legislation applies. The key is that A Ltd is only getting the profit share because of A's power to enjoy and the relevant tax amount is lower as a result of the arrangements. That A chooses not to extract the profits allocated to A Ltd at that time does not alter the fact that he has the power to enjoy them.

It is also possible that Condition X (deferred profit arrangements) applies to this arrangement.

### *3.2.9 B's profit share influenced by the power to enjoy* (S850C(3)(c))

Where the power to enjoy requirement is met, then it must also be reasonable to suppose that B's profits are higher than they would otherwise have been because of A's power to enjoy them.

A may have an interest in the non-individual partner but this may be so small that it is clear that the profit share has not been affected.

***Example 14***

This example looks at where an individual member has a small investment in a corporate member such as a quoted company.

*MMM LLP has as members, A, B and C, together with X Plc. A has a small investment in X Plc as part of a share portfolio. B has a small investment as she used to work for X Plc and received the shares under an incentive scheme. There are no other arrangements by which they can benefit from the profit share of X Plc*

It would not be reasonable to suppose that the profit share of X Plc has been increased because A and B have shares. Their holdings are such that they could not have influenced the allocation of profits to C Plc.

The crucial factor for the mixed membership partnership legislation to apply is that there has been a diversion of profits from an individual to a non-individual member. Profits of a non-individual member can only be reallocated to an individual member to the extent that it is reasonable to suppose that those profits are attributable to the individual member's power to enjoy them. This is to be determined on a just and reasonable basis.

***Example 15***

This example looks at where an individual assigns part of their interest in the LLP to their company.

*O is a member of the ON LLP. He sells part of his interest in the LLP to his company ONO Ltd, which becomes a member of the ON LLP.*

> *Following the sale, O's share of the profit is reduced, and what he terms an "equity profit" is allocated to ONO Ltd.*

ON LLP is a mixed membership partnership. ON Ltd provides no services or capital to ON LLP so the appropriate notional profit is NIL.

It is reasonable to assume that ONO Ltd is receiving this profit because of O's power to enjoy and profits should be reallocated accordingly.

If O withdrew from the partnership to prevent the mixed membership rules from applying then he would continue to be taxed as a partner as a result of section 850D, with the excess allocation to the company then being treated as his profit share.

***Example 16***

This example looks at a situation where there are a number of corporate members.

> *X LLP has individual members D, E and F together with three companies D Ltd, E Ltd and F Ltd. D is the 100% shareholder of D Ltd. E is the 100% shareholder of E Ltd. The shareholders of F Ltd are F and his spouse.*
>
> *Prior to the admission of the three corporate members D, E and F shared profits 60:20:20 and following the admission of the corporate members their individual profit share entitlements are each reduced by the amount allocated to their respective companies. D Ltd, E Ltd and F Ltd are not entitled to any profit share if D, E and F respectively cease to be LLP members.*

The profit shares of D Ltd, E Ltd and F Ltd are attributable to D, E and F respectively. It is reasonable to ascribe direct causal connection between the profit share allocated to D Ltd (for example) and D’s status as a member of X LLP and shareholder in D Ltd. It is also clear that D’s profit share (for example) is lower than it would have been had he not been shareholder in D Ltd with ability to access the profit share allocated to D Ltd.

***Example 17***

This is a general example looking at what happens under the new legislation when individuals use a corporate member to defer paying tax.

> *The membership of ABC LLP consists of three individuals, A, B and C, who decide that they want to retain funds in the LLP for working capital. In order to avoid the retained profits being taxed at higher income tax rates, they introduce a corporate member, ABC Ltd, which is fully owned by A, B and C.*
>
> *ABC Ltd does not provide any services and only a nominal amount of capital. A, B and C work out what they wish to draw personally and allocate the balance of the profit to ABC Ltd. The profit share allocated is invested or retained in the partnership by the company member as additional partnership capital or advances.*

The individual members meet the enjoyment conditions in relation to the sums allocated to their company.

The three individual members are taxed on an additional profit, split on a just and reasonable basis, equal to the profit share allocated to ABC Ltd, less a sum that represents an appropriate notional return on the nominal amount of capital introduced by ABC Ltd.

It is also likely that this is an arrangement that has a main purpose of securing corporation tax treatment of the profit. It is also possible that Condition X (profit deferral) applies.

***Example 18***

This is a further general example where an individual diverts profits through a company owned by a close relative.

> *D is a member of DEF LLP. With the agreement of the other members, D introduces as a member, D Ltd, a company that is owned by his wife. D continues as a member, only now he does some work for the LLP through D Ltd. D Ltd provides only a nominal amount of capital.*
>
> *The only change is that the profit share, previously allocated to D, is now allocated partly to D himself, but mainly to D Ltd.*

D Ltd is owned by the wife of D, so a connected person is in a position to enjoy the profits of D.

D is taxed on an additional profit equal to the profit share allocated to D Ltd. Whilst D Ltd is providing services to DEF LLP, the reality is that the work is such services as are being provided by D, another member. These services are ignored in determining the appropriate notional consideration for services. D Ltd provides no other services, so the appropriate notional consideration for services is nil.

## Businesses transferred to the LLP

This section looks at the tax treatment of the transfer of a business to a partnership by a company, where the company and a shareholder of the company both become (or are) partners in the firm, and where the consideration given for the transfer is in the form of an equity stake in the partnership.

This situation is covered by the mixed membership legislation.

The transferor company will generally (but not always) be credited in the capital account of the partnership with the value of the assets transferred. Provided that this is a contribution to the firm within the meaning of S850C (13) an appropriate notional return on the amount of its capital may be allocated to the company without giving rise to any reallocation to the individual partner (see sub-section 3.2.7.for the meaning of contribution to the firm and the calculation of the appropriate notional return on capital).

If the transferor company retains assets which it makes available to the LLP then an appropriate notional consideration for services may similarly be allocated to the company without giving rise to any reallocation to the individual partner, see sub-section 3.2.7.

The legislation recognises the value of the business transferred. If the profit share allocated to the transferor company exceeds the "appropriate notional profit" then the question is whether the transferor company has received that excess by reason of the ability of an individual member to enjoy the profit.

Put another way, the question is whether there is any reason why the company should receive an additional profit share having regard to the work being done for the firm by the partner who is earning the profit? That is, is this a device whereby the individual aims to alienate what would otherwise be personal income in a way that reduces tax overall?

HMRC's general approach is that in cases where a shareholder continues to be involved in the business after the transfer, it will nearly always be reasonable to conclude that the excess allocation of profits to a company which he substantially owns (whether or not with connected individuals) is attributable to his continuing involvement with the firm, with the result that any such profit allocated to the corporate member will be reallocated to the individual under section 850C(4).

Cases where this is not the case will be exceptional. The most likely scenario is where the company is widely owned and there are a majority of shareholders unconnected with the partner, and who are not involved with the business but who get the benefit of the profits allocated to the company. In those circumstances it is very unlikely that the individual members are using the company member to alienate their income since the effect of allocating excess profits to the company would also be to give them away to third parties.

The following examples set out how HMRC would approach cases where a company has transferred its business to an LLP.

***Example 19***

This example looks at the basic situation where a business is transferred from a company to an LLP.

> *John and Jane are shareholders in a company, S Ltd, which runs a securities trading business. John has 90% and Jane has 10%. Both are highly qualified and work in the business. The company transfers its business to a partnership, S LLP, and it, John and Jane become partners in the business. The partnership agreement provides that 50% of the profits of the firm are paid to the company indefinitely, and the individual partners share the rest of the profit equally (i.e. 25% each).*

S Ltd will be entitled to be taxed on an appropriate notional return on capital (in this case, the value of the assets contributed to the firm). The question is then whether any profits in excess of this allocated to S Ltd are attributable to John and Janet's power to enjoy those profits. Given the nature of the business, and the fact that Jane and John are still as actively involved in it as they always were, HMRC would consider that all of the excess profit should be reallocated from S Ltd to John and Janet. This is a 'people' business and the profits rely on John and Janet's continuing involvement in the business. Janet and John control the profit allocation and it is not reasonable to suppose that they would allow profits to be allocated to S Ltd if they did not have the power to enjoy those profits. .

***Example 20***

This is another example of a transfer of a business from a company to an LLP.

> *PeopleCo Ltd is a professional firm that had been trading for many years. A few years ago P, the 100% owner of PeopleCo Ltd decided that he wanted to reorganise the business to motivate his key staff and give them an ownership interest. He also had in mind succession to the business when in due course he retires. Recognising that PeopleCo Ltd was a people business, he set up an LLP, whose members are P, PeopleCo Ltd and the key staff who he hopes will take over the business. PeopleCo Ltd transfers the business to the LLP.*
>
> *PeopleCo Ltd receives the profit share agreed when the business was transferred to the LLP.*
>
> *P remains a member of PeopleCo LLP and receives a personal profit share.*

As in example 20, PeopleCo Ltd will be entitled to be taxed on an appropriate notional return on capital (again, the value of the assets contributed to the firm). The question is then whether any further profits allocated to PeopleCo Ltd in fact reflect the work done by P. As he is continuing to work in the business in the same way as he has done previously, it would be expected that the profits for periods after the transfer should be allocated to him and not to the company.

A helpful way to look at this is to ask whether the profit sharing arrangement between PeopleCo Ltd and the LLP is the same as it would have been had P actually retired, and whether P's own profit share is commensurate with the work done.

***Example 21***

This looks at an example of a transfer of a business from a company to an LLP where the founder is retiring.

> *Oldco Ltd had been trading for many years. A few years ago P, the owner of Oldco Ltd decided that he wanted to retire. He set up an LLP, whose members are P, Oldco Ltd and a number of individuals who he hoped would take over the business. The business is then transferred to the LLP and Oldco Ltd is credited with the value of the business as capital introduced.*
>
> *Oldco Ltd receives a profit share.*

> *P is working a reduced number of hours in the business and receives a small personal profit share that is commensurate with the work he does.*

The first question is whether the profit share received by Oldco Ltd exceeds the appropriate notional profit. If the profit share is less than the appropriate notional profit then there is no reallocation.

Assuming that there is such an excess allocation the next question is whether this is by reason of the economic connection. If the particular facts show that any economic connection between the individual and non-individual members does not result in profit being shifted from the individual partners to the non-individual, the mixed membership partnership legislation will not apply.

In this case, it is possible that P could demonstrate that as he was playing a reduced role in the business and received a profit share commensurate with the services he provides, the profit share of Oldco Ltd was not attributable to his power to enjoy. This however would depend upon the company having contributed to the partnership something that is still generating profits for the firm (in excess of the notional profit) which entitles it to the excess return.

***Example 22***

This looks at the transfer of a manufacturing business from a company to an LLP.

> *Widgets Ltd is a manufacturing firm that had been trading for many years and has built up a substantial reputation in the market for producing excellent widgets and supplying them promptly. A few years ago Mr Widget, the owner of Widgets Ltd decided that he wants to retire. He set up an LLP, whose members are himself, Widgets Ltd and a number of individuals whom he hoped would take over the business. The business is then transferred to the LLP and Widgets Ltd is credited with the value as capital introduced.*
>
> *Widgets Ltd receives the profit share agreed when the business was transferred to the LLP. This share reflects its founding role in the business and is based on the fact that it contributed the business to the LLP.*
>
> *Mr Widget receives a small personal profit share that is commensurate with the work he does.*

The facts show that Widgets Ltd receives a profit share reflecting the fact that it transferred its business to the LLP. The business has a value over and above the work done by the partners in the business after the transfer. The same profit share would have been received by Widgets Ltd if Mr Widget fully withdrew from the business, including as an LLP member. Looking at these facts, no adjustment would be required.

***Example 23***

This example looks at where a company transfers its business to an LLP some of whose members are minority shareholders in the company.

*Oldco Ltd is a manufacturing firm that had been trading for many years. A few years ago P, the majority owner of Oldco Ltd decided that he wanted to retire. He set up QRS LLP, whose members are Oldco Ltd and a number of unconnected individuals whom he hoped would take over the business, three of whom, Q R and S, were minority shareholders in Oldco, holding 35% of the ordinary shares between them, P holding the remaining 65%.*

*Oldco Ltd receives the profit share agreed when the business was transferred to the LLP.*

*P retires at the time of the transfer of the business and subsequently provides no services to the LLP.*

Q, R & S will potentially receive part of Oldco's profit shares in the form of dividends. The question is whether the share allocated to Oldco exceeds the notional profit because they are shareholders. The shares in Oldco all carry equal voting rights and rights to a dividend, and P, a non member of the LLP, controls Oldco, holding 65% of the shares. In this case there is nothing to suggest that the connection Q, R &S have with Oldco has influenced the profit-sharing arrangements – in particular, most of the profits flow to an unconnected individual who is no longer a member. The position could be different if P, Q, R & S held different classes of shares with different rights.

### ***3.2.10 Relevant tax amount*** *(S850C(2)(b) & (9))*

The profit allocation legislation only applies where it is reasonable to suppose that the "relevant tax amount" is lower than it would have been had the profit shares not been diverted from the individual member to a non-individual member.

The relevant tax amount is the tax that would have been payable by:

- the individual on the profit share that they were allocated; and
- the non-individual partner on the profit share, as originally allocated.

### ***3.2.11 Reallocating the profits*** *(S850C (4))*

This section looks at how the amount of profits to be reallocated is calculated.

**Increase in the individual's profit share**

The individual's profit share is increased by the amount of his or her deferred profit or by the amount by which their profit is less than it would have been apart from the power to enjoy profits of the non-individual, as determined on a just and reasonable basis.

In deferred remuneration cases, the amount to be reallocated is simply the amount of the deferred profit, so far as is just and reasonable.

In cases other than deferred remuneration arrangements, the amount by which the individual's profit share can be increased is limited to the amount by which the non-individual partner's profit share exceeds its appropriate notional profit, i.e. the excess profit. For guidance on the appropriate notional profit, please see sub-section 3.2.7.

In addition, the increase must be reduced by any increase that has been made in the case of that individual in respect of any reallocation of deferred profit.

Often, the same non-individual partner will be allocated the profit shares properly attributable to a number of individual partners. If so, then the profit that is to be reallocated is split between the individual members on a just and reasonable basis.

In such a case the reallocation would be fact specific, but would seek to put each individual in the same position that they would have been in absent the power to enjoy or the existence of the profit deferral arrangements. Relevant considerations would be the extent of the individual members' shareholding in the corporate member and any informal agreements between the partners. In the absence of any other detail, the starting position would be that the excess profit should be reallocated in the same proportions that those individuals have actually been allocated profit shares in that period.

**Adjustments to non-individual's profits** (S850C(5) and CTA2009/S1264A)

As the individual is being taxed on part of the profit share allocated to the non-individual member, the taxable profit share of the latter has to be reduced, so that the profits are taxed only once.

There may be differences between the way that the taxable profits are calculated for individual and non-individual members, in particular, due to different computational rules for income tax and corporation tax. Therefore, rather than simply reducing the profit share of the non-individual member by the amount by which the individual members' profit shares are increased, any adjustment should be made on a just and reasonable basis.

### *3.2.12 Payments by the non-individual out of its reallocated profit share (S850E)*

Although profits may be reallocated for tax purposes, the reality is that the relevant profit share was allocated to the non-individual member. At some point, the money may need to pass from the non-individual to other persons. The legislation provides a rule to prevent the same profits suffering a disproportionate level of tax.

If as a result of an agreement in place in relation to B's excess profit share, B makes a payment to another person out of the excess profit share:

- the payment is not treated as income of the recipient;
- it is not taken into account in calculating the profits or losses of B or otherwise allowed as a deduction against B's income;

- it is not treated as a distribution.

This applies for both income tax and corporation tax purposes. – section 1264A(3) CTA 2009.

The excess profit share is so much of the non-individual's profit share as is represented by the individual member's profit as increased under section 850C(4) or section 850D(4)...

This rule does not apply if the payment is part of a scheme or arrangement with a main purpose of obtaining a tax advantage.

***Example 24***

This looks at a "plain vanilla" payment from the corporate member to the individual member.

> *A and his company A Ltd are members of the ABC LLP. A has been taxed on £50,000 representing the excess profit allocated to A Ltd. A has an agreement with A Ltd that it will pay him £50,000..*

The sum is ignored for tax purposes; it is not treated as A's income and is not deductible from A Ltd's profits.

### *3.2.13 Interaction with AIFM deferral arrangements*

The mixed membership partnership legislation is applied before the profit deferral arrangements legislation applicable to AIFM firms described in Chapter 4 of this note.

***Example 25***

The basic position where deferred profit is allocated to a corporate member.

> *X, a partner in an AIFM firm, is due a profit share of £100,000 which is to be deferred under the AIFM rules.*
>
> *The firm allocates this deferred profit to a corporate member.*

The mixed membership partnership legislation applies and this £100,000 is re-allocated to X. Subject to the conditions being met, X will be able to use the AIFM mechanism described in Chapter 4 in respect of the profits reallocated to him.

***Example 26***

There is no re-allocation of profits where the profits are treated as allocated to the firm itself under the AIFM Rules.

> *The firm has made an election so that "relevant restricted profits" can be allocated by individual members to the firm.*

*The individual allocates their deferred profits of £100,000, allocated to them under the profit allocation rules, to the firm. As the firm is treated as an individual, there is no re-allocation from the firm back to the individual under the mixed membership partnership rules.*

The firm pays tax on that amount in accordance with the AIFM rules.

### *3.2.14 Anti-avoidance (S850D)*

Section 850D applies where an individual carries out work for a partnership or LLP and their role looks like the role that you would expect a partner or member to have, but they are not themselves a member.

Irrespective of the complexity of the structure, the legislation will apply if:

- the individual (A) carries out work for the partnership or LLP,
- at that time A is not a member/partner
- a non-individual is a member/partner and receives a profit share
- it is reasonable to suppose that A has “the power to enjoy” the profit share allocated to the non-individual or that the profit share includes deferred profits in relation to A; and
- it is reasonable to suppose that A would have been a partner in the absence of the excess profit allocation rules.

If the legislation applies, then the individual is treated as if they were a member of the partnership or LLP.

The mixed membership partnership test is then applied and the individual is taxed on the appropriate amount of the profits reallocated to them.

The “reasonable to suppose” test (i.e. that A would have been a partner but for the excess profit allocation rules) is treated as met if A is a member of another partnership which is associated with the firm. A partnership is associated with the firm if:

- it is a member of the firm, or
- it is a member of a separate partnership that is associated with the firm.

The excess profit allocation legislation came into force when it was announced on 5 December 2013. It cannot be inferred that an individual would have been a member but for the new rules if the individual withdrew from a partnership before that date.

***Example 27***

Example of the effect of the anti-avoidance rules where individual members resign and are replaced by personal service companies.

> *X, Y, Z and XYZ Ltd are the members of the XYZ LLP.  In response to the new legislation, they decide that all the individual members should cease to be members of the LLP with effect from 6 December 2013 being replaced by their personal service companies.*

X, Y & Z continue to work for the XYZ LLP, it is reasonable to suppose that they would have continued to be members but for the introduction of the legislation.

Under S850D, X, Y & Z are treated as members and the mixed membership partnership legislation applied accordingly.

Their share of the firm's profit, determined under the mixed membership rules, is chargeable to income tax for the tax year in which the relevant period of account ends. Assuming this period straddles the 6 April 2014 (the date the legislation comes into effect), then this period is split into two notional periods with the latter having a commencement date of 6 April 2014. Only the profits attributable to this latter period will actually be re-allocated to X, Y & Z.

***Example 28***

Example of the impact of the anti-avoidance rules.

> *M, N, O and MNO Ltd are the members of the MNO LLP.  In response to the new legislation, they decide that from 1 April 2014 all the individual members should become members of the MNO New LLP.  From 1 April 2014, the members of MNO LLP will be MNO Ltd and MNO New LLP.  Whilst M, N & O are the members of the MNO New LLP.*

Under S850D (8), it is assumed that M, N & O would have been members of the MNO LLP.  The mixed membership partnership legislation applies on the basis that they are deemed to have been members of the MNO LLP.

***Example 29***

Example of where the anti-avoidance rules do not apply to events before 5 December 2013.

> *Firm A has only individual members. Before 5 December 2013, the individual partners decide to retire and transfer their interests in the partnership to limited companies which would become partners in their place.  The actual transfer was carried out on 12 December 2013.*

Although the change was not made until 12 December, there is clear evidence to show that the decision was made before 5 December so the partners could not be aware of the mixed membership partnership legislation as at that time the new rules had not been published. As a result section 850D does not apply.

### 3.2.15 Particular Issues

The following sections look at the application of the excess profit allocation rules to specific issues.

### 3.2.16 Private equity investment

In some cases an outside investor, such as a private equity fund will become a partner, directly or indirectly and inject capital into the firm.

If they chose to do so through a corporate vehicle then it may make the firm a mixed membership partnership, but the excess profit allocation rules will not apply as the individual members do not meet the power to enjoy requirement.

***Example 30***

Example looking at where capital is injected by external investors using a corporate vehicle.

> *The LMN LLP has received an injection of capital from a group of external investors, none of whom are members of LMN LLP. The investors have chosen to invest through a limited company.*

This is a mixed membership partnership but the legislation does not apply as the individual members do not benefit from the sums allocated to the company.

If one of the individual partners in the firm had a small stake in the private equity fund then the position would be as set out in Example 18.

***Example 31***

This example looks at where the corporate member is jointly owned by the private equity fund and the individual members.

The question is whether it is reasonable to suppose that the corporate member's profits have been increased as a result (Condition Y at S850C (3)).

> *The MNO LLP has received an injection of capital from a private equity fund via a corporate member, MNO Ltd, which is jointly owned by the fund and the individual members of the MNO LLP.*

This is a mixed membership partnership and the individual members are in a position to enjoy profits paid via the corporate member. However that does not necessarily mean that the excess profit allocation rules apply. Is there any evidence that the profit share allocated has been influenced?

*MNO Ltd has ordinary share capital and preference shares. All the preference shares are held by the private equity fund. The profit share allocated to MNO Ltd is calculated so that it is enough to pay the dividend on the preference shares only.*

Condition Y is not satisfied as it is not reasonable to suppose that the profit share allocated to MNO Ltd is attributable to the fact that the individual members could benefit.

Alternatively:

*MNO Ltd is jointly owned by the fund and the individual members of the MNO LLP. MNO Ltd only has one class of shares, of which the fund holds 60%.*

It is reasonable to take into account as evidence that the profit share allocated to the corporate member is not influenced by the fact that the individual members can benefit, if in actual fact the transfer of value to the unconnected fund is greater than the tax saving for the individual members.

***Example 32***

This is a more complex example:

*A LLP has 50 individual members and a corporate member B Ltd with 100 issued ordinary shares. 30 of the shares of B Ltd are listed on AIM and owned by investors otherwise unconnected to the LLP or its individual members. The remainder of the shares are owned by 40 of the individual members together with 20 former LLP members (who no longer provide services of any form to the LLP).*

*So as to attract the initial investment on IPO and to retain the external investor appetite, B Ltd has 100% control of A LLP including control of any changes to the contractual profit share entitlements of the individual members which are determined entirely at its discretion and in accordance with market rate levels of remuneration. Most of the Directors of B Ltd are also members of A LLP; they are subject to Directors fiduciary duties to ensure that every decision taken is in the best interests of the shareholders, that is as shareholders and not in their role as members.*

The answer to this example will turn upon the facts. It is, however, helpful to remember that the purpose of the excess profits allocation legislation is to prevent partners from obtaining tax advantages by using the mixed membership structure to alienate their personal income.

Factors to take into account include:

- Do profits allocated to B Ltd provide an increase in share value and dividend rights for **both** members and non-members in **equal measure**?

- Would B Ltd would receive the same profit share if/when the member-shareholders were no longer members of the LLP and/or if/when they remain members but are no longer shareholders e.g. if they sold their shares on the AIM market?

### *3.2.17 Pseudo share schemes*

The question has been raised over how the mixed membership partnership legislation applies to schemes that are intended to mimic the effect of a share scheme for employees.

Unlike a partnership (including a Scottish partnership) which is simply a relationship between persons, an LLP is a body corporate and can be distinguished from its members.

The LLP is governed by the LLP agreement. In some cases, the LLP agreement provides for the LLP to have something comparable to the share capital in a limited company.

Other schemes involve buying shares in a limited company linked to the LLP.

The excess profit allocation rules will apply where a non-individual member receives a profit share that is used to:

- buy shares of "units" that are intended as rewards for individual members;
- buy shares or units back from individual members.

***Example 33***

This example involves a corporate member that is used as part of a "share scheme" for partners.

> *L Ltd is a corporate member of the LMN LLP. It receives a profit share which it uses to buy shares in a related company LMN Plc. It is agreed that if certain events take place, the shares will be transferred to individual members.*

The excess profit allocation rules apply as this is a deferred profit so Condition X is satisfied. Under S850C (8), the fact that there are conditions that may not be satisfied does not affect the position.

***Example 34***

This example involves a corporate member of a partnership that uses warehoused profits to buy the "interests" of individual members seeking to retire.

> *P is a member of the PQR LLP. P is approaching retirement and is looking to retire. The partnership operates an exit mechanism whereby profits are allocated to and allowed to accumulate in PQR Ltd, the corporate member of PQR LLP, in order to buy retiring partners' interests at their "market value".*

P meets the enjoyment conditions in relation to part of the profit allocated PQR Ltd in the years prior to his retirement. PQR Ltd is only getting this profit share because of P's power to enjoy and the relevant tax amount is lower as a result of the arrangements.

It is also possible that this is an arrangement that has a main purpose of securing corporation tax treatment of the profit, and that Condition X (profit deferral arrangements) applies.

### 3.2.18 International structures

A number of LLPs form part of structures that cross international boundaries.

***Example 35***

This looks at a case where one member is a tax transparent entity.

> *The PQR LLP only has individuals as members, so it is not a mixed membership partnership.*
>
> *Rather than have a branch, the members decide to ring-fence a new business venture overseas. They set up FOR LLP, which is a UK LLP whose members are PQR LLP and those individual members of PQR LLP involved in the project, a mixture of individuals resident in the UK and in the country where the firm operates.*
>
> *Profits allocated by FOR LLP to PQR LLP are in turn allocated to the members of that firm all of whom are individuals resident in the UK.*

FOR LLP is a mixed membership partnership as one of the members is an LLP, which is not an individual. As noted above, the fact that some individual members are non-UK resident does not make it a mixed membership partnership.

However the Mixed Membership partnership legislation is unlikely to apply. All the profits are allocated to, and taxed upon individual members. In this case the relevant tax amount is not lower as a result of the structure.

***Example 36***

This example looks at where the UK firm is a subsidiary part of a wider global network.

> *The XYZ LLP is the UK operation of ABC, a global business with substantial operations in a number of jurisdictions.*
>
> *XYZ LLP has a number of individual members and ABC Ltd.*
> *ABC Ltd is owned, via one or more intermediate entities, by ABC Inc, the ultimate parent of the global business.*

*ABC Inc is owned by an unconnected external corporate investor and a number of individuals several of whom are also individual members of XYZ LLP.*

As the membership of XYZ LLP consists of individuals and ABC Ltd, XYZ LLP is a mixed membership partnership so that the excess profit allocation rules apply.

The question that needs to be considered is what part (if any) of the profit allocated to ABC Ltd can be said to be attributable to the fact that individual members of the XYZ LLP are also amongst the ultimate owners of ABC Ltd?

- If the members of XYZ LLP have a minority interest in ABC Inc (and assuming they receive only a corresponding minority benefit from ABC Inc's share of XYZ LLPs' profit) then this is a strong indicator that the profit allocation is not linked to the fact that the members of XYZ LLP are also members of ABC Inc.

- If a member of XYZ LLP receives their profit share from ABC rather than XYZ UK LLP then that is an indicator that the excess profit allocation rules will apply.

- If the members of XYZ LLP receive a priority distribution out of ABC then that is an indicator that the excess profit allocation rules will apply

***Example 37***

This example looks at where a member of the UK firm is rewarded from another arm of an international network.

*DEF LLP is the UK operation of DEF US.*

*The members of DEF LLP are individuals and a company owned by DEF US (DEF Ltd).*

*DEF Ltd receives a profit share from DEF LLP. This is paid by dividend to DEF US.*

*A is a member of both DEF LLP and DEF US. He works in the UK for DEF LLP, but receives no profit share from DEF LLP, only from DEF US.*

*Under the agreement A receives a profit share from DEF US that is 75% of the profit share received from DEF LLP via DEF Ltd.*

DEF LLP is a "mixed partnership" as it has both individual and a corporate member.

A is a member of DEF LLP, working in the UK for DEF LLP but he receives no profit share from that firm, only one from DEF US.

A works for DEF LLP and receives his profit share via the profit share allocated to DEF Ltd. The legislation applies, with the result that A will be subject to increased profits under section 850C(4).

### *3.2.19 Commencement*

The mixed membership partnership legislation applies to periods of account commencing on or after 6 April 2014.

There are special rules which apply where a period of account begins before 6 April 2014 and ends on or after 6 April 2014.

You look at the period from 6 April 2014 to the end of the period of account. If the mixed membership partnership legislation does not apply, then you do not need to take action.

If the mixed membership partnership legislation does apply, then the profits have to be calculated as if there were two notional periods of account, one ending on 5 April 2014 and the second commencing on 6 April 2014. The notional periods of account are only to be taken into account for the purposes of the mixed membership partnership rules.

## 3.3 Excess loss allocation (ITA/S116A and S127C)

### *3.3.1 Overview*

Partnerships and UK LLPs are governed by the agreements between the partners/members. This allows flexibility in the arrangements for allocating profits and losses. The excess loss allocation rules are designed to counter avoidance arrangements using mixed membership partnerships, which aim to secure the availability of tax losses to individuals.

In a typical case, arrangements are made between a company and wealthy individuals, where the individuals will contribute funding to a business venture in return for the losses generated in the early years of the partnership, perhaps through capital allowances. The losses will be less valuable to the company than to the individuals, who are taxable at higher income tax rates. When the business becomes profitable, the individual members will have their contribution returned and they will withdraw from the partnership.

The rules ensure that individuals do not get tax relief where there are tax-motivated arrangements in place which mean that losses are allocated to the individual, or a group of individuals, rather than to a company or other non-individual in order to gain a tax advantage.

### *3.3.2 When do the loss restrictions apply? (ITA/S116A (3) and S127C (3))*

The legislation states that:

> ***116A Excess loss allocation to partners who are individuals***
> *(1) Subsection (2) applies if.*
> *(a) in a tax year, an individual ("A") makes a loss in a trade as a partner in a firm, and*
> *(b) A's loss arises, wholly or partly.*

*(i) directly or indirectly in consequence of, or*
*(ii) otherwise in connection with, relevant tax avoidance arrangements.*
*(2) No relevant loss relief may be given to A for A's loss.*

And:

***"127C Excess loss allocation to partners who are individuals***
*(1) Subsection (2) applies if -*
*(a) in a tax year, an individual ("A") makes a loss in a UK property business or an overseas property business as a partner in a firm, and*
*(b) A's loss arises, wholly or partly -*
*(i) directly or indirectly in consequence of, or*
*(ii) otherwise in connection with, relevant tax avoidance arrangements.*
*(2) No relevant loss relief may be given to A for A's loss".*

These restrictions apply when:

- an individual makes a trading or property business loss as a partner in a firm;

- which arises, wholly or partly, as a consequence or in connection with tax avoidance arrangements to which the individual is a party, a main purpose of which is to secure that losses are allocated or arise to the individual, rather than a non-individual; and

- with a view to the individual obtaining relief for the loss.

The fact that the non-individual is not a partner in the firm or is unknown or does not exist at the time does not prevent the restriction applying.

The restrictions do not apply where the partnership/LLP only consists of individuals and there are no plans or arrangements to introduce a non-individual as a member.

A relevant tax avoidance arrangement can be any agreement, understanding or any form of arrangement for the loss to be allocated to one or more individuals rather than a non-individual.

The allocation of the losses does not have to be the main purpose of the arrangements, only one of the main purposes.

***Example 38***

For the purposes of the loss rules an overseas individual remains an individual.

*The EXP LLP expands its overseas operations. For regulatory reasons, its operations it sets up a local partnership the EXP partnership. A, B & C are members of both the EXP LLP and the EXP partnership.*

*In the first year, EXP partnership makes a loss which is allocated to A, B & C, local members D, E & F receiving neither a profit nor loss.*

The excess loss provisions do not apply as an overseas individual is still an individual.

### *3.3.3 Which losses are affected? (ITA2007/S116A(6) and S127C(6))*

The restriction applies to relief for trade or property business losses and also to claims to use trading losses as relief for capital gains.

### *3.3.4 What is the effect of the restrictions? (ITA2007/S116A(2) and S127C(2))*

Where the restrictions apply, no loss relief is available to the individual for his or her losses from the partnership.

***Example 39***

Basic example of when the provisions apply.

> *An LLP has 100 individual members and 1 company member. Each of the individual members introduces capital of £40,000 and the company member provides capital of £60m (total capital £100m). The LLP spends the £100m on an asset that qualifies for 100% upfront tax relief generating a £100m tax loss (but not an accounting loss) in the first year of business but with a significant income stream in later years. The profit sharing agreement provides that:*
>
> - *In year 1, all the profits or losses are allocated to the individual members; and*
> - *In year 2 onwards, all or most of the profits are allocated to the company member.*

The LLP agreement is written so that the individuals can claim the loss relief. It is clearly one of the main purposes. The excess loss allocation legislation (S116C) prevents the individual obtaining relief for these losses.

### *3.3.5 Transitional Provisions*

These rules apply for losses made in 2014-15 and later years.

There are transitional provisions that apply if a loss arises in a period of account that begins before 6 April 2014 and ends on or after that date. In these cases, the loss is to be apportioned on a time basis between the period up to 5 April 2014 and the period from 6 April 2014.

If allocation by time basis produces a result that is unjust or unreasonable, then the loss is to be allocated to the periods on a just and reasonable basis.

The excess loss allocation rules apply to the period from 6 April 2014; they do not apply to the period up to 5 April 2014.

# 4. Alternative Investment Fund Managers: Deferred Remuneration Etc

## A guide to this Chapter

## 4.1 What is this about?

As part of EU-wide strategy for investor protection, AIFM regulations and FCA's rules made pursuant to an EU Directive require AIFM firms to subject part of the "remuneration" of key individuals to performance conditions and to defer when they can access that remuneration.

If an AIFM is a member of a partnership (including an LLP), tax is payable on the profits as they arise rather than when they are received. The AIFMD deferral restricts access to profits of a member of an AIFM partnership, which means that the member is required to pay tax on profits that they do not have access at the time when the tax charge arises under existing partnership tax rules.

The new AIFM tax provisions will allow the AIFM partnership to elect to pay the tax instead of the individual member. The individual member will then receive a corresponding tax credit when the remuneration is received or vests. In addition, the liability to Class 4 NICs will be deferred until the remuneration vests with the individual member.

This part of the technical note explains how these provisions work including a summary of the mechanism (section 4.2).

## 4.2 Overview of mechanism

This section gives an overview of how the mechanism works.

The mechanism will be introduced for the 2014/15 and subsequent tax years. It will permit members of AIFM partnerships or their delegates to allocate certain "restricted" profits to the partnership. Restricted profits are those that represent variable remuneration under the AIFMD other than upfront profits which are received in cash.

The legislation will impose a charge to tax on these profits at the additional rate of tax (45% for 2014/15) to be paid by the AIFM partnership.

The balance of the variable profit (i.e. after tax has been paid) will be retained until a particular point (the "vesting date"). If the restricted profits vest in the partner who originally allocated them to the partnership, this individual will be liable to income tax on those profits in the period of vesting, but the individual will be able to claim a tax credit corresponding to the tax paid by the partnership upfront. The individual can then set the credit against tax liabilities or obtain a repayment of the tax, depending on his or her circumstances at the time of vesting.

The upfront charge on the partnership applies only to income tax. No Class 4 NICs charge will arise until the time when the remuneration vests in the individual partner.

The key features of the mechanism are set out in section 4.3.

## 4.3 Introduction - key features

This section introduces the **key features** of the mechanism as set out below and cross-references key topics for this part of the note:

- once an AIFM partnership has made an election to use the mechanism, any partner in the firm can allocate all or part of their "relevant restricted profit" to the firm (see sections 4.8 and 4.9). Relevant restricted profit is deferred remuneration (within the meaning of the AIFMD) together with any remuneration which is awarded in the form of instruments that must be retained for a period of at least 6 months (see sub-sections 4.8, 4.9 and 4.12);

- tax is charged at the additional rate of income tax (45% in 2014/15) on that income, with no reliefs or allowances to be available to set against it (see sub-section 4.7.1);

- where the relevant restricted profit ultimately vests with the partner who initially allocated it to the partnership, this is treated as taxable income of the partner in the relevant tax year. Credit will be available for the tax initially paid by the partnership on the profit, and any overpayment of tax may be repaid (see sections 4.10 and 4.11); and

- for capital gains tax purposes, the partner is treated as receiving any securities at a base cost equivalent to the amount of remuneration they represent, net of tax. The same amount is treated as the consideration for the disposal to the partner (see sub-sections 4.12.3 and 4.12.4).

If the deferred remuneration does not vest in the partner who originally allocated the amount to the firm, that partner will not be liable to tax or NICs on the profits that are forfeited. Any subsequent payment of all or part of the forfeited profits to one or more different partners will be treated like any other distribution of partnership profits. It will not represent a taxable event and there will be no further tax liability and no entitlement to recover the tax paid on that element of the deferred remuneration (see section 4.11).

## 4.4 Who is in the scope of the mechanism?

### *4.4.1 Which partnerships are eligible?* *(S863H)*

The mechanism can be used where an election is made by a partnership which is an AIFM firm with an AIFM trade. It is not confined to LLPs. For election, see section 4.6.

An AIFM firm is defined by reference to the AIFM Regs as a firm:

- the regular business of which is managing one or more AIFs, or

- which carries out one or more functions of managing one or more AIFs as that person's delegate, or as the sub-delegate of a delegate of that person.

An AIFM trade is a trade of an AIFM firm which involves these activities.

#### *4.4.2 Which partners are eligible? (S863I)*

The mechanism applies, if they choose to use it, to a partner in an AIFM firm for any period of account in respect of which a valid election made by the partnership is in force, where the calculation of the partner's profits or losses of the trade produces a profit and the share of profit would, apart from the mechanism, be the relevant restricted profit chargeable to income tax under Chapter 2 of Part 2 of ITTOIA.

If the partnership is an AIFM firm which qualifies for the mechanism because it is a delegate, the mechanism only applies to partners who are 'identified staff' for the purposes of the ESMA Guidelines.

The meaning of "relevant restricted profit" is discussed in sections 4.8 and 4.9.

## 4.5 Interaction with excess profit allocation rules (S863J(9))

Any profit reallocated to the individual partner of an AIFM partnership from a non-individual partner within the same partnership by virtue of the excess profit allocation rules (S850C) will be eligible to be elect to use the mechanism, if they have profit deferral arrangements in place as a result of the AIFMD.

One of the excess profit allocation rules, S850E, which permits certain adjusting payments under the excess profit allocation rules to be made without tax consequences, is ignored for the purposes of this provision (S863J(9)).

## 4.6 Election and profit allocation to the AIFM firm (S863H(2))

An election must be made by the AIFM firm to HMRC within 6 months after the end of the first period of account for which the election is to have effect. Schedule 1A of TMA applies to it.

Where an election has been made by an AIFM firm, any eligible partner who has relevant restricted profit in that period or any subsequent period may allocate all or any part of that profit to the AIFM firm.

The AIFM firm that elects under section 863H to use the mechanism is required to file a tax return, pay income tax as appropriate and give information to HMRC – see section 3.15. A partner is not required to make a return of income which is allocated to the partnership until the income vests. The amount allocated to the partnership must be shown on the partnership statement forming part of the partnership tax return.

## 4.7 Effect of allocation

### *4.7.1 **Partnership** (S863I)*

Where a partner has allocated relevant restricted profit to the partnership, the partnership is liable to account for income tax on that profit (S863I (3)-(4)). The allocated profit is excluded from the partner's profit in that period of account.

For this purpose, the AIFM firm is treated as if it were itself a person who is a member in the AIFM partnership (the AIFM firm). The usual rules then apply to the AIFM firm as a partner, including the self assessment requirements and the obligation to pay tax by instalments (S863I (3)-(4)). The AIFM firm will be required to submit a return on its own behalf for the purposes of the mechanism in addition to the usual partnership returns for self assessment purposes – see section 3.15. The firm will also be required to provide HMRC with certain other information about the partners who have allocated income to it in a separate return.

Income tax is payable on the full amount of the profit allocated to the AIFM firm without any allowances or reliefs, such as personal allowances and relief for losses from prior years (S863I(4)(b)).

The rate of income tax applicable is the additional rate of tax which applies to the whole amount (S863I(4)(d)).

### *4.7.2 **Partner** (S863I)*

Any deferred remuneration which is relevant restricted profit and is validly allocated to the partnership is excluded from the partner's profit for that period of account and is accordingly not subject to income tax in the partner's hands until it vests (S863I(3)(a)).

A partner will not be subject to income tax on remuneration within the mechanism which does not vest. The tax consequences where remuneration does not vest are set out in section 4.11.

This treatment applies to deferred remuneration in cash or instruments. It also applies to upfront remuneration in the form of instruments with a retention period of at least 6 months (S863I(6)). However, upfront remuneration in the form of cash is not eligible for the mechanism. Section 4.12 provides more information on the treatment of remuneration in the form of instruments.

It should be noted that the mechanism only applies to income which would otherwise be chargeable on the partner as his or her profits from the firm. If there is an allocation of remuneration which has accrued in a prior year to someone else (for example, cash or instruments which have not vested following an allocation to some other partner), the mechanism does not apply to the new recipient of the allocation, as this simply represents a distribution of taxed profit.

## 4.8 Relevant restricted profit: Variable remuneration (S863I)

In order for the scheme to apply, the partner's profit share must be relevant restricted profit. This means variable remuneration awarded to the partner (P), which can be:

- deferred remuneration (including deferred remuneration which, if it vests in P, will vest in the form of instruments); and
- upfront remuneration which vests in P in the form of instruments with a retention period of at least 6 months.

"Variable remuneration" and "deferred remuneration" have the same meaning as in the ESMA Guidelines (S863I(9)).

It is also a requirement that the variable remuneration is awarded in accordance with arrangements which are consistent with the ESMA guidelines – see section 3.10.

The treatment of deferred remuneration in the form of cash is described in section 3.12. The treatment of deferred remuneration in the form of instruments is described in section 3.13.

## 4.9 Relevant restricted profit: ESMA Guidelines (S863I(7))

It is a requirement for the scheme to apply that the variable remuneration is awarded to the partner in accordance with arrangements which are consistent with the ESMA Guidelines.

**The ESMA Guidelines - Definition**

The ESMA Guidelines are defined in S863L as the Guidelines on Sound Remuneration Policies under the AIFMD issued by the European Securities and Markets Authority on 3 July 2013 (ESMA/2013/232).

**What the guidelines say**

The ESMA Guidelines broadly require firms managing cumulative assets exceeding certain limits to:

- defer 40-60% of the variable remuneration of key staff by up to 3-5 years, and
- pay at least 50% of the total variable remuneration in units or shares of the funds they manage, or equivalent ownership interests, rather than cash.

The application of the rules is subject to a 'proportionality' limitation, based on size, internal organisation, and the nature, scope and complexity of activities.

The effect of these Guidelines is that a partner's remuneration may be in two parts:

- *Upfront element:* this will represent 40% to 60% of the variable remuneration with half taken in cash, which can be drawn immediately, and the other half in instruments in the fund under management. The instruments have to be retained for a minimum period (retention period) of six months from the time they are awarded; and

- *Deferred element:* this will represent the balance of the variable remuneration. The deferral required will be 40-60% of the remuneration which must be deferred by up to 3-5 years. Half of the remuneration must be in instruments in the fund. Vesting will normally be pro rata annually. So 40-60% of the year 1 variable profit might not be paid to a partner until years 3 to 5. In some cases, where conditions are not met or the individual has left the firm, the profit may never vest and revert back to the partnership (and therefore to the partners).

**Application of ESMA Guidelines**

Not all AIFM firms are required to apply the ESMA Guidelines. For example, small authorised UK AIFMs or small registered UK AIFMs are not required to comply with the AIFM Remuneration Code nor the Guidelines.

A firm that is not required to apply the guidelines may choose to do so as a matter of ‘best practice’. Provided that the other conditions are fulfilled, including that the arrangements are consistent with the other provisions of the guidelines, the arrangements may still be eligible for the scheme. In order to be accepted as consistent with the guidelines, the arrangements must incorporate all the relevant provisions of the guidelines as they would do if the guidelines were applicable to the individual concerned.

Where an AIFM firm applies the guidelines, the mechanism may also apply to partners in the firm who are not within the scope of the ESMA Guidelines but are remunerated on terms consistent with them. This is subject to the limitation in the case of a firm which qualifies as an AIFM firm as a delegate or sub-delegate, that the individual must be ‘identified staff’ (see sub-section 4.4.2).

Arrangements entered into by a firm with its partners may in some cases impose conditions (for example, on the proportion of remuneration which is paid in instruments, or on the deferral period) which are more stringent than those required by the ESMA Guidelines. Such arrangements are considered to be consistent with the ESMA Guidelines.

Arrangements which satisfy the remuneration principles which the Financial Conduct Authority requires to be followed by AIFMs will also be accepted as consistent with ESMA Guidelines.

## 4.10 Vesting: meaning of “vest” (S863J (8))

The period in which a partner pays tax on remuneration to which the mechanism applies depends on when it vests. “Vest” for this purpose has the meaning in the ESMA Guidelines: an amount of remuneration vests when a person receives payment and becomes the legal owner of the remuneration.

## 4.11 Vesting: remuneration in the form of cash

The mechanism applies to variable remuneration awarded to a partner which is deferred. It does not apply to the upfront remuneration element of any profit earned by a partner which is awarded in the form of cash. The latter is taxed in accordance with the normal rules.

For the position in relation to variable remuneration in the form of securities, see section 4.12.

In principle, the partner is taxed at the time when the variable remuneration vests, as described below in this paragraph. For the meaning of "vest", see section 4.10. The income is also treated at that time as partnership income for pension purposes. (FA2004/S189(2B)).

### *4.11.1 Partner still carrying on the trade (S863J(2))*

Where the partner is still carrying on the trade (whether as a partner in the AIFM firm or otherwise) the amount of variable remuneration which vests is treated as profit of the 'relevant tax year' made by the partner in the trade, chargeable to income tax under Chapter 2 of Part 2 of ITTOIA.

"Relevant tax year" means, in the case of cash, the tax year in which the vesting occurs (S863J(4)).

Reliefs and allowances are available against the profit which vests in the same way as for other trading profit taxable in the same tax year.

The profit to be brought into account is the amount of restricted profit which has vested, net of the income tax on that amount for which the firm is liable in accordance the mechanism, but grossed up by:

- income tax on that amount which the firm has paid by the time of vesting and
- where the amount has vested in the same period as it is allocated to the firm (in the case of up-front instruments), income tax paid by the firm on that profit in respect of the tax year of vesting. This applies even if the tax has not been paid at the time of vesting or at the time the return is filed (S863J(5)).

Provided that the AIFM firm has paid the tax, a refund of the tax credit may be available if the partner has unused allowances and reliefs for the year of vesting after they have been applied against other taxable income of that year. If the rate of tax has gone up, further tax will be payable. If the rate has gone down, tax may be repayable (S863J(6)).

The profit will be taken into account as earnings from self-employment for Class 4 NICs purposes.

#### 4.11.2 Partner no longer carrying on the trade *(S863J(3))*

Where variable remuneration vests in a partner at a time when the partner no longer carries on the AIFM trade (whether as a partner in the AIFM firm or otherwise), the amount is treated as income received in the relevant tax year. This is a stand alone tax charge on the individual – the income is not eligible for treatment as post-cessation receipts under Chapter 18 of Part 2 of ITTOIA.

The income will not be subject to Class 4 NICs as earnings from self-employment.

The relevant tax year and the chargeable amount are determined in the same way as for a partner still carrying on the trade.

#### 4.11.3 What happens if remuneration does not vest?

Where remuneration in cash covered by the scheme does not in fact vest in the individual, for example because performance targets are not met, the event is disregarded for tax and NICs purposes. Consequently:

- no further income tax is payable beyond the tax already paid or payable by the AIFM firm. This is, in principle, the same position as with other amounts of profit retained by a firm which have already been taxed;
- no one is eligible to claim or recover credit for that tax; and
- no NICs payment will be collected on the profits which do not vest.

### 4.12 Remuneration in the form of instruments

#### 4.12.1 AIFMD requirements and definition *(S863I(6) & (9))*

The ESMA Guidelines require 50% of variable remuneration to be paid in the form of instruments. The tax legislation provides specifically for the treatment of instruments with a retention period of not less than 6 months and those forming part of deferred remuneration (S863I(6)(b)). Other instruments will be taxed in accordance with the usual rules (normally, as profit of the period of account in question).

For the purpose of the scheme, 'instruments' has the same meaning as in the ESMA Guidelines (S863I(9)). These define instruments as 'units or shares of the AIFs managed by the AIFM or equivalent ownership interests (including those AIFs issuing only unit-linked instruments), subject to the legal structure of the AIFs concerned and their rules or instruments of incorporation, or share-linked instruments or equivalent non-cash instruments.'

#### 4.12.2 Remuneration in the form of instruments: income tax *(S863I(6))*

For the definition of "instruments", see sub-section 4.12.1.

The mechanism applies to upfront variable remuneration in the form of instruments with a period of retention of at least 6 months. It also applies to deferred variable remuneration in the form of instruments.

Where a valid election has been made, such remuneration in the form of instruments can be allocated to the partnership and excluded from the partner's return in the same way as with remuneration in the form of cash (see section 4.7).

A partner will be subject to tax on the remuneration when the right to the instruments vests. The same principles apply as for remuneration in the form of cash (see section 4.11).

***Example 40 (Remuneration in the form of cash and instruments)***

**Facts**

TDH LLP is an AIFM firm (S863I), consisting of three members, T, D and H Ltd. The LLP has been trading for many years and draws up accounts to 31 December in each year.

Under the arrangements entered into with TDH LLP, T's remuneration is payable on 1 May 2015, and includes variable remuneration of £1m in respect of his share of the firm's profits for the year ended 31 December 2014 (2014/15 tax year). Of this, £500,000 is paid in cash and the same amount in instruments. 60% of the variable remuneration is deferred. All the instruments have a retention period of at least 6 months. The deferred remuneration is due to vest annually on 1 May in each year up to and including 1 May 2020. For the purposes of this example, it is assumed that the arrangement is consistent with the ESMA Guidelines.

On 1 May 2015, T's non-deferred remuneration is £200,000 in cash and £200,000 allocated in instruments.

Each year of the five year period, therefore, T's entitled to cash of £60,000 and one fifth of the remaining instruments, subject to satisfying the conditions under which the remuneration is awarded.

***A - If no election is made by TDH LLP:***

T is treated for tax purposes as receiving his variable remuneration in full and is taxed on £1m as part of his profit share for the year of account ending on 31 December 2014. This is included in T's assessable income for the tax year 2014/15, with the tax due on 31 January 2016 (subject to the normal payment on account rules). The actual tax liability will depend on T's other income and reliefs.

No further tax is payable by T on the variable remuneration in later years. He is not eligible for any relief if any part of the variable remuneration does not, in fact, vest.

***B - If TDH LLP elects for the mechanism to apply and T allocates all his variable remuneration to the LLP to the maximum extent possible:***

*2014-5*

T can allocate to the LLP his entire entitlement to instruments (upfront and deferred - £500,000 in total) and all the deferred remuneration in the form of cash (£300,000). He can therefore allocate £800,000 to the LLP.

In addition to the normal partnership return filing obligation, TDH LLP must make a separate return and pay income tax on the £800,000 for the year 2014/15 as if it was an individual partner in the firm. Assuming that the additional tax rate is 45%, the total tax payable by the LLP will be £360,000, due on 31 January 2016. The LLP will also need to make payments on account for the year 2015/16, of which £180,000 is payable on 31 January 2016 and £180,000 is payable on 31 July 2016.

In order to pay the tax, TDH LLP will only spend the net of tax amount on purchase of instruments. Therefore, assuming it buys all the instruments to fulfil its obligation to T at once, it will spend £275,000 on instruments (and pay £225,000 as tax in relation to them).

T will need to return his non-deferred variable remuneration (£400,000) as a partnership profit share on his 2014/15 tax return. He will remain chargeable to income tax on the amount received in cash (£200,000) for the tax year 2014/15. However, he is entitled to claim a tax credit of £90,000 in respect of the amount to be settled in instruments. This is on the basis that the tax has already been paid by TDH LLP by the time the vesting of this element of the profits has occurred, or is paid on time for 2014/5.

*2015/16 onwards*

In each year that remuneration vests, T receives one fifth of his deferred remuneration (£120,000) net of a tax credit of the corresponding amount accounted for by the LLP (£54,000). Therefore, T will actually receive £33,000 in cash and equities (worth £33,000 when the award was made). The gross amount and the corresponding tax credit should be declared on T's tax return. T will pay more tax, or recover part of the tax credit, depending on his personal tax position and the rates of tax in that year.

The value of instruments on the vesting dates will not be relevant to the income tax calculation.

***C – as in B, but the final instalment of the variable remuneration does not vest in T because he has left the partnership***

In this case, T has no deferred remuneration to report on his tax return. No further tax is payable by him or by TDH LLP in respect of that element of the variable remuneration and none of the tax paid by TDH LLP on that element is repayable.

### *4.12.3 Remuneration in the form of instruments: partner's CGT position (TCGA/S59B and S59C)*

A special CGT rule (S59B) is introduced into TCGA to determine the base cost of instruments representing variable remuneration where the mechanism is used. It applies where:

a) a partner ("P") in a partnership allocates to the partnership an amount of profit ('the allocated profit') representing variable remuneration which, if it vests in P, will vest in the form of instruments;

b) there is a disposal to P by the partners of instruments which are partnership assets of the partnership for the purposes of section 59 of TCGA; and

c) by virtue of that disposal the variable remuneration vests in P.

In this case, the base cost of the instruments to the partner for CGT purposes is the allocated profit net of the income tax which the partnership has paid.

S59C of TCGA has the same effect where the instruments are disposed of to P by a company which is a partner in the partnership and the company would, as another partner, have been charged to tax on the allocated profit but for adjustments under the excess profit allocation provisions (see sub-section 3.3.3).

### *4.12.4 Remuneration in the form of instruments: partnership's CGT position (TCGA/S59B and S59C)*

The special CGT rule applies to determine the base cost if a partner has allocated variable remuneration represented by instruments to the firm and the variable remuneration vests. Where this rule applies, the disposal by the partners in the AIFM firm will be treated as made for a consideration of the same amount as the partner's base cost (i.e., the allocated profit net of the income tax which the partnership has paid).

In other cases, the capital gains tax position of AIFM partnerships will follow the general principles set out in SPD12. Assets are treated as being disposed of or acquired by partners for consideration equal to their market value at the time of the allocation. Guidance is included in HMRC's Capital Gains Manual at paragraph CG27400 (Partnership assets divided in kind among the partners: SPD12).

***Example 41 (remuneration in the form of instruments)***

**Facts**

X, P and S are members of an LLP which is an AIFM firm. They share profits in equal shares and are treated as partners in a partnership for capital gains tax purposes. In respect of profits for the year ended 31 December 2014, on 31 May 2015 X becomes entitled to variable remuneration of £1m. None of the other members receives any variable remuneration. The remuneration is all deferred and payable in one instalment on 30 April 2018. 50% of the remuneration is payable in instruments comprising units in a hedge fund. For the purposes of this example, it is assumed that this is consistent with the ESMA Guidelines.

The LLP has elected under section 863H to use the mechanism and X has allocated all her remuneration to the LLP. On 1 May 2015, each unit in the hedge fund is worth £1; on 1 May 2016 it is worth £1.50 and on 30 April 2018, when the remuneration vests, the units are worth £5 each. The LLP buys 275,000 units on 1 May 2016 for £412,500 to hold as partnership assets and transfer to X on the vesting date in satisfaction of her deferred entitlement.

**Income tax treatment**

LLP pays income tax on £1m for the tax year 2014-5 (see example 1 above). Assuming the additional rate of tax is 45%, income tax payable is £450,000 so that a net amount of £275,000 is attributable to the cash and the same amount to the instruments. X's entitlement to instruments is therefore to 275,000 units.

On the vesting date, X is treated as receiving taxable income of £1m, including a tax credit of £450,000.

**Capital gains tax treatment**

The instruments are acquired on 1 May 2016 as assets of the LLP. SPD12 will apply so that each partner is treated as owning a fractional share of the total instruments held, in accordance with the partnership sharing arrangements. Assuming that X and her fellow partners have an equal share in all partnership assets, she is treated as acquiring a one-third share in the instruments on 1 May 2016 as a partner in the firm, while P and S are treated as acquiring the other two one-third shares.

Vesting of the instruments with X on 30 April 2018 represents a disposal by the LLP, which is treated as a disposal by P and S of their shares in the instruments to X. (As X cannot dispose of assets (i.e., her one-third share) to herself, it is only P and S who make disposals for chargeable gains purposes.) The consideration they receive is deemed to be equal to the appropriate share of the net-of-tax profit allocated to the LLP in accordance with section 863I in respect of the deferred remuneration to be settled in instruments (S59B(2)).

P and S each receive consideration of 1/3 x £275,000 = £91,666
Their one-third shares cost 1/3 x £412,500 = £137,500
So each has an allowable loss of £137,500 - £91,666 = £45,834

X's base cost (to be used in computing her gain or loss on any subsequent disposal) is determined by adding amounts equal to the consideration received by P and S to the cost of X's own one-third share: (2 x £91,666) + £137,500 = £320,833 (rounding errors corrected).

If X sells the units shortly after the vesting date (30 April 2018) whilst they are still worth £5 each, she will realise a chargeable gain of:

(£5 x 275,000) – (£320,833) = £1,054,167.

If the instruments never vest in X, perhaps because performance criteria are not met, SPD12 will still apply to determine the base cost of the instruments for the partners. Each partner (including X) will have a base cost of £137,500 to take into account on any disposal of the instruments in the future (including on a disposal to a third party or to another individual partner after a new allocation of deferred remuneration).

### *4.12.5 Remuneration in the form of instruments: dividends etc*

Where income (such as dividends) is received by the firm in respect of instruments held by the firm as remuneration which has not yet vested, there are no special provisions to determine who is taxable on the income. This will therefore normally be taxable as income of the partner or partners entitled to it under the partnership agreement.

## 4.13 Vesting statements (S863K)

Where variable remuneration vests in a partner, the AIFM firm must provide the partner, if requested in writing, with a statement showing:

- the amount of the allocated profit, or the part of it representing the part of the variable remuneration, gross of the income tax for which the AIFM firm is liable in respect of the allocated profit or the part of it;
- the amount of the income tax for which the AIFM firm is liable and
- so much of that amount as has been paid by the AIFM firm by the time when the vesting occurs or, if the tax is payable in the same year as the remuneration vested, the amount of tax which is paid on that, as set out in section 3.12(a).

The partner can enforce a duty to comply with a request under this section (S863K(3)).

## 4.14 Tax returns and compliance

A new team is set up within HMRC's High Net Worth Unit to manage the mechanism from 6 April 2014. AIFM partnerships should contact the unit for matters relating to the mechanism. AIFM partnerships and partners should contact their existing tax offices, or if appropriate, customer relationship managers/co-coordinators about their own tax affairs. The AIFM team can be contacted at

AIFM Team – S1278
PO Box 202
Bootle
L69 9AL
(Telephone: 03000 527 405)

### 4.14.1 Election form

From 2014/15, AIFM firms can elect into the AIFMD mechanism. To do so, AIFM firms must elect in writing to HMRC within six months of the end of the first accounting period to which the election is to have effect. A downloadable form is available from the gov.uk website at the following address:

> https://www.gov.uk/government/publications/alternative-investment-fund-managers-mechanism-election-form

The election must be submitted in paper form to the new team (see the contact details in above).

The election will continue to have effect until revoked.

The form requires the name, Unique Taxpayer Reference ('UTR') and address of the partnership or LLP. It must be signed by an individual who is authorised to make the election on behalf of the partnership or LLP. In so doing, the individual confirms that the partnership or LLP is an AIFM firm within the meaning of the legislation, and specifies the first period of account to which the election is to apply.

When this form has been processed, the AIFM firm is effectively treated as a partner ("the AIFM partner") within the partnership. It will be allocated a separate UTR which will be notified in writing, and any returns and correspondence will be sent to the partnership address, addressed to the AIFM partner.

### 4.14.2 Partnership returns – Annual statement

Where an AIFM firm has made an election to use the mechanism, it must file returns itself in the usual way. The partnership statement must show the amount of profits allocated to the firm (under S863I).

The legislation provides for HMRC to require further information for the purposes of these provisions (TMA/S12ADA). The details of the information which will be required will be published in the near future.

### 4.14.3 Partner returns

In the year of deferral, where profits are allocated to the AIFM firm, the partner will return only that income which is outside the mechanism (see sections 3.7 and 3.8).

When profits vest in the partner, they should return these on their individual self assessment tax returns but include a tax credit equal to the amount of income tax paid by the AIFM firm at the time of allocation. This may result in further tax being due, or a refund of tax being due, depending on the tax rates and the personal circumstances of the partner. Further guidance on how to complete the returns will be published as part of the Self Assessment notes in the near future.

If the partner still carries on the AIFM trade at the time of vesting, a Class 4 NIC charge on the vested profits will arise. There will be no Class 4 NIC liability if the partner no longer carries on the AIFM trade when the profits vest.

Where profits do not vest in the partner to whom they were originally allocated, any distribution of these profits to another partner will be a non-taxable event, as with any other partnership distribution. There will be no further tax payable and no credit for the up-front tax met by the AIFM firm.

# 5. Transfers of assets and income streams through partnerships

## A guide to this Chapter



## 5.1 What is this about?

A number of avoidance schemes have sought to manipulate the flexibility of partnerships to reduce tax by exploiting the differing tax attributes of the members.
These 'tax attribute' schemes involve the transfer of assets or income streams through or by partnerships. Generally, some value will pass between the members, reflecting their difference in tax treatment, as part of the arrangements. Draft legislation published with this note will block such schemes.

## 5.2 Overview

The legislation is designed to counter 'tax attribute' schemes involving the transfer of assets and income streams through or by partnerships. These schemes do not rely necessarily on the partnership comprising mixed membership, although mixed membership partnerships are within the scope of the rules. The transferor and transferee members may have different tax attributes if, for example:

- the transferee is a company and the transferor is an individual,
- the transferee has losses to use whereas the transferor does not,
- the transferee and transferor are subject to different rate of tax, or
- transferor and transferee are subject to differing tax computational rules in relation to the asset or income.

Where there is a disposal of an asset or income stream through or by a partnership and a main purpose is to secure an income tax or corporation tax advantage, the rules will impose a charge to tax on income on the person making the disposal.
The legislation will not apply where the disposal by or through a partnership is from a member to the member's relative.

## 5.3 When will the legislation apply?

(ITA/S809AAZA & S809DZA for income tax and CTA2010/S757A & S779A
for corporation tax)

The legislation will apply where:

- a taxable person (the transferor) disposes of, actually or in substance, all or part of an asset (being an asset the proceeds for the sale of which would be treated as an income receipt for tax purposes) or a right to "relevant receipts",
- by or though a partnership to another person (the transferee),
- the transferor and transferee are, at any time, members of the relevant partnership or an associated partnership (i.e. a partnership that is a member of the relevant partnership or another associated partnership), and
- the main purpose, or one of the main purposes, of the disposal, or any of the steps by which the disposal is effected, is to secure a tax advantage in relation to the charge to income tax or corporation tax on income.

Relevant receipts means any income (a) which would be charged to tax as income of the transfer or (b) which would be brought into account as income for tax in calculating profits of the transferor.

The legislation does not apply where:

- the transferor is the spouse or civil partner of the transferee and they are living together, or
- the transferor is a sibling, ancestor (e.g. grandparent) or lineal descendant (e.g. grandchild) of the transferee.

## 5.4 What is the effect of the legislation?

(ITA/S809AAZB & S809DZB for income tax and CTA2010/S757B & S779B for corporation tax)

When the legislation applies, the "relevant amount" is brought into account as income of the transferor. The relevant amount is the amount of consideration received by the transferor on the disposal. Where a right to receipts is transferred and the consideration received is substantially less than the market value of the right, the market value is used instead

## 5.5 What date does the legislation come into effect?

The legislation will apply to arrangements entered into on or after 6 April 2014 for income tax payers and 1 April 2014 for those within the charge to corporation tax.

## 5.6 Examples

***Example 42 (Transfer of income streams)***

> *C Ltd contributes an income producing asset to a partnership. C Ltd would otherwise be chargeable to corporation tax on that income. A new partner, D Ltd, joins the partnership and contributes capital equal to the present value of the income stream. The partnership's profit-sharing arrangement provides that the profits arising from the income stream will be allocated to D Ltd until such time that the value of its contribution has been repaid, along with a lending return. The arrangement allows C Ltd the right to the capital of the partnership, including D Ltd's contribution and the ownership of the underlying asset.*

In effect, there has been a sale of an income stream for an upfront lump sum, i.e. D Ltd's capital contribution. Assuming that a main purpose of this arrangement was to obtain a tax advantage, C Ltd will be charged to tax as income on the lump sum payment.

***Example 43 (Transfer of assets)***

> *A company, J Ltd, contributes an asset with an unrealised gain (of a type which if realised would give rise to a charge to tax on income), such as an intangible fixed asset, to a partnership on a tax neutral basis. A new partner, K Ltd, joins the partnership, making a capital contribution equal to the value of the asset.*

The partnership sharing arrangements are manipulated so that K Ltd had nearly all rights to capital or income until the asset is disposed of, whilst J Ltd has the right to all other partnership assets.

The substance of the arrangements is that there has been a "disguised disposal" of the asset for the amount contributed by K Ltd in order to avoid the tax charge that would have otherwise arisen. The amount of K's contribution will be treated as income of J Ltd.

***Example 44 (transfer of profits 1)***

Mr A, an individual member of a partnership, sells his partnership interest to a corporate member of the partnership, A Ltd. The consideration of £1m is left outstanding on loan account (ie the debt of £1m continues to be owed by A Ltd). Both Mr A and A Ltd remain members of the partnership.

Thereafter, profits of the partnership are to be allocated to A Ltd. The profit will be used to repay the outstanding consideration for the sale of the partnership interest.

Mr A has transferred to A Ltd amounts which would otherwise be brought into account as income in determining his taxable profits. Accordingly, the arrangement is one whereby Mr A has transferred his right to receive relevant receipts to A Ltd. Assuming a main purpose of the arrangement was to achieve a tax advantage then section 809AAZA will apply.

***Example 45 (Transfer of profits 2)***

Consider a partnership that wants to borrow money. In calculating the partnership profits a deduction will be allowed for interest but not principal repayment of the loan. Each of the partner's profit shares is reduced by the amount of the interest but not of course by the principal repayment of the debt.

If however the borrowing required is borrowed by a member of the partnership (M) which contributes the loan as its partnership capital and an amount equal to the loan principal repayment amount is allocated to M, then all of the other members (in effect) get a deduction from their profit share for this principal amount.

M does not of course get a deduction for the profit share allocated to it, but if M is subject to a lower rate of tax than the other members of the partnership then overall less tax is paid. In addition the existing members of the partnership may indirectly obtain the benefit of those profits if under the arrangements they later obtain the benefit of M's capital contribution.

In such a case section ITA2007/s809AAZA or CTA2010/s757B may apply.