HM Revenue & Customs

Partnerships: A review of two aspects of the tax rules

Consultation document
Publication date: 20 May 2013
Closing date for comments: 9 August 2013

Subject of this consultation:	As announced at Budget 2013, the Government is consulting on how to change two aspects of partnership tax rules in order to prevent tax loss arising from disguising employment relationships through limited liability partnerships (LLPs), and from certain arrangements involving allocation of profits and losses among partnership (not just LLP) members.
Scope of this consultation:	The Government has formulated proposals for changing the tax rules in line with its core principles and objectives for fairness and flexibility, and is seeking views to inform the detailed policy design.
Who should read this:	Interested parties who are involved in a partnership (particularly LLPs) and may be affected by the proposed changes, in particular those (traditional or LLP) partnerships that include company members and LLPs where members are engaged on terms similar to contracts of employment.
Duration:	20 May - 9 August 2013
Lead official:	Richard Rogers, Deputy Director, HM Revenue & Customs
How to respond or enquire about this consultation:	Enquiries and comments can be sent: • by email to partnership.review@hmrc.gsi.gov.uk; or • by post to Partnerships Review Consultation, c/o Tax Administration Policy Team, HM Revenue & Customs, 1C/06, First Floor, 100 Parliament Street, London, SW1A 2BQ. Please see Annex A for detail.
Additional ways to be involved:	HM Revenue & Customs (HMRC) will be willing to hold meetings with interested parties to discuss the issues raised during this consultation. Please contact HMRC (contact details above), if you are interested in a meeting. Depending on the level of interest, HMRC may also organise an open day to explain and answer questions on the proposals. Again, please use the contact details above if you would be interested.
Getting to this stage:	The Government indicated in an Autumn Statement 2012 Written Ministerial Statement that this issue would be considered as part of its review of high risk areas of the tax code. There was a further announcement at Budget 2013 of the two areas that the consultation would cover.
Previous engagement:	Informal discussions have been held with interested parties after the Budget announcement. HMRC has considered the views and suggestions received and this document reflects the comments made.
After the consultation:	Responses will be taken into account in developing legislation and a summary of responses will be published in autumn 2013 after the consultation closes. There will be a further consultation on proposed draft legislation in late 2013 with legislation being introduced in the National Insurance Contributions Bill 2013 and Finance Bill 2014.

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Foreword

The vast majority of individuals and businesses pay their fair share of tax. This Government is committed to preserving fairness in the tax system and tackling behaviour that tries to use the rules to gain unintended tax advantages. As part of this strategic approach to tackling avoidance, the Chancellor announced at Budget 2013 that HMRC will consult on a review of two aspects of the partnership rules in order to:

- remove the presumption of self-employment for some members of Limited Liability Partnerships (LLPs) that seek to disguise employment relationships; and
- counter the manipulation of profit or loss allocations by some partnerships (not just LLPs) to achieve a tax advantage.

The Government recognises that LLPs are an important and legitimate commercial structure and that the majority of LLPs operate in a way that does not disguise employment relationships. However, there is currently an unintended inconsistency in the way that LLPs and general partnerships are treated that means that some LLPs are able to avoid their employment tax obligations. This strand of the review will level the playing field in the tax treatment of all partnerships, ensuring that employment taxes are paid for LLP members who should properly be counted as employees. It will also ensure that the LLP structure is preserved for legitimate use in the future.

The second strand of the review will look at schemes where partnerships allocate profits or losses in order to reduce tax. These schemes often involve partnerships (traditional partnerships or LLPs) where there is a mixture of individual and company members. The Government's objective is to prevent unfairness and market distortion within the tax system by ensuring that inappropriate partnership allocations to a company or similar vehicle cannot create tax advantages.

Fundamentally, this consultation is about levelling the playing field. It will have no impact on those partnerships or LLP members that use partnership structures as Parliament originally intended.

David Gauke MP
Exchequer Secretary to the Treasury

1. Introduction

Exploitation of partnership tax rules and Budget 2013 announcement

1.1 The Government is committed to tackling tax avoidance and has a strong track record of doing so, focusing on preventing avoidance, and detecting and counteracting it where it occurs.

1.2 At Budget 2013, the Government announced that HMRC will consult on two aspects of the partnership rules:

- removing the presumption of self-employment for some LLP members, to tackle the disguising of employment relationships through LLPs; and

- countering the manipulation of profit and loss allocations (by some LLPs and other partnerships) to achieve a tax advantage.

1.3 This consultation document sets out in Chapters 2 and 3 proposals for changes in these two areas. It invites views on how to implement those changes, and seeks information about how they would impact on businesses in terms of costs of compliance. The Government will use this information to finalise the detailed policy design and the initial tax impact assessment as described in Chapter 4.

1.4 Particular questions on the proposals are included in Chapters 2 and 3, and are brought together with some additional general questions in the summary of questions in Chapter 5. Responses are intended to assist in the detailed legislative design and should focus on how the stated policy objectives can be achieved whilst reducing impacts outside the specified targeted areas.

1.5 This work is separate from and is not subject to the review by the Office of Tax Simplification which will focus on ways to simplify the taxation of partnerships.

1.6 The following sections provide an outline of the two issues under review.

Issue one: Salaried members of LLPs (Chapter 2)

1.7 Current tax rules mean that individuals who are members of an LLP are taxed as if they are partners in a partnership established under Partnership Act 1890 (traditional partnership) even if they are engaged on terms closer to those of employees.

1.8 This produces unfairness in the tax system as an individual member of an LLP who is treated as a partner receives more favourable treatment of income tax and National Insurance Contributions ("employment taxes") than an individual who is an employee engaged on similar terms. As a result, LLPs can be used to disguise employment and to avoid employment taxes. There is evidence that LLPs are increasingly being used and marketed on that basis.

1.9 The Government recognises that LLPs remain an important and legitimate commercial structure but is keen to remove inconsistencies in their use. The ability to use LLPs to disguise employment was never intended and gives rise to significant scope for the avoidance of employment taxes. If left unchecked, these arrangements will continue to distort the LLP purpose and ultimately threaten its future use.

1.10 To preserve fairness and prevent avoidance through LLPs, the Government will make changes to employment taxes rules to:

a) remove the presumption that all individual LLP members are treated as partners and hence self-employed for tax purposes; and

b) set out the factors which will be taken into account in deciding whether an individual member of an LLP should be treated as an employee for the purposes of employment taxes.

1.11 This will preserve the LLP structure for legitimate purposes whilst ensuring the correct amount of employment taxes can be collected.

1.12 Chapter 2 sets out in more detail this issue and Government's proposals for legislative change in this area.

Issue two: Allocation of partnership and LLP profits and losses (Chapter 3)

1.13 The second area of review, partnership allocations, concerns schemes where partnerships allocate profits or losses in order to reduce tax. These schemes often involve partnerships (not just LLPs) where there is a mixture of individual and company members. The Government's objective is that tax advantages will not arise where there are inappropriate partnership allocations to a company or similar vehicle.

1.14 The partnership model allows significant flexibility in the way that profits and losses are allocated to partners and members of LLPs. In this context, the term "partnership" refers to general and limited partnerships as well as LLPs. Further details about various types of partnership are given in Annex B.

1.15 HMRC is seeing increasing use of particular partnership structures to reduce tax combined with some aggressive interpretations of the law. These include the exploitation of differences between corporation and income tax rates, sheltering tax charges and optimising the use of losses.

1.16 Chapter 3 describes the allocation issue in some detail including information about some of the avoidance arrangements and the Government's proposals for addressing the problem.

Timetable

1.17 The Government proposes to introduce changes in Finance Bill 2014 and in a National Insurance Contributions (NICs) bill to be introduced this year. The changes will take effect from 6 April 2014.

1.18 This approach is intended to:

- allow sufficient time for consultation and development of legislation which is soundly based and which will remain fit for purpose into the future;
- ensure a fairer tax system, by preventing partnerships from being used in ways that can give rise to tax advantage or avoidance; and
- comply with the Government's commitment to early and continuing engagement on tax changes[1].

[1] See the HM Treasury / HMRC Tax Consultation Framework (March 2011), available at http://www.hmrc.gov.uk/consultations/tax-consultation-framework.pdf

2. Disguised Employment

Background

2.1 The Limited Liability Partnership (LLP) Act 2000 introduced a new form of legal entity known as an LLP.

2.2 The LLP Act was introduced in response to concerns that the risks associated with large legal claims for professional firms set up as traditional partnerships were no longer appropriate. In particular, it was considered inappropriate that partners in the major accountancy firms could become liable for losses incurred in areas of the profession quite remote from those in which they operated or could know anything about.

2.3 LLPs have become increasingly popular as a vehicle for carrying on a wide variety of businesses. According to the latest statistics from Companies House, there are currently more than 50,000 LLPs on the register[2].

2.4 A member of an LLP must be registered as such on the LLP partnership register and any changes in membership must be notified to Companies House. The LLP Act allows two or more persons associated for carrying on a lawful business with a view to profit to form an LLP by subscribing to its incorporation document. Additional members can be introduced if existing members agree and the new member is registered at Companies House.

2.5 The LLP is a body corporate and has little in common with a traditional partnership apart from its tax treatment. In most areas, it is subject to the same rules as a company. Like a limited company, it gives members the benefits of limited liability.

2.6 In the absence of specific tax rules, the LLP would be taxed as a company[3]. However, for most tax purposes, the LLP and its members are treated like a partnership. This means that the profits of an LLP are taxed in accordance with the tax rules that apply to partnerships. Individual members are taxed as self employed partners and company members are liable to corporation tax according to their respective profit shares.

2.7 The LLP is a unique entity as it combines limited liability for its members with the tax treatment of a traditional partnership. However, individual members of an LLP are taxed as if they are partners even if their membership terms are such that the individual would normally be regarded as being in an employer-employee relationship. For example, members will be taxed as partners even if they have fixed salaries, are not exposed to risk, take no substantive role in the management of the business and have no right to profits or assets if the

[2] http://www.companieshouse.gov.uk/about/busRegArchive/businessRegisterStatisticsOctober2012.pdf
[3] Section 1 of the LLP Act 2000 provides that the LLP is a body corporate with legal personality separate from that of its members and it is formed by being incorporated under section 1(2) of the Act.

partnership ends.

Problems with the current approach

2.8 The original tax policy aim was to place members of LLPs in the same position for tax purposes as partners in a traditional partnership. However, the relevant tax legislation goes further than that by deeming an LLP member to be a partner for all the activities of the LLP[4]. This legislation applies only to LLPs and is the legislative basis for treating LLP members as self-employed in all cases. The Government considers that the continuation of this favourable treatment for an individual who, but for the legislation, would otherwise be employed by the LLP is unfair to other taxpayers and can create avoidance opportunities.

2.9 There is evidence that the current rules are not producing the desired policy outcome across a range of sectors and income groups. At one end of the scale, groups of low paid workers who would normally be regarded as employees are being taken on as LLP members as a condition for their obtaining work. Unlike becoming a member of a traditional partnership, accession to membership of an LLP is not likely to be seen as a career aspiration or sign of status. This may instead have downsides such as the loss of certain benefits and protections associated with employment. In some cases, employees of a company are being transferred wholesale to the LLP as members.

2.10 At the other end of the scale, individuals who would normally be regarded as employees in high-salaried professional areas such as the legal and financial services sectors are benefitting from self-employed status for tax purposes as a consequence of the arrangements in place, which then leads to a loss of employment taxes payable.

2.11 The Government believes that action should be taken in this area to achieve fairness within the tax system, to remove market distortions, and to prevent avoidance. Accordingly it will introduce legislation, with effect from 6 April 2014, to provide that certain LLP members will be taxed as employees.

Proposed changes

2.12 The policy aim is to prevent a member of an LLP benefiting from the default partner status if the terms of his or her engagement with the LLP are tantamount to an employment. This will be achieved by providing that an individual member who meets either of two conditions (as set out in paragraphs 2.15-2.23 below) will be classed as a "salaried member" and, in that capacity, will be liable to income tax and primary (Class 1) NICs as an employee. The

[4] For example, section 863 of Income Tax (Trading and Other Income) Act 2005.

LLP will become the secondary contributor and be liable to pay secondary NICs.

2.13 These conditions are not intended to apply to members who are in essence partners of a traditional partnership that is now carried on as an LLP. This means they are not intended to affect the status of members who carry on the partnership in common with a view to profit, who take risk in the business and who are to a significant degree rewarded on the basis of a share in the profits. They are also not intended to affect the status of persons who are taken on as members at an appropriate point in their career in recognition of their professional knowledge and personal skills, and who sacrifice an entitlement to salary in exchange for the opportunity to participate in the business in much the same way as a senior partner, even if as junior partners they are substantially rewarded by a fixed profit share.

2.14 The overall approach of these conditions is intended to be similar but not necessarily equivalent to the wide-ranging tests that would be applied in determining whether a person were a partner in a traditional partnership[5]. Applying these tests to salaried partners and fixed share partners in traditional partnerships is not straightforward. It would be even harder to apply those tests to LLP members because the limits on their financial liability prevent the unlimited risk characteristic typical of traditional partners from being present. The proposed approach is a relatively simple approach for HMRC, taxpayers and tax practitioners to use in order to determine whether a particular member is or is not to be treated as an employee.

The first condition

A "salaried member" of an LLP is an individual member of the LLP who, on the assumption that the LLP is carried on as a partnership by two or more members of the LLP, would be regarded as employed by that partnership.

2.15 Whether this condition is met would be determined by reference to normal tests, as set out in the Employment Status Manual[6] published on the HMRC website.

2.16 The intention is that this condition would provide a relatively straightforward test (at least no more complicated than the standard test of whether a person is an employee) that would in many cases clearly identify particular LLP members as employees. For example, it is expected that this condition would apply to many members who are engaged on standard terms as part of a mass recruitment exercise or who having been employees of a company then become members of a successor LLP on essentially identical terms.

[5] The Court of Appeal decision in *Tiffin v Lester Aldridge* [2012] EWCA Civ 35 contains useful comments.

[6] See http://www.hmrc.gov.uk/manuals/esmmanual/esm0500.htm

The second condition

2.17 HMRC recognises that the terms of the LLP agreement may be such that it is difficult to characterise it as similar to a contract of service, even though it confers rights that in substance amount to employment. In particular, the agreement may be expressed in terms that are more typical of a partnership agreement even though it has practical effects that are equivalent to employment.

2.18 HMRC considers that the most significant indicators that an LLP agreement confers rights equivalent to employment are that the member has no significant entitlement to reward that is related to profitability of the LLP, and that, in the event that the LLP makes a loss, there is no significant downside for the member. Downside in the context of an LLP refers to the risk of loss of capital contributed to, or accumulated in, the LLP or an obligation to repay drawings to the LLP that are paid on account of an expected participation in profits in the business for that period of account[7].

2.19 Accordingly, there would be a second condition which would be used to determine if the individual is a salaried member as set out below:

A "salaried member" of an LLP includes an individual member of the LLP who does not meet the first condition but who:

(a) has no economic risk (loss of capital or repayment of drawings) in the event that the LLP makes a loss or is wound up;
(b) is not entitled to a share of the profits; and
(c) is not entitled to a share of any surplus assets on a winding-up.

2.20 For the purpose of the second condition, any risk or entitlement will be ignored if, having regard to all the circumstances and in particular the total economic rewards available or likely to be available to the member, it is reasonable to regard the risk or entitlement as insignificant.

2.21 What is insignificant will be determined in the light of all the circumstances and by reference to the overall package of benefits derived from the partnership agreement. In line with normal practice, an entitlement to share in the profits that for practical purposes would never be more than 5% of any fixed entitlement would be unlikely to be regarded by HMRC as significant.

2.22 The Government would be concerned if taxpayers tried to circumvent the proposed changes by introducing into a membership agreement terms that were intended to have no practical effect other than to disapply the legislation. It considers that the classification of an LLP member as an employee or self-employed should depend upon the substance of the matter and not the inclusion in an agreement of terms that are never intended to have practical

[7] It does not refer to the theoretical risk that a negligent member may have personal liability in the event of an insolvent liquidation of the LLP since this risk would be the same for all members.

effect. It is therefore proposed that a targeted anti-avoidance rule[8] will be introduced that will provide that in determining the tax status of the LLP member, no account would be taken of certain arrangements. the main purpose, or one of the main purposes, of which is to prevent the first or second conditions from being met (as in Example 3 below).

2.23 The examples below set out how the rules just described would be expected to apply in some typical scenarios.

Examples

Example 1: Member A receives a salary of £200,000. This is guaranteed so it is payable irrespective of the level of profits or losses. There is no requirement to contribute capital, no right to participate in profits and no requirement to repay salary in the event that the partnership is not profitable for the period of account.

On the facts given, Member A is a salaried partner.

Example 2: Member B receives a salary of £50,000, which may be reduced if the profits are insufficient to pay all the agreed members' salaries. In addition, Member B receives a 10% share of profits remaining after members' salaries have been paid.

Member B is genuinely exposed to the risk of loss of entitlement to the salary and enjoys the prospect of benefitting from partnership profits. Accordingly, Member B is not a salaried partner.

Example 3: The facts are as for Example 1, but in addition, Member A will receive 10% share of the profits if the profits exceed a figure that is many times the actual turnover of the business. The intention is that Member A will only ever receive the guaranteed salary, and the profit-sharing entitlement is intended to prevent the legislation from applying.

On the facts given, Member A is a salaried member.

Consequences of salaried member status

2.24 It is intended that the legislation will provide explicitly that a salaried member is to be treated in relation to their work for the LLP as an employee for both income tax and NIC purposes (including benefits in kind).

2.25 It is also intended that costs of employing salaried members will be deductible in the computation of the profits of an LLP.

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[8] As set out in B8 of HMRC's Guidance on the General Anti-Abuse Rule (http://www.hmrc.gov.uk/avoidance/gaar-part-abc.pdf), there are likely to be arrangements which cannot be described as abusive, but which fall outside the range of acceptable tax planning. The TAAR would be intended to deter and counteract such arrangements.

2.26 HMRC would welcome comments on the following:

Question 1: Whether the current definition of "salaried members" set out in 2.19 is appropriate to catch those members who should be subject to employment taxes and thereby provide a more equitable tax and NIC treatment?

Question 2: Is there a simpler alternative for delivering the same policy objectives, whilst reducing uncertainty and preventing avoidance?

Question 3: Are the conditions as currently framed clear enough or are there other criteria that you consider should be added that would more clearly achieve the policy aims?

Question 4: Is there an alternative to the proposed TAAR which would prevent attempts to sidestep the rules? How could a TAAR be expressed so as to ensure that it has the desired effect but does not apply inappropriately?

Question 5: Guidance will be issued to indicate how the test will be applied. We would welcome views on any specific scenarios or points this guidance should cover.

3. Profit & Loss Allocation Schemes

Background

3.1 The issues discussed below concern partnerships involving mixed members (typically companies and individuals) and arrangements where profits are sold through partnership arrangements. They relate to all types of partnership including LLPs, foreign partnerships and entities established in other jurisdictions that are treated for UK tax purposes as partnerships. However, they do not cover cases where family members use partnership structures to allocate profits between them tax efficiently in circumstances such as those considered in the *Arctic Systems* case[9].

3.2 A range of structures may be adopted by a person setting up in business. For example, the person may operate as a sole trader, through a company, or by acting in partnership with others. Each of these choices has distinct tax consequences which will be relevant to commercial considerations and the ultimate decision as to which structure to adopt.

3.3 If the corporate model is adopted, then the company is charged to corporation tax on its profits. The directors of the company are taxed as employees on remuneration they receive and the company obtains a tax deduction for those remuneration payments. If the directors are also shareholders in the company, income tax will also be payable on any company profits distributed to them.

3.4 If the partnership model is adopted, then the partners are charged to tax on the profits allocated to them under the profit-sharing agreement applicable during that period. They are not taxed on profits drawn from or distributed by the partnership. The partnership's profits are those determined in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law. However, the partnership agreement may afford significant flexibility around the allocation of those profits (or losses) between the partners[10].

3.5 Under partnership law, it is not necessary for sharing ratios to be in proportion to contributions, effort or capital, to be the same from year to year, or for profits and losses to be shared in the same proportions. Profits and losses are

[9] Jones v Garnett 2007 UKHL 35:
http://www.publications.parliament.uk/pa/ld200607/ldjudgmt/jd070725/jones%20-1.htm

[10] HMRC's Business Income Manual (BIM72055) flags up this flexibility:
"Profits, losses or other income may be shared as the partners may mutually agree from time to time (Sections 19 and 24 Partnership Act 1890). The sharing ratio need not be in proportion to contributions of effort or capital. It is not necessary for the partners to share profits and losses in the same proportions, nor income from other sources in the same proportions as trading or professional income. A partner's share of the income on which they are assessable is computed according to their entitlement in the partnership's accounting period."

allocated in accordance with the partnership agreement in force for the relevant period.

3.6 In recent years, HMRC has seen an increasing number of arrangements which use the flexibility of partnership profit and loss sharing arrangements to secure tax advantages. HMRC considers that many of these arrangements do not work, but in order to prevent any new avoidance the Government considers that new legislation is now required to remove the risk.

3.7 There are three distinct types of arrangement that the Government plans to address:

- Partnerships with mixed members (typically companies and individuals) where profits are allocated to a member that pays a lower rate of tax. The issues are described in paragraphs 3.8 to 3.25 (*partnerships with mixed membership – profits*).

- Partnerships with mixed members where losses are allocated to a member that pays a high rate of tax. The issues are described in paragraphs 3.26 to 3.29 (*partnerships with mixed membership – losses*).

The proposed policy responses to these arrangements involving mixed member partnerships are described in paragraphs 3.30 to 3.41.

- Partnership arrangements where members reduce their profit entitlement in return for payment made by other members who will be taxed more favourably on those profits (*partnerships with members with differing tax attributes*). The issues and proposed policy responses are set out in paragraphs 3.42 to 3.54.

Issue 1: Partnerships with mixed membership - profits

3.8 This issue concerns the sharing of profits in ways that may allow income tax payers to obtain the benefits of corporation tax rates while retaining other commercial and income tax benefits of the partnership structure.

3.9 A partnership may involve different types of entity, for example, it may include both company and individual members. In some cases the company may be owned by some or all of the individual members. There may be reasons (unrelated to tax) for this structure. For example:

- flexibility for external investment (for example, because the company may have previously carried on the business or may have an established credit record);

- partnership interests may be transferred through their sales of shares; and

- certain assets used by the firm (for example, property) may have been held by the company for historic reasons and it may now be impractical or unnecessary to transfer them to the partnership.

3.10 However, HMRC has seen an increasing number of arrangements involving such mixed structures where the profit-sharing ratios are calculated in such a way as to minimise the overall tax paid by the partners. For example, profits may be allocated to a member such as (but not limited to) a company subject to low rates of tax, while other partners indirectly obtain the benefit of those profits as a result of having an economic interest in that member. The overall effect of the arrangement is to transfer profit between entities subject to different tax rules in a way that reduces the overall liability to tax.

3.11 Typical arrangements that HMRC has under review involve large professional firms using a partnership structure and making substantial profits. The company member makes nil or negligible contribution to generate the firm's profits, but significant amounts of profit are allocated to it. Wider arrangements result in those profits flowing through the company for the economic benefit to some or all of the individual members. The allocation of profits to the company reduces the income tax payable, and because of rate differentials or other arrangements in which the companies are involved, is claimed to give rise to a significant overall tax saving. In the most aggressive cases, it is claimed that no tax at all is paid either by the company or the individual members when they access the profits.

3.12 There are various ways in which this claimed tax saving may be achieved, some of which are described in Annex C (examples 1-3).

3.13 Schemes exploiting profit allocation have become increasingly common as the difference between income tax and corporation tax rates has increased.

3.14 The Government considers that the schemes create unfairness and market distortion within the tax system for a number of reasons as set out below:

- the arrangements are intended to give the best of all worlds, by allowing individuals to access corporation tax rates but without giving rise to the full tax consequences of operating as a company, rather than a partnership. Adopting a company model has other tax consequences (for example, leading to the members being taxed as shareholders and, perhaps, as directors or employees), but these consequences are avoided by the use of the mixed structure which gives the advantages of both corporation tax rates and the commercial and tax benefits of a partnership;

- the arrangements are clearly tax-driven because it is evident that the allocation of profits to the company would not occur if it were taxed at the same rate as the individual members. That is seen clearly in the examples in Annex C and also in relation to the profit deferral and working capital arrangements described below, which are expressly aimed at reducing the tax payable on partnership profits;

- it is a principle of partnership taxation that partnership profits are taxed when earned and not when distributed or drawn from the business, but the arrangements seek to defer taxation until profits are actually drawn (with lower tax, if any, paid at that point); and

- if no action is taken, they are likely to proliferate in a way that would be unfair to those who operate partnership structures as intended.

Partnership with mixed membership - profits: Profit deferral and working capital arrangements

3.15 HMRC is aware of arrangements where partnership agreements may not permit individual members to withdraw partnership profits in the period they are earned.

Profit deferral arrangements

3.16 Profit deferral arrangements occur in the banking and hedge fund sectors. Amounts may be awarded to particular executives but during a deferral period be subject to forfeiture depending on the performance by the executive or a wider group over that time. The amounts may also be forfeitable if anticipated benefits of past deals do not materialise. The aim of these deferral arrangements is to align incentives with long-term performance and discourage the taking of risks which may yield short-term profits but long-term losses.

3.17 Such provisions are most commonly seen in employment contracts where a company wishes to incentivise long term performance of its employees. However, the same effects can be produced by partnership agreements. For example, a partnership that manages investments will make profits through fees paid to it by the funds. The partnership remuneration agreement may allot those profits to particular members but, in order to incentivise long-term performance, may require a proportion of those profits to be retained within the partnership until a deferral period expires. To reduce the upfront tax charge, such “retained” profits can, instead, be initially allocated to a company member in which the members of the partnership hold an equity stake. When the profits finally vest with the member, the company is dissolved and the proceeds are distributed to the member.

3.18 Profit deferral arrangements are related to but distinct from clawback provisions under which a person may have to pay back amounts already received. More detail on both types of arrangement is given in Annex D . The annex sets out HMRC’s understanding that at present it is exceptional for partnerships to be subject to any regulatory requirement to operate either profit deferral or clawback, but that this may change in the future.

Working capital arrangements

3.19 In working capital arrangements, the partnership business model envisages that profits will be retained in the business, to be used as additional "working capital" to finance the growth of the business. The post-tax working capital can be maximised by allocating profits to a company member that pays tax at a rate lower than that of the individual members.

3.20 The effect of these arrangements is that the individual partners are taxed only on the profits that correspond to the “remuneration” they need to draw from the business, while the remainder of the partnership profits are taxed at lower corporation tax rates.

Analysis

3.21 In both the profit deferral and working capital arrangements, the admission of a company partner has no material effect on the commercial profitability of the firm. This means that one or more other partner will be allocated a lower share of profits than would otherwise be the case. Those partners agree to this only because the estrangement from the profits is intended to be temporary: their connection with the company partner will allow them to continue to maintain an ability to benefit from the profits allocated to it.

3.22 The argument given in favour of using a company partner to minimise tax is that it is unfair to tax profits on the individuals in a period during which the individuals are unable to access them (or while the profit allocation is to some extent contingent) or if the partnership uses the profits to develop the business. HMRC has been told that retaining working capital by means of the arrangements effectively gives access to cheap finance. It has also been pointed out that the member may be taking risks in respect of the profits since, if the business fails, or the profits do not vest, the amounts may in fact never be received.

3.23 Although the Government acknowledges these arguments, it considers that they do not override the risks of unfairness and market distortion described in paragraph 3.14.

3.24 The arrangements described are designed to enable members of a partnership to benefit from the low tax rate and timing benefits that would apply if the partnership were a company, but without the full tax consequences that would arise if they were employees of the company, for example, liability to employment taxes. They also result in unfairness because they allow mixed member partnerships to access more favourable tax treatment, or obtain cheaper working capital, than an almost identical partnership that does not have a company member. This puts those partnerships which do not have a mixed membership in a disadvantageous position. If left unchecked, such arrangements would become the “norm” resulting in tax loss and introducing unfairness to those who operate partnership structures that do not involve mixed members.

3.25 Accordingly, the Government considers that the profit deferral and working capital arrangements should be addressed in the same way as other profit sharing allocation arrangements involving partnerships with mixed membership described in Annex C. However, in relation to profit deferral arrangements, the Government is interested in views on whether a retrospective relief could be given if a contingent profit award does not vest or whether there should be provision for a member to elect to be treated as a salaried member instead (please see questions 10 and 11 below).

Issue 2: Partnerships with mixed membership - losses

3.26 Like the profit allocation schemes, these arrangements make use of differences in tax rates applicable to different categories of partnership member. A typical example is that of a partnership carrying on a business which gives rise to initial tax losses followed by later taxable profits. In the initial loss making period, all losses are allocated to individual partners to allow them to claim loss relief against their general income which would otherwise be chargeable at higher rates of income tax. Their overall tax liability is reduced as a result. In the profitable periods, all profits are allocated to the company member so that the profits are liable to lower corporation tax rates or possibly not within the scope of UK tax at all.

3.27 Such schemes may aim to secure relief for amounts[11] that are not subject to the cap on income tax reliefs effective from 6 April this year.

3.28 The partnership allocation, therefore, results in relief being given against the individual partners' general income liable to higher income tax rates, while the later profits are taxed at a lower corporation tax rate or not at all.

3.29 An example of a scheme is set out in Annex C (example 4).

Partnerships with mixed membership: Proposed changes

3.30 Income tax avoidance arrangements involving partnerships with mixed membership schemes rely on the features described below:

- a person becomes a member of a partnership or there is a change in profit-sharing ratios;
- at least one member of the partnership is a person chargeable to income tax in respect of partnership profits and at least one member is a person not so chargeable. That member may be a company or a person not chargeable to tax or a non-resident person. In each case, it pays tax at a lower rate than normal rates of income tax or does not pay tax at all;

[11] An example is Business Premises Renovation Allowance.

- the relevant partnership sharing arrangement is that a significant amount of the partnership profits will be allocated to the member not chargeable to income tax, or that losses are allocated to members who are chargeable to income tax;

- it is clear that the arrangements give rise to an overall reduction in tax and the profit/loss sharing arrangements would not have been entered into if no such reduction could be achieved (for example, if the company member would have been charged to tax on the profits at the same rate as the individual members);

- in the **profit allocation schemes,** there is an economic connection between the members not charged to income tax and those within the charge, by which the latter will be able to benefit, directly or indirectly, from partnership profits allocated to the former. The benefits could arise through reallocation of partnership capital, by an increase in value of an equity instrument or an interest in a trust, by the ability to declare a dividend or by any other means; and

- in the **loss allocation schemes,** this economic connection need not be present; instead, the aim is to secure that the losses can be relieved against other income of any of the individual members.

3.31 The proposed changes are not intended to affect those entering into arrangements that are not tax-motivated, but are intended to deter arrangements that exploit the tax treatment of mixed membership partnerships. The proposals will give rise to a degree of complexity since they will ensure that where such arrangements are nonetheless entered into the tax advantage that is sought will not arise. The proposals will apply where a partnership meets the "mixed membership requirement" and either the "profit condition" or the "loss condition" is met[12].

The mixed membership requirement

3.32 The mixed membership requirement is that the partnership consists of one or more members who are persons within the charge to income tax (P) in respect of partnership profits and one or more members who are not (C) - be that a company, a non-UK resident person or any other person not chargeable under the normal income tax rules on profits allocated to them by the partnership.

The profit condition

3.33 The profit condition is that it is reasonable to assume that the main purpose or one of the main purposes, of the partnership profit-sharing arrangements applicable for a period of account is to secure an income tax advantage for any

[12] This rule would take priority over, and would displace, any other tax charge that might arise – for example, any charge under new Chapter 3A in Part 10 of Corporation Taxes (CTA) Act 2010 (introduced by Finance Bill 2013) extending the "close company loans to participators" rules.

person[13].

3.34 This condition will apply only in relation to profits allocated to C where there is an economic connection between P & C such that P may benefit from C's profits. The most obvious form of economic connection is that P is a shareholder of C but (as illustrated by the examples in Annex C) the way in which C's profits are to be allocated to P may also be set out in a side agreement or other arrangement.

3.35 Where the rule applies, the proposed counteraction is for all or part of profits allocated to members not within the charge to income tax to be allocated to members within the charge.

3.36 The basis of reallocation would depend upon the form of the economic connection between P & C and would take into account all the circumstances. For example, if the only connection were that P held shares in C then the re-allocation of profits from C to P would be by reference to that shareholding. In the case of profit deferral arrangements, the reallocation would be by reference to the profits awarded to P for the relevant period of account (ignoring the fact that they have not yet "vested"). If the only connection were by reference to a side agreement, then HMRC would expect it to be clear from its terms what the appropriate reallocation should be because the individual members would know exactly what their entitlement was.

3.37 For this reason, HMRC considers that the most appropriate basis for counteracting the tax advantage is to use a just and reasonable basis of reallocation that takes into account all the circumstances including in particular the factors set out above.

Question 6: HMRC would welcome views on this approach to counteraction, particularly what other specific indicators should be taken into account and possible alternative approaches that would counteract the tax advantages (including timing advantages).

The loss condition

3.38 The loss cases are somewhat different in that they do not depend upon an economic connection between P & C. Accordingly, the loss condition for mixed membership cases is that it is reasonable to assume that the main purpose, or one of the main purposes, of arrangements in force for a period of account is to allocate a partnership loss to a partner with a view to that partner obtaining a reduction in tax liability by way of income tax reliefs or capital gains relief[14].

3.39 The proposed counteraction where this condition is met is that no income tax relief or capital gains relief will be given for the relevant partner's partnership

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[13] Income tax advantage would take its normal meaning, see, for example, section 684 of Income Tax 2007 (person liable to counteraction of income tax advantage); this would include any reduction or deferral of tax.

[14] For example, section 261B of Taxation of Chargeable Gains Act 1992 (use of trading loss as a Capital Gains Tax loss).

loss for the period.

3.40 For both profit and loss cases, the counteraction would have effect for income tax and NIC purposes.

Partnerships with mixed membership – questions

3.41 HMRC would welcome views on these proposals in relation to the following aspects:

Question 7: Would the legislative approach set out above provide an effective deterrent and counter the schemes described?

Question 8: Would the proposed changes impact on situations that are not in line with the stated policy objectives? If so, HMRC would welcome detailed explanation of why you believe these situations fall outside the intended target areas.

Question 9: Do you consider that there are circumstances in which this rule would give rise to outcomes inconsistent with the policy objectives and, if so, in what circumstances and how might these situations be addressed?

Question 10: As described above, it is proposed that the profit deferral arrangements will be tackled in the same way as the other mixed membership arrangements. HMRC would welcome views on whether relief could be given retrospectively in the event that a contingent profit awards does not ultimately vest. To prevent the risk of abuse, such relief would be confined to clearly defined circumstances and would also need to provide for additional tax charge to be imposed on other members in the event that those profits are re-allocated to other members.

Question 11: A possible alternative to the approach suggested in question 10 would be to allow a member subject to a profit deferral arrangement to elect to be taxed as a salaried member, with the consequences then being as set out in paragraphs 2.24 and 2.25 above. Views on this proposal would be welcome.

Issue 3: Partnership members with differing tax attributes

3.42 HMRC has seen a number of schemes in which a member (referred to below as the “transferee member”) contributes capital to a partnership or makes a payment to another member (the “transferor member”) in return for the transferee member receiving a new or increased share of profits. The profit obtained by the transferee is equal to the profit forgone by the transferor member, who would otherwise have been within the charge to tax on income on the profit. The transferee member is either not taxed at all on the profit or is taxed at a much lower rate than the transferor member would have been.

3.43 There are number of reasons why the transferee partner may be taxed at a lower rate. The arrangements may take advantage of differences in the direct tax treatment and tax rates between:

- companies and individuals
- those with losses to use against profits and those without such losses
- income and capital
- exempt and non-exempt partners
- traders and investors
- banks and other (non-financial) traders
- UK resident partners and non-residents.

3.44 Two examples are given in Annex C (examples 5 and 6).

3.45 The schemes result in members of the partnership receiving payment that is not taxed as income in return for profit that would have been charged to tax as income. The new members acquire those profits and pay less tax because of their particular tax attributes.

3.46 The schemes are distinct from those where family members use partnership profit-sharing ratios to allocate profits between them tax efficiently in circumstances such as those considered in the *Arctic Systems* case[15] since in such cases there is no payment given for the profits transferred.

3.47 However, these arrangements are similar to those dealt with by the legislation concerning transfer of income streams and structured finance arrangements[16] (Chapters 1 and 2 in Part 16 of Corporation Taxes Act (CTA) 2010). The transfer of income stream provisions currently apply to partnerships only in very limited circumstances[17] and the structured finance arrangements rules apply only where the arrangement is accounted for as a financing transaction. These requirements mean that the rules do not apply in all cases in which partnership structures can be used to sell profits in a way that avoids a tax charge on the transferor.

3.48 The tax attribute schemes are different from the mixed membership schemes considered above. They do not rely upon different types of entity being members, but involve a payment being made to a partnership or to a member of the partnership in return for a share in the partnership profits, in order to secure a more favourable tax treatment for the profits. The payment made will be calculated by reference to the value of those profits and in substance is consideration given for their transfer. This transfer would ordinarily give rise to an upfront tax charge on income but the adoption of the partnership structure prevents that charge from arising.

[15] Jones v Garnett 2007 UKHL 35:
http://www.publications.parliament.uk/pa/ld200607/ldjudgmt/jd070725/jones%20-1.htm
[16] See HMRC's guidance including CFM7700+, SAIM11000+ and CFM73010 for more detail.
[17] Section 756 CTA 2010: this can apply only if the relevant receipts fall out of the charge to tax in entirety.

Partnership members with different tax attributes: Proposed changes

3.49 The Government intends to introduce legislation that will apply where the transferee member becomes entitled to a share of profits or an increased share of profits (relevant profits) as part of a profit transfer arrangements and it is reasonable to assume that the main purpose, or one of the main purposes, of the arrangements is to secure a tax advantage. That tax advantage would arise as a result of the differing tax attributes of the transferor and transferee members.

3.50 An arrangement would be a profit transfer arrangement if it is reasonable to assume that the transferee member's entitlement is in consequence of receipt of money or any other asset by the transferor member and that in the absence of the arrangement the transferor member would have been charged to tax on income on the relevant profits. This would apply whether the receipt of money or other asset were direct from the transferee to the transferor or indirect (for example, through the partnership). To prevent sidestepping of the rule, it would also apply where the transfer or payment is by a person connected with a relevant member.

3.51 Where the legislation applies, the payment received will be treated for tax purposes in the period in which it is received as income of the transferor member or connected person, chargeable to tax in the same way and to the same extent as that in which the relevant profits would have been[18].

3.52 The legislation will not apply if the arrangement is one to which the legislation concerning transfer of income streams and structured finance arrangements (Chapter 1 and 2 in Part 16 of CTA 2010) applies because these rules already ensure that the arrangement is taxed appropriately. Nor would it apply if the mixed partnership rules described above were applicable.

3.53 The legislation would also not apply if and to the extent the payment were otherwise charged to tax as income.

3.54 The legislation would override any "exclusivity rule" such as those within section 464, 699 or 906 of CTA 2009 (priority of loan relationships rules, derivative contracts rules and intangible fixed assets rules for corporation tax purposes).

Question 12: Should there be any other exceptions to the proposed treatment? If so, please provide information why these cases should be excluded and suggestions on how these exclusions can be effected.

Interaction of the General Anti-abuse Rule and this measure

3.55 The General Anti-abuse Rule (GAAR) is aimed at abusive tax avoidance schemes. The criteria for applying the GAAR and examples to illustrate how

[18] This approach is based on that of the transfer of income streams legislation - see section 753(1) CTA 2010.

these can apply in practice are included in HMRC's GAAR guidance. Whilst it is possible for the schemes discussed in this document to exhibit the necessary features for the GAAR to apply, the flexible use of profit and loss allocations is in itself a choice that tax legislation offers.

3.56 Taking action through this measure is intended to send a signal that the partnership structures targeted by the measure should not be able to secure the sought-after tax advantages. As set out in the GAAR guidance, arrangements entered into to exploit any loophole or shortcomings in legislative provisions may fall foul of the GAAR.

Commencement

3.57 The rules will apply with effect from 6 April 2014 in relation to profits and losses that arise on or after that date. There will be no grandfathering for arrangements entered into before this date.

4. Tax Impact Assessment

4.1 This table represents the Government's current understanding of the impact of this measure. This information will be updated to take into account responses to this consultation and a revised table will be published as part of the Tax Information and Impact Note alongside draft legislation in the autumn.

Exchequer impact (£m)	2013-14	2014-15	2015-16	2016-17	2017-18
	0	+125	+365	+300	+285
	These figures are set out in Table 2.1 of Budget 2013 and have been certified by the Office for Budget Responsibility. More details can be found in the policy costings document published alongside the Budget.				
Economic impact	The Government expects the economic impact to fall on a number of professions and partnership businesses; affecting only those that use a partnership model in the ways described in this document. It is intended to result in some individuals and corporates paying significant amounts of additional tax and NICs and restriction of certain personal income allowance limits where "employment" income has been reclassified.				
Impact on individuals and households	Except where indicated above, the Government does not expect the impact on individuals to be significant and there is no impact on households given the scope of this measure (see above).				
Equalities impacts	No impacts on any protected equality groups are expected from these options for the reason set out in the box above.				
Impact on businesses including civil society organisations	This measure is expected to affect LLPs who use membership status to disguise employment, partnership structures where there is a mixed membership of companies and connected individuals and partnership structures where profits are transferred in exchange for payment. This is expected to be a minority of partnership structures. There would be costs of change as professions and businesses which may include the third sector organisations need to understand the new rules and communicate them to their scheme members.				

Impact on HMRC or other public sector delivery organisations	HMRC expects to apply the existing processes for the change proposals and options, and the operational impact would not be significant. A few public sector organisations using the partnership model may be affected and they would also incur costs of change like private sector organisations.
Other impacts	Some small businesses may be affected by this measure, but the majority of the tax yield is expected to derive from large professional partnerships. The existing evidence suggests that the majority of partnerships, irrespective of size, will not be affected.

5. Summary of Consultation Questions

Chapter 2: Disguised employment

Question 1: Whether the current definition of "salaried members" set out in 2.19 is appropriate to catch those members who should be subject to employment taxes and thereby provide a more equitable tax and NIC treatment?

Question 2: Is there a simpler alternative for delivering the same policy objectives, whilst reducing uncertainty and preventing avoidance?

Question 3: Are the conditions as currently framed clear enough or are there other criteria that you consider should be added that would more clearly achieve the policy aims?

Question 4: Is there an alternative to the proposed TAAR which would prevent attempts to sidestep the rules? How could a TAAR be expressed so as to ensure that it has the desired effect but does not apply inappropriately?

Question 5: Guidance will be issued to indicate how the test will be applied. We would welcome views on any specific scenarios or points this guidance should cover.

Chapter 3: Profit and loss allocation

Mixed member partnership – profits

Question 6: HMRC would welcome views on this approach to counteraction, particularly what other specific indicators should be taken into account and possible alternative approaches that would counteract the tax advantages (including timing advantages).

Mixed member partnerships – profits and losses

Question 7: Would the legislative approach set out above provide an effective deterrent and counter the schemes described?

Question 8: Would the proposed changes impact on situations that are not in line with the stated policy objectives? If so, HMRC would welcome detailed explanation of why you believe these situations fall outside the intended target areas.

Question 9: Do you consider that there are circumstances in which this rule would give rise to outcomes inconsistent with the policy objectives and, if so, in what circumstances and how might these situations be addressed?

Question 10: As described above, it is proposed that the profit deferral arrangements will be tackled in the same way as the other mixed membership arrangements. HMRC would welcome views on whether relief could be given retrospectively in the event that a contingent profit awards does not ultimately vest. To prevent the risk of abuse, such relief would be confined to clearly defined circumstances and would also need to provide for additional tax charge to be imposed on other members in the event that those profits are re-allocated to other members.

Question 11: A possible alternative to the approach suggested in question 10 would be to allow a member subject to a profit deferral arrangement to elect to be taxed as a salaried member, with the consequences then being as set out in paragraphs 2.24 and 2.25 above. Views on this proposal would be welcome.

Partnership members with differing tax attributes

Question 12: Should there be any other exceptions to the proposed treatment? If so, please provide information why these cases should be excluded and suggestions on how these exclusions can be effected.

General questions

Question 13: Would there be situations that are not in line with the Government objectives? If so, the Government would welcome detailed explanation of why you believe these situations fall outside the intended target areas and, if possible, any suggestions on how these situations may be effectively excluded from the legislation?

Question 14: Do you agree that the legislation can help the Government to meet with the wider objectives of fairness without adversely affecting the flexibility of the partnership structure?

Question 15: Can interested parties offer views on any other likely costs that partnerships and their partners may incur in order to implement the changes?

Question 16: Will the proposals described above provide a comprehensive response to all schemes involving manipulation of partnership profit and loss allocations (including but not limited to the arrangements described in Annex C)? If not, what other types of scheme should be tackled?

Annex A: The Consultation Process

This consultation is being conducted in line with the Tax Consultation Framework. There are 5 stages to tax policy development:

Stage 1	Setting out objectives and identifying options.
Stage 2	Determining the best option and developing a framework for implementation including detailed policy design.
Stage 3	Drafting legislation to effect the proposed change.
Stage 4	Implementing and monitoring the change.
Stage 5	Reviewing and evaluating the change.

The Government has announced its intention to make changes to give effect to the policy objectives set out in this consultation document. While there are some aspects of detailed policy design that are still open, this consultation is at stage 3 and is about ways to achieve the objectives stated in the consultation document while ensuring that the proposals do not have unexpected impacts.

Further technical consultation on draft legislation is envisaged, with the legislation coming into force from April 2014.

How to respond

A summary of the questions in this consultation is included at chapter 5.

Responses should be sent by **9 August 2013**:

- by e-mail to partnership.review@hmrc.gsi.gov.uk or
- by post to Partnerships Review Consultation, c/o Tax Administration Policy Team, HM Revenue & Customs, 1C/06, First Floor, 100 Parliament Street, London, SW1A 2BQ.

This document can be accessed from the GOV.UK Internet site at https://www.gov.uk

All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

When responding please say if you are a business, individual or representative body. In the case of representative bodies please provide information on the number and nature of people you represent.

Confidentiality

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentially can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HMRC.

HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

Consultation Principles

This consultation is being run in accordance with the Government's Consultation Principles.

The Consultation Principles are available on the Cabinet Office website: http://www.cabinetoffice.gov.uk/resource-library/consultation-principles-guidance

If you have any comments or complaints about the consultation process please contact:

Amy Burgess, Consultation Coordinator, Budget Team, HM Revenue & Customs, 100 Parliament Street, London, SW1A 2BQ.
Email: hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk

Please do not send responses to the consultation to this address.

Annex B: Types of Partnership

There are strictly only two types of partnership in the UK, a general partnership and a Limited Partnership (LP). A Limited Liability Partnership (LLP) is a corporate body subject to company law, not a partnership subject to partnership law, although LLPs are treated as partnerships for most direct tax purposes.

An LP is one in which at least one of the partners restricts their liability for the debts and obligations of the firm to a pre-determined sum, instead of bearing unlimited liability as a partner normally does. There must be at least one general partner within a limited partnership and this partner manages the business and bears unlimited liability to creditors.

LLPs were introduced by the LLP Act 2000 that took effect from 6 April 2001. An LLP is available as a business vehicle to any “two or more persons associated for carrying on a lawful business with a view to a profit” by a simple registration with the registrar of companies. They were developed to combine the organisational flexibility of a partnership with the benefit of limited liability for its members. They therefore provide an alternative business structure to, on the one hand a company, and on the other a general partnership.

Unlike members of ordinary partnerships, the LLP is itself responsible for any debts that it runs up, not the individual members, and without special tax rules, LLPs would be taxed as companies because they are bodies corporate. However, as with other partnership entities, the LLP remains transparent for the purposes of income tax or capital gains tax for individuals and corporation tax due from corporate partners. In deciding to adopt an LLP, the tax position may therefore be the decisive factor.

When LLPs were introduced by the Act, they were primarily envisaged as being the commercial vehicle for professional firms, such as accountants and solicitors. This vehicle was expected to appeal mostly to professionals because it allows them to limit their exposure to liabilities at the same time as retaining the feel of a traditional firm.

Key features of LLPs include:

- it is a body corporate, i.e. a separate legal entity to its members. The LLP can own and hold property, employ people and take on obligations under a contract;
- an LLP has members and not shareholders or directors. The LLP has no share capital and is not subject to the rules governing the maintenance of capital by companies;
- members of the LLP have limited liability and the LLP itself is liable for all its debts to the full extent of its assets;
- an LLP has unlimited capacity which means that there are no restrictions on its activities;
- there are no requirements for board meetings or annual meetings. An LLP will not have memorandum or articles of association;
- the LLP is required to keep accounting records, submit audited annual accounts and an annual return to Companies House just the same as

companies. The exemptions available to companies relating to abbreviated accounts and exemption from audit also apply to LLPs; and
- an LLP member can face action under the Company Directors Disqualification Act 1986 and then be precluded from being a member of an LLP.

Because LLPs are regarded as bodies corporate, parts of the Companies Act 1985 apply to them. They are therefore required to register with Companies House. Limited partnerships, although they are not bodies corporate are also required to register with Companies House, so that there is a public record of the amount of capital contributed by each limited partner (to which their liability is limited). There are no registration requirements for general partnerships.

The tax treatment of partnerships is the same across all legal forms. For income tax (and corporation tax, where there are company partners), partnerships are treated as entirely tax transparent. Any profits of the partnership are attributed to the partners and tax is then levied at that level through the Income Tax self-assessment (or Corporation Tax self-assessment) system. Partners who are individuals rather than companies are also charged NICs. There is no joint liability for tax due on partnership profits. Similarly, reliefs for partnership trading losses may be claimed by each partner independently of the others. However, partnerships, rather than the individual partners are responsible for VAT, employment taxes and Stamp Duty Land Tax.

Annex C: Examples of Profit & Loss Allocation Schemes

The following are examples of tax avoidance schemes that HMRC considers would be appropriate targets for application of the legislation. HMRC would regard all of the arrangements as avoidance arrangements and would challenge them and where possible counteract them using standard technical challenge.

Mixed Membership Schemes: Profits

Example 1:

Some self-employed individuals set up as an LLP. Members include those individuals and a company. Initially, income is allocated to the company member, which pays corporation tax at a very low rate. The income allocated is invested or retained in the partnership by the company member as additional partnership capital. The individuals then access this capital by means of arrangements (not described here) that are intended not to result in any additional tax charge.

Example 2

An individual partner may sell a significant part of his partnership interest to a company that he owns, but continue to participate in the business as previously. The aim of the arrangement is to save significant amounts of tax.

This would be caught by the profit allocation rule, which as noted in paragraph 3.52, will take priority over the tax attributes rule.

Example 3

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.

Mixed Membership Scheme: Losses of the firm are allocated on a different basis from profits.

Example 4

An LLP is formed with 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.

Tax Attribute Schemes

Example 5

Scheme A: Income stream sold for upfront lump sum

- A company (M) transfers an income-producing asset to a partnership of which it is a member. Ordinarily, M would be charged to corporation tax on that income.
- A new partner (C) then joins the partnership and contributes capital equal to the present value of the income stream. This capital is then loaned to M.
- The income is allocated to C, until such time that C has received the capital it contributed back plus a lending return. Because of losses or some other tax attribute, C pays no tax on the income or pays tax at a much lower rate of tax than M. (As none of the income is allocated to M, M pays no tax on it.)
- Once this has happened, M then acquires the other partner's partnership interest, thus reacquiring economic ownership of the underlying asset.

The substance of the arrangement is that M obtains the benefit of the upfront payment and does not have to repay it because it has transferred what would otherwise be its taxable profit share to C.

Under the rule proposed above, and provided that a main purpose of the arrangement is tax avoidance, M would be charged to tax as income on the lump sum paid to the partnership.

The provision would not apply if the arrangement were one to which the structured finance arrangement rules in Part 16 of CTA 2010 applies or to the extent that the payment were otherwise charged to tax as income.

Example 6

Scheme B: Disguised realisations of assets

- The avoiding company transfers an asset with an unrealised gain such as a loan relationship to a partnership on what it claims is a tax neutral basis.
- A new partner joins in return for a capital contribution equal to the value of the asset.
- The new partner has nearly all rights to capital or income until the asset redeems or is sold.
- The avoiding company has the right to all other partnership assets including the capital contributed by the new partner.

Under the rule proposed above, the avoiding company would be charged to tax as if it had sold the asset for the contribution.

Annex D: Deferred Remuneration Structures

The following paragraphs set out HMRC's understanding of deferred remuneration structures operated by some financial institutions and of the current regulatory position.

There is a distinction between adjustment to deferred variable remuneration that has not yet vested (performance adjustment) and clawback:

- Performance adjustment (or malus) is the adjustment downwards of awards that have been made but have not yet vested. This applies to deferred awards and long term incentive awards before the point that they vest.

- Clawback is different in that it relates to the clawing back money from an individual which has already vested as a result of exceptional circumstances. HMRC's understanding is that clawback provision is not currently a feature in remuneration agreements.

Under current regulations, the requirement for partnerships to operate malus is limited. The existing Remuneration Code issued by the former Financial Services Authority predominantly focuses on the major banking organisations which are established as corporate entities not partnerships.

Moving forward, European Commission proposals will introduce similar requirements for the asset management sector which potentially brings into scope the majority of the industry regardless of whether or not they are structured as companies or partnerships.

Under the Alternative Investment Fund Managers (AIFM) Directive, the rules specifically require that:

"The variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the AIFM as a whole, and justified according to the performance of the business unit, the AIF and the individual concerned. The total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the AIFM or of the AIF concerned occurs, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or clawback arrangements"

Criteria on which to base performance adjustment decisions may include:

- evidence of misbehaviour or serious error by the individual (codes of conduct etc);
- whether the fund or manager suffers a significant downturn in financial performance; and
- whether the fund or the manager suffer a significant failure of risk management

- significant changes in the manager's financial situation.

The AIFM Directive does not address what happens to any amounts that are prevented from vesting in relation to a particular individual or are clawed back. If the individual is an employee in a corporate, the failure to vest or clawback would increase the profits of the company. If the individual is a member of a partnership then failure to vest or clawback would not increase partnership profits since the allocation of profits (or the reversal of an allocation) has no effect on profits. It is likely that the amount in question would simply be allocated to some or all of the other partners (but not the individual who suffered the clawback or non-vesting).

All of this is separate from any clawback of performance fees between the fund and the fund manager. Where there is clawback of performance fees in relation to fees received in previous period, this would reduce the profits of the partnership and so reduce the amount that can be allocated to members in the later period.

In terms of tax, if the individual is an employee in a company and a bonus or award actually paid is clawed back, it is unlikely that tax or NICs would be repayable. For this reason, many arrangements will provide that clawback is limited to a net amount (so that the employee is not at risk of being in a worse position than if the award had never been made). As for the company, the increase in profits may result in an additional corporation tax charge if a deduction for the remuneration had been previously given. If an amount has been awarded but has not actually vested, then depending on the facts, it is possible that no employment taxes will have been paid at the point of the award but only on vesting.