



HM Revenue
& Customs

Partnerships: A review of two aspects of the tax rules

Summary of Responses

10 December 2013

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1. Executive Summary

Background

- 1.1 Following Budget announcement, HM Revenue & Customs (HMRC) published on 20 May 2013 a consultation document, *Partnerships: A review of two aspects of the tax rules*¹, consulting on how to change two aspects of partnership tax rules.
- 1.2 The two main areas covered were: the disguising of employment relationships through limited liability partnerships (LLPs) and the tax-motivated allocation of business profits or losses in partnerships (not just LLPs) involving mixed members (typically individuals and corporate members). It was made clear that legislation would be introduced in Finance Bill 2014 in each area and comments were sought on the detailed design of the legislation. Associated changes to the National Insurance contributions (NICs) legislation are being introduced in the NICs Bill 2013².
- 1.3 The legislation takes effect from April 2014. The rules relating to partnerships with mixed members have anti-avoidance provisions that come into force from 5 December 2013 (see details of the provisions in Chapter 4: paragraphs 4.24-4.27).
- 1.4 The consultation ran for 12 weeks until 9 August 2013. HMRC received about 110 written responses representing a wide variety of businesses. Respondents included a large number of law and accounting firms and their professional bodies, the financial sector particularly representatives for alternative investment fund managers (AIFMs), representative bodies of the agricultural and retail sectors, and various individuals and businesses operating through partnership structures or considering doing so.
- 1.5 The majority of the written responses (70-90%) provided views on disguised employment and tax-motivated profit allocations. HMRC also held a number of meetings with interested parties to discuss the consultation proposals, and the feedback from these meetings was considered as part of the consultation exercise. All of the comments and suggestions are summarised in this document.
- 1.6 HMRC is grateful to all the respondents and those who attended consultation meetings for taking the time to consider the issues raised in the consultation document and to provide their views. A list of the respondents is included at Annex A.

¹ <https://www.gov.uk/government/consultations/a-review-of-two-aspects-of-the-tax-rules-on-partnerships>

² The NICs bill 2013 and their clauses including the partnerships clauses concerning disguised employment and alternative investment fund managers can be found at: <https://www.gov.uk/government/collections/national-insurance-contributions-bill> Details of the progress of the Parliamentary scrutiny of the Bill are posted on the Parliament Bill pages at: <http://services.parliament.uk/bills/2013-14/nationalinsurancecontributions.html>

Headline summary of the responses

1.7 The responses are summarised below and will be set out in later chapters.

- There was general acceptance that the Government should legislate to prevent tax loss arising in the areas identified in the consultation document.
- Whilst there was support for tackling structural inconsistencies in the tax system as described in the consultation document, many respondents also noted that the proposals were wider than traditional anti-avoidance actions taken by the Government.
- Some respondents stressed the importance of the partnership structure for businesses, particularly the use of LLPs which combine limited liability with the flexibility of partnerships.
- There was a call for clarity and certainty in the new legislation, echoing the simplification theme adopted by several consultation questions included in the consultation document.

Disguised employment

- There was general support for the proposal to prevent the avoidance of employment taxes through the disguising of employment relationships using an LLP structure.
- Responses focused on the detailed design of the new legislation, particularly around the conditions that should be used in determining whether an LLP member is in fact an employee.
- A large number of the respondents objected to the use of traditional employment status rules (the first of the two conditions proposed in the consultation document). They did not think that the self-employed and employee tests described in HMRC employment status manuals would be appropriate to determine the status of large professional LLP members.

Tax-motivated allocation of profits and losses by mixed membership partnerships

- There was widespread agreement that the most abusive arrangements should be countered. However, many considered that this measure would restrict flexibility afforded by the current tax rules and would make the partnership structure less competitive. These respondents believed that tax advantages arising from the differential between corporation tax and income tax rates were a straightforward choice offered by the Government in setting these rates.
- Many considered that preventing profits from being accumulated in partnerships in ways that would attract tax at the lower corporation rates

- Overall, a blanket rule preventing this type of tax-motivated allocations from having a tax effect was seen by many as an over-reaction. Alternative suggestions included legislating a new narrowly-defined Targeted Anti-Avoidance Rule (TAAR) or relying on the General Anti-Abuse Rule (GAAR).

Summary of what the Government proposes to do

1.8 The Government recognises that partnerships including LLPs are important commercial structures and that the majority of partnerships do not operate in a way that gives rise to tax loss. This Autumn Statement has confirmed the Government's plan to take forward the partnerships proposals which will prevent avoidance and remove tax advantages in the areas set out in the consultation document, achieving fairer taxation overall. In light of the many useful consultation responses, the Government has modified the detailed design of the original proposals. The main changes are as follows.

- **Disguised employment:**

- dropping the first condition (employment status) and as a consequence, strengthening the second condition (economic risks) in line with the responses. In particular, the revised condition now focuses on whether the member's remuneration is a fixed amount, the amount of any capital contribution and the degree of control the member has over the partnership business.

- **Profit and loss allocations using mixed membership partnerships:**

- replacing the "main purpose" test originally proposed for the profit allocation rules with an objective test that looks simply at whether the profit-sharing arrangement has the effect of reducing the aggregate tax payable;
- preventing "double taxation" by introducing a relieving rule as part of the mixed membership partnership proposals to allow corporate members to make payments representing reallocated profits; and
- introducing a mechanism to collect tax from AIFM partnerships, rather than from individual members, on profits allocated to those individuals but subject to deferral under new EU regulatory requirements (AIFMD)³ This addresses the problem arising from members having to pay tax on profits that they are unable to access.

³ Detail of this Alternative Investment Fund Managers Directive (2011/61/EU) can be found in the European Union Journal: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:01:EN:PDF>

2. Summary of Responses

The arrangement of this summary of the responses

- 2.1 This document summarises the responses to the consultation document. This includes written responses and views obtained during consultation meetings. The current chapter describes the principles and objectives of the consultation and an outline of the responses, and sets out the next steps for this work.
- 2.2 Chapters 3 and 4 cover in more detail the responses to the original consultation proposals. Chapter 5 sets out the new tax and NICs proposals for AIFMs. Chapter 6 provides some additional points made in response to the general questions raised in the consultation document. Annex A lists the organisations that provided a written response and Annex B is the list of consultation questions.

Principles and objectives for review

- 2.3 This review is about removing structural inconsistencies in the tax system. The Government believes that the majority of individuals and businesses pay their fair share of tax. It also recognises that partnerships including LLPs are legitimate commercial structures and the majority do not disguise employment relationships, nor do they manipulate business profits, losses or assets in ways that reduce their tax liabilities. However, the Government is determined to take decisive actions against tax-motivated arrangements to prevent tax loss and protect fairness.
- 2.4 There are two strands of change to partnership taxation that were announced at Budget 2013 and consulted on between May and August 2013:
- removing the presumption of self-employment for those LLP members, who are “salaried members”, in order to tackle the disguising of employment through LLPs (see Chapter 3); and
 - countering the tax-motivated allocation of business profits or losses in mixed membership partnerships (typically a mixture of individuals and companies), and the tax-motivated disposal of assets through partnerships with members that have differing tax attributes (see Chapter 4).
- 2.5 The Government also proposes to introduce a statutory mechanism for those AIFMs who operate through a partnership to allow income tax at the additional rate to be paid by the partnership (rather than the individual member) on profits which the member is prevented from accessing as a result of the AIFMD. The legislation also includes provisions concerning the tax treatment of the profits when they “vest” with the member. HMRC has worked with the Financial Conduct Authority (FCA) and sector representatives on the design of this new mechanism, which now forms part of the review (see Chapter 5).

Outline consultation outcome

2.6 HMRC held around two dozen meetings with interested parties during the consultation period, including an open day and meetings with individuals, firms and representative bodies. About 110 written responses were received and some were joint responses (see the respondent list in Annex A).

2.7 The composition of the written responses is set out below:

- 76 (70 per cent) were received from firms, individuals or professional bodies involved in the accountancy, tax or law professions;
- 10 (9 per cent) were from the financial services sector. They included responses from three representative bodies, the Alternative Investment Management Association, the British Venture Capitalist Association and the Investment Management Association. These respondents were primarily interested in the AIFMD issue;
- 7 (6 per cent) were from businesses that are, or are considering restructuring as, LLPs (excluding legal/accountancy firms). The proposed disguised employment rules were their key area of concern;
- 6 (5 per cent) were from professional bodies/associations in agricultural farming or land and property sectors. These responses focused on the proposed mixed membership partnership rules; and
- 2 (2 per cent) and 8 (7 per cent) were from the recruitment industry and individuals respectively.

2.8 The majority of the responses included views on disguised employment and tax-motivated profit allocations, with the following breakdowns:

- disguised employment (89%);
- profit allocations (72%);
- loss allocations (12%); and
- disposals of assets (or tax attributes/income streams) (22%).

2.9 Taking into account the views expressed in the written responses and at the consultation meetings, the disguised employment and profit allocation proposals have been modified. Details of the modified proposals are given in the rest of this response document.

Further proposals and next steps

2.10 The mixed membership partnership legislation was first published in draft on 5 December 2013. The full set of the primary tax legislation has been published today (10 December), alongside this document and a Technical Note.

- 2.11 The legislation will be introduced in the Finance Bill 2014 (and, in the case of the new NICs rules on disguised employment and the AIFMD mechanism, the NICs Bill 2013 and regulations) to take effect from the 2014-15 tax year, with the exception of the anti-avoidance rules introduced as part of the mixed membership partnership legislation which come into force on 5 December 2013.
- 2.12 Comments on the Technical Note will be welcomed, as will examples of specific situations which arise in practice as these can usually be addressed in further detailed technical and operational guidance. HMRC would also welcome comments on technical aspects of the draft legislation, particularly where there are concerns that these could lead to consequences that are not in line with the policy objectives of the partnerships review.

3. Detailed Responses – Disguised Employment

The issue

- 3.1 Current tax rules mean that individuals who are members of an LLP are always taxed as if they are partners in a partnership established under Partnership Act 1890 (i.e. a traditional partnership) even if they are engaged on terms closer to those of employees.
- 3.2 This can produce 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 NICs (“employment taxes”) than an individual who is an employee engaged on similar terms. The LLP is also not liable to employer’s NICs on a member’s profit share, whereas it would be on an employee’s salary. As a result, LLPs can be used to disguise employment and to avoid employment taxes. There is evidence that LLPs have been used and marketed on that basis.

The original change proposals

- 3.3 The consultation document proposed to:
 - remove the presumption that all individual LLP members are treated as partners and hence self-employed for tax purposes; and
 - set out the factors to be taken into account in deciding whether an individual member of an LLP should be treated as an employee (or a “salaried member”) for the purposes of employment taxes.
- 3.4 It was proposed that employment taxes would apply to an LLP member if either of the two conditions was met.
- 3.5 The first of these conditions was based on normal tests of employment status as set out in HMRC guidance and case law, while the second focused on whether the member was exposed to financial risks and given a reward commensurate with their having an ownership interest in the business carried on by the partnership.

The consultation questions and responses

Question 1: *Whether the current definition of “salaried members” set out in [paragraph 2.19 of the consultation document] 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?*

3.6 Responses on these two questions divided broadly into three categories:

- those who thought that a streamlined version of the proposals would provide a suitable response;
- those who thought that existing legislation, case law and guidance would suffice if selectively strengthened; and
- those who set out detailed alternative tests which would be preferred.

3.7 Approximately one third of the respondents disagreed with the use of the traditional employment status rules as proposed under the first of the two conditions in the consultation document. The main concern here was that normal self-employed vs. employee tests as described in HMRC’s employment status manuals would not be effective tests in this context.

3.8 The reason for this is that the tests in HMRC’s manuals have been devised to differentiate between self-employed consultants and employees rather than between partners and employees. The tests therefore have regard to matters such as paid holiday entitlement, working in a fixed location or having set office hours, or the right of the worker to substitute another person. It is likely that some of these tests might not be met even by a senior equity partner in a large professional firm, whereas the policy objective is that such individuals should be excluded. Applying these tests to LLP members would therefore not produce the intended policy outcome.

3.9 Where the respondents preferred a streamlined approach, there was mixed opinion as to which condition would prove more effective. Some commented that they had not been able to identify an approach which achieved the same objectives with less complexity.

3.10 Around 35 per cent of the respondents suggested that the presumption of self-employment of LLP members should simply be removed, so that whether someone was an employee should follow the test set out in section 4(4) of LLP Act 2000. Several respondents cited the *Tiffin* case⁴ as an example of the courts determining the status of an LLP member under this Act.

⁴ *Tiffin v Lester Aldridge LLP* [2012] 2 All ER 1113

- 3.11 Some respondents also thought it inadvisable to introduce a test of employment for tax purposes which differs from the legal test for other purposes such as employment law.
- 3.12 Other suggestions included:
- amending section 863 of Income Tax (Trading and Other income) Act 2005 to specifically exclude salaried members (“disguised employees”) from being taxed as partners, bringing them into PAYE;
 - using a direction along a similar line to section 690 of Income Tax (Earnings & Pensions) Act 2003 for foreign employees;
 - introducing a TAAR to tackle the most egregious instances of abuse;
 - restructuring the NICs regime to address the NICs issue specifically;
 - reforming the tax system including removal of the distinction between employment and self-employment; and
 - using employment law itself to demonstrate the distinction between salaried members and genuine partners.

Government response

- 3.13 Having considered the views expressed during the consultation period, the Government proposes to withdraw the first condition (employment status) and rely instead on strengthening the second condition (economic risks) to focus on fixed salary entitlement, capital risks and ownership.
- 3.14 The Government does not consider that its objective of legislative clarity would be achieved by simply repealing the presumption of self-employment. There is a general lack of agreement over the interpretation of case law in this area. Relying on this would, in practice, give rise to a greater administrative burden and would not provide the level of certainty that many respondents have demanded. In order to achieve a workable approach, the legislation will provide a more certain method of determining the status of members, based on, but not identical to, the factors, that will be taken into account in determining whether an individual is an employee as opposed to a partner.
- 3.15 Where all of new conditions A to C (as set out below) are met, then with effect from 6 April 2014, an individual member of an LLP will be treated as an employee of the LLP for tax and NICs purposes:
- **Condition A:** the member is to perform services for the LLP in his or her capacity as a member, and is expected to be wholly or substantially wholly rewarded through a “disguised salary” that is fixed or, if varied, varied without reference to the profits or losses of the LLP;

- **Condition B:** the member does not have significant influence over the affairs of the partnership; and
- **Condition C:** the member's contribution to the LLP is less than 25% of the disguised salary.

3.16 The possible divergence of employment status between employment law and tax rules is an inevitable consequence of a measure that seeks only to alter the tax status of relevant individuals. The Government has been clear from the start that the proposals will only address tax and NICs loss and are not intended to affect employment protection. The Government notes the other wider proposals for reforming the tax or NICs systems and will keep all tax and NICs rules under review.

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?*

3.17 Most respondents agreed with the Government that clarity in legislation was important as this would help its application. This point was particularly stressed by LLP businesses outside the legal and accounting professions. Their main concern related to junior members and they suggested that these members should be exempted from the new rules or given a grace period. A similar request was made for retiring partners. Some respondents were concerned about the transitional period and called for the implementation to be delayed. A number of the respondents asked for a centralised clearance procedure in respect of existing or future arrangements. Others wanted to ask their existing contacts in HMRC (notably HMRC's Customer Relationship Managers) to provide advice on the application of the new legislation.

Government response

3.18 The Government aims are to provide clarity in legislation and support customers with detailed guidance on how the rules will apply through examples and scenario analysis. We have carefully considered the responses on the clearance point and have decided that the best option is to use the existing non-statutory process if clearance is required.

3.19 The Government has considered the request for special rules for new joiners or retiring partners, but concluded that such "concessions" would increase complexity and would also be unfair to other partners.

3.20 The original start date of 6 April 2014 will not be deferred given that there has been a long lead time for customers to prepare for these changes following the Budget 2013 announcement.

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?*

- 3.21 Many respondents did not see the need for a TAAR. In some cases, this was because they considered that a properly designed status test would not need a TAAR. In other cases, it was because the GAAR was felt to be sufficient to deal with specific cases. However, some respondents suggested that a TAAR was more appropriate than a wider reform which would risk catching non-tax-motivated arrangements. Some respondents considered that an arrangement that was deliberately structured to make someone a partner should be respected, even if it were to result in a tax advantage.

Government response

- 3.22 The Government considers that a TAAR is needed in the draft legislation in order to counter abusive arrangements structured specifically to avoid the application of the new provisions. This TAAR will not apply if the LLP decides genuinely to engage the member on terms that amount to a partner rather than a salaried member in line with the objectives of this partnerships review. The TAAR will, however, catch those arrangements that are intended to prevent any of the new “salaried member” conditions from being met, if these arrangements have no other substantive effect.

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.*

- 3.23 HMRC has received many useful examples since the consultation started and included a number of them in the Technical Note published on 10 December 2013 to assist businesses and individuals in understanding how they should apply the new legislation. Further comments or suggestions on the technical guidance are welcome. Views would also be gratefully received on the detailed design of the draft legislation, bearing in mind the overall context of the Government principles and objectives for this review.

4. Detailed Responses – Mixed Membership Partnerships & Asset Disposals

4.1 There are seven questions relating to the second strand of the partnerships review. Chapter 3 of the consultation document set out the three issues concerning this strand: tax-motivated allocation of profits or losses, or tax-motivated disposals of assets through partnerships. The respondents' views on each issue are set out in the following sections alongside the relevant Government responses.

Issue 1: Mixed membership partnerships – profit allocation

4.2 Under partnership and tax law, it is not necessary for profit-sharing ratios to be in proportion to contributions, effort or capital, or to be the same from year to year. This flexibility can be used to generate tax advantages. For example, profits may be allocated to a low tax entity, such as a company, while other partners taxable at higher rates ultimately receive the benefit of those profits in low-taxed or even non-taxable form.

4.3 The main area of tax risk is where the individuals exercise control over or have some other significant connection with low-taxed corporate members, since this may result in the profit-sharing arrangement being tax-driven. This connection may also facilitate arrangements by which the individuals can access the profits in ways which attract less tax than if the profits had been directly allocated to the individuals.

4.4 This risk relates to all types of partnerships, including LLPs.

The original change proposals

4.5 The consultation document proposed that profits allocated to a corporate partner would be treated for income tax purposes as arising to an individual partner in the following circumstances:

- the partnership comprises one or more members who are persons within the charge to income tax and one or more members who are not;
- there is an economic connection between those members, by which the individuals are able to benefit, directly or indirectly, from partnership profits allocated to the non-individual members; and
- 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 person.

The consultation questions and responses

General comments

- 4.6 As mentioned above, many respondents noted that the proposals were a departure from traditional anti-avoidance measures of the Government. Some were concerned that the new rules could adversely affect the flexibility offered by current partnership rules. These respondents considered that enjoyment of the benefits secured by the tax-motivated allocation of profits to a corporate member was a straightforward choice resulting from the difference between corporation tax and income tax rates.
- 4.7 There was a suggestion from some respondents that it was appropriate to retain profits in a partnership to fund working capital, and to tax those profits at low corporation tax rates rather than higher personal tax rates, and that preventing this would give incorporated businesses an advantage over partnerships. These respondents said that taxing retained profits at the income tax rates could result in loss of access to working capital and a significant cash flow issues for some smaller professional partnerships.
- 4.8 Other respondents considered that only a timing advantage was obtained through the use of such corporate members, since taxable dividends would be paid out to individual members some years later based on the company's retained profits. It was suggested that a better alternative was to introduce specific rules targeted against the particular Government concern.
- 4.9 In conclusion, many respondents thought that a blanket rule, preventing the tax-motivated allocation of profits to the corporate member from having tax effect, was an over-reaction. Many would have preferred a new narrowly-defined TAAR or to have relied on the recently-introduced GAAR.

Government response

- 4.10 The key aim of this element of the review is to prevent partnerships from introducing corporate partners to reduce the tax liabilities of individual members. The consultation document itself made clear that this was not a traditional anti-avoidance measure, but about making structural changes to partnership tax rules. The Government recognises that the vast majority of partnerships pay the right amount of taxes and do not use mixed membership partnership structures to gain tax advantages. However, action is appropriate now given the increased use of these structures in tax planning.
- 4.11 HMRC's analysis indicates that arrangements involving partnerships with mixed members give rise to permanent tax loss, and that any later tax attributable to dividend income is significantly less than the tax lost at the point of allocation. The Government considers that blocking excessive allocations at the start is the only certain way to stop this tax loss and that replacing the mixed membership proposals by anti-avoidance rules could not secure the same outcome since the arrangements rely on the structural flexibility afforded by existing partnership tax rules and not on avoidance.

- 4.12 The Government plans to introduce the mixed membership proposals as originally announced, subject to the key changes as described in the remaining part of this chapter.

Question-specific comments

- 4.13 Most respondents provided their views on six consultation questions in relation to profit allocations in mixed membership partnerships. The responses are organised into four groups with a detailed Government response for each group.

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).*

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

- 4.14 There was concern that the legislation would be complex to administer and would add to the administrative burdens of businesses, particularly where a corporate partner was considered necessary for commercial reasons.
- 4.15 The “connection” requirement, whereby a partnership’s profits would only be subject to reallocation from a company to an individual where the partnership is “connected” with the company, also raised concerns.
- 4.16 Some respondents questioned how in practice HMRC would determine whether an allocation of profits (or losses) was appropriate. A number of the respondents noted that it was unusual for profit-sharing to be on a fixed percentage basis, as there was often a performance element to the allocation; as such, there was concern that significant work would be required to demonstrate that an allocation was appropriate. Others noted that profit-sharing ratios would be dictated by the partnership agreement, and therefore a purpose test was inappropriate.
- 4.17 It was also suggested that a “just and reasonable” test would be too imprecise in the common scenarios where a corporate partner provided services to the partnership. Some respondents commented that taxing partnership profits at income tax rates in the base year could give rise to double taxation if the same profits were taxed again when distributed by the company as dividends.
- 4.18 Others commented that a likely behavioural response to a rule that applied only to mixed partnerships would be for partnerships to be set up with corporate-only members.

- 4.19 Some respondents asked for exemption for small family partnerships, a disincorporation relief for removal of corporate partners and greater consideration of interaction with other rules such as the close company rules.

Government response

- 4.20 To increase certainty, the Government intends to replace the “main purpose” test proposed in the consultation document with a more objective test by focusing on the effect of the profit-sharing arrangement. The new test is to determine if it is reasonable to assume that the effect (rather than the purpose) of the profit-sharing arrangement is to reduce the aggregate tax payable. It will generally be clear that this condition is met if the individual member is taxed at high income tax rates while the corporate member pays the standard rate of corporation tax.
- 4.21 The legislation will prevent allocations to a corporate member from having tax effect where these exceed the “notional” value of the services or capital the company provides to the partnership and this is the consequence of a connection between the individual member and company.
- 4.22 The determination of this notional value for services will follow principles already used where service companies provide services to a partnership.
- 4.23 Where the corporate partner provides capital for use in the partnership, the return on this should not exceed a return which is economically equivalent to interest.
- 4.24 The Government considers that avoiding the rules by the use of corporate-only partnerships would be contrary to the policy objectives underlying the review.
- 4.25 In response to this risk, provision has been made, coming into force as of 5 December 2013 that will look through attempts to disapply the legislation by means of arrangements whereby individuals provide services to the partnerships through an intermediary entity rather than by the individual as a partner.
- 4.26 This provision will apply if it is reasonable to conclude that the individual would have been a member of the partnership but for the existence of the mixed membership rules. In such cases, the mixed membership rules will apply as if the individual were actually a member.
- 4.27 It is important to note that no tax charge can arise as a result of the new rules until 6 April 2014 (the date on which these rules have effect). The reason for announcing the anti-avoidance rules on 5 December is to ensure that certain steps that partnerships might otherwise take during the period between 5 December and 5 April 2014 to circumvent the new rules will be ignored.
- 4.28 To address concerns about “economic double taxation”, corporate members will be allowed to make payments to individual members out of profits that have

been reallocated to those individuals for tax purposes, without any additional tax charge arising.

- 4.29 The Government does not consider that a disincorporation relief is necessary as the non-tax reasons given for corporate members suggests that corporate members will continue as members after the legislation comes into effect.
- 4.30 The Government has considered the request to exempt family partnerships. Exemption for particular businesses or groups would be inconsistent with making the structural changes to the tax rules that the Government considers necessary to secure fairness across the tax system. As noted at paragraph 4.34 below, the tax rules will not affect the commercial uses of corporate members as they will merely be an overlay that will in certain cases adjust the tax treatment.
- 4.31 HMRC would be grateful to receive detail of any unintended interactions with the close company loans to participators rules, and if necessary, would consider how to address these during the final phase of the technical consultation on the draft legislation.

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?*

- 4.32 The respondents provided an extensive list of commercial uses of corporate partners, albeit to varying degrees of detail, as listed below:
- corporate members needed to satisfy requirements of banks for firms to borrow using a corporate vehicle;
 - those satisfying similar requirements of landlords in relation to property;
 - firms wanting to expand overseas in places where the use of LLPs is problematic for cultural or legal reasons;
 - regulated entities using non-regulated corporates for non-regulated business to reduce reporting and compliance requirements;
 - arrangements entered into by international law firms to enable them to comply with regulatory and similar requirements in different jurisdictions where profits were allocated differently between the different partners in different but connected firms (which would not always have the status of partnerships);

- "alternative business structures" in the legal sector (firms with outside corporate members which contributed capital);
- agricultural partnerships which often had corporate members that were introduced for various reasons such as land tenure, and had existed for many years; and
- cases where partnerships were formed by transfer of a business from a corporate vehicle which retained an interest in the business as a member of the firm.

4.33 In particular, representatives of the agricultural sector argued in their written responses that the use of mixed partnerships was long established and existed for reasons which had nothing to do with income tax avoidance, such as tenure, compliance with bank requirements and ease of succession. Full incorporation would not be an option for many tenant farmers, due to severe limitations on land tenure arrangements. They pointed out that there were also tax disadvantages of mixed membership partnerships, such as the lack of access to Annual Investment Allowance (thus deferring tax reliefs on capital expenditure) or Stamp Duty Land Tax charges on transfers of land.

Government response

4.34 Many of the comments focused on the commercial reasons for structuring a partnership with a corporate member. The consultation document acknowledged the legitimate reasons for the use of corporate partners. The tax rules will not affect these commercial uses as they will merely be an overlay that, in certain circumstances and for tax purposes only, will result in part of the partnership profits being reallocated to the individual member simply to remove the tax advantage that results from such use. Partnerships can continue to use the corporate member for non-tax purposes as listed in the last section and only the tax advantages of doing so will be prevented. The Technical Note also explains in detail the impact of the new legislation on some of the scenarios described above.

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.*

4.35 The issue of deferred profits (remuneration) is addressed in paragraphs 3.16-3.18 of the consultation document and received most objections. The Government does not consider that the deferral of payment of profits to partners, which is a common feature of many professional firms, justifies special treatment. However, the AIFM sector representatives suggested that it

would be inappropriate for members of AIFM partnerships to be taxed on income which they could not access as a matter of regulation under the AIFMD and associated legislation.

Government Response

- 4.36 The Government considers that any general exception for profit deferral arrangements would be inconsistent with making the structural changes that are needed to secure the revenue associated with this measure. An exemption would also increase complexity and result in lack of clarity. Accordingly, and as made clear in the original consultation document, there will be no exception for either profit deferral or working capital arrangements, both of which are intended to trigger the application of the legislation.
- 4.37 However, the Government has noted the impact of the regulatory requirements of the AIFMD and the tax results arising from existing partnerships tax rules. Following extensive discussions with the FCA and AIFM sector representatives, the Government has now modified the mixed membership partnership proposals to include a new mechanism for taxing these partnerships at additional rate on profits allocated to their members but deferred by the AIFMD.
- 4.38 The primary objective of this change is to address the tax issue arising from restricted access to profits. The new mechanism will provide members of AIFM partnerships with a fair solution without recourse to arrangements involving tax-motivated allocations of business profits, which will be prevented as part of the partnerships review. Further details are provided in Chapter 5.

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 [of the consultation document]. Views on this proposal would be welcome.*

- 4.39 There was no support for this proposal. The Government has decided not to pursue this alternative approach.

Issue 2: Loss allocation in mixed membership partnerships

- 4.40 Loss allocation arrangements also involve mixed membership partnerships. When losses are made, they are allocated to individual members, thus securing relief at high income tax rates.
- 4.41 These arrangements can be used where the business carried on by the partnership has a predictable tax profile. For example, initial losses created by capital allowances followed by large profits after those allowances are exhausted.

The original change proposals

4.42 The consultation document proposed that where such arrangements are in place, income tax relief for the losses against the partners' other income will be denied.

The consultation questions and responses

4.43 A small proportion of the respondents (12%) provided specific comments on this strand of the proposals without direct reference to the consultation questions. There was broad acceptance of the Government objectives and general acknowledgement about abusive arrangements. However, some considered that the proposed condition for loss allocations appeared too broad in remit.

4.44 Concerns were raised about the amount of work which would be involved in both ensuring and demonstrating that losses were allocated on a "just and reasonable basis". Other respondents raised concerns about the tax motive test and the uncertainty that might arise. Some respondents asked for a new advance clearance process and detailed guidance to be provided for this test.

4.45 A further point made was that even where losses were allocated to individual partners instead of the corporate partner, it should be recognised that these partners would have a certain amount of genuine loss. These respondents did not consider that a complete withdrawal of the loss relief was appropriate.

4.46 The respondents proposed two alternative loss allocation conditions:

- losses should be allocated in accordance with each partner's capital contributions (or in certain cases their share of retained profits). Relief for losses allocated over and above this ratio could be disallowed; or
- profits that have been disproportionately allocated to the corporate member could be offset by a recapture of losses previously claimed by individuals.

Government response

4.47 The loss restrictions will apply where an individual is party to arrangements with a main purpose of diverting partnership losses from a non-individual to an individual in order that the individual may access income tax loss reliefs or capital gains relief.

4.48 There is no reason why the main purpose test proposed should create uncertainty as tests of this type are well understood. A clearance mechanism would be inappropriate as individuals who enter into tax avoidance arrangements do so knowingly and deliberately whilst individuals who have not entered into tax avoidance arrangements will not have to consider the test.

- 4.49 The Government does not consider it appropriate to introduce rules that would attempt to apportion the individual's losses between those that arise through manipulation and those that would otherwise arise to the individual. To do so would add significant complexity, and whether using either a "just and reasonable" approach or the more mechanical rules suggested, would create uncertainty, and would not necessarily produce an allocation that matches the economic reality.
- 4.50 The Government's position on arrangements regarded as tax avoidance is clear. If individuals choose to enter into arrangements of this sort, once the new rules are in force, then that will be a choice made in the full knowledge of the consequences of such action.

Issue 3: Partnership members with differing tax attributes in relation to asset disposals

- 4.51 Tax attribute schemes involve the use of partnership arrangements to channel profits between unconnected parties in ways that reduce tax. The reduction stems from differences in the specific tax status of the particular partners.

The original change proposals

- 4.52 The consultation document proposed that the consideration paid for the transferred profit would be charged to tax as income in the hands of the transferor partner.

The consultation questions and responses

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.*

- 4.53 All responses relating to partners with different tax attributes in relation to disposals of assets and income streams were received from firms involved in the accountancy, tax or law professions. There was general agreement that the examples at points 5 and 6 in Annex C of the consultation document (as raised in General Question 16 set out in Chapter 6) should be counteracted.
- 4.54 With specific reference to question 12, responses were mixed as to whether the policy objective would be best achieved by use of the existing GAAR, implementation of a specific TAAR, or updates to existing legislation. Several respondents noted similarities to the existing "transfers of income streams" legislation and suggested that this could be extended to cover the scenarios listed.

Government response

- 4.55 The Government intends to introduce legislation based on the proposals set out in the consultation document.
- 4.56 The legislation will apply where a person disposes of all or part of an asset or income stream through a partnership if the main purpose, or one of the main purposes, of any of the steps by which the disposal is effected, is to secure a tax advantage in relation to the charge to tax on income. The legislation will impose a charge to tax on income on the person making the disposal.
- 4.57 The legislation will not apply where the disposal by or through a partnership is from a member to a relative of the member. This ensures that the legislation cannot apply where partnership structures are used to allocate profits tax efficiently in circumstances like those considered in the *Arctic Systems* case⁵.

⁵ Jones v Garnett 2007 UKHL 35:
<http://www.publications.parliament.uk/pa/ld200607/ldjudgmt/jd070725/jones%20-1.htm>

5. Detailed Responses – Alternative Investment Fund Managers

- 5.1 As a result of information received during the consultation process, in particular press coverage suggesting widespread use of mixed membership partnerships in the AIFM sector and also information given in written responses, HMRC has carried out a detailed analysis of the effect of the AIFMD and its interaction with existing partnership rules. The following paragraphs summarise this analysis and the Government's proposals.

Alternative Investment Fund Managers Directive (AIFMD)

- 5.2 The aim of the AIFMD (2011/61/EU) is to improve investor protection across Europe and promote efficiency and cross-border competition. It came into force in the UK on 22 July of this year and was implemented through secondary legislation and the FCA rules. A transitional period of twelve months applies to all existing UK firms during which time firms can become authorised in accordance with the Directive and with FCA's approval. Some firms may prefer to seek authorisation sooner, for example, if they wish to make use of the AIFMD passport to market in other European Economic Area states.
- 5.3 The remuneration provisions of the AIFMD require certain firms to defer 40-60 per cent of the variable remuneration of key staff by 3-5 years and pay at least 50 per cent of that variable remuneration in units or shares of the funds they manage, or equivalent ownership interest, rather than cash. The FCA also encourages all AIFMs to comply with this deferral requirement and it is possible that some may take voluntary compliance actions as a result of investor pressure. Further details were given in the FCA consultation document⁶ published on 6 September 2013. This consultation closed on 6 November and the FCA plans to publish a response early next year.

Tax Issue

- 5.4 The full impact of these AIFMD requirements came to light during the consultation on the partnerships review. The majority of AIFM firms are companies and would not have tax issues arising from these regulatory changes. However, under existing partnership tax rules, partners (including LLP members) are taxed on their shares of the profits for the period rather than when the partners actually receive the money. As a result, members of AIFM partnerships can face a tax charge on part of their profits that will be deferred under the AIFMD and hence they cannot access.

⁶ The Financial Conduct Authority recently published and consulted on draft guidance on the implementation of the AIFMD: <http://www.fca.org.uk/your-fca/documents/consultation-papers/cp13-09> The document includes a description of the new statutory AIFMD mechanism (see Chapter 14 and Appendices 14A and 14B).

- 5.5 Feedback that HMRC have received suggests that some AIFM partnerships intend to resolve this issue through the use of tax-motivated corporate partner arrangements, which will be blocked by this measure. Instead the Government proposes to introduce a statutory mechanism to allow tax on deferred remuneration of these partners to be collected upfront from the partnership rather than from the individual partner. HMRC has worked with the FCA and sector representatives on the design of the mechanism, which now forms part of the review. This mechanism provides a fair solution without the need to recourse to the use of such arrangements.

Proposed statutory mechanism

- 5.6 The mechanism will be introduced for the 2014/15 tax year and will permit members of AIFM partnerships to allocate certain “restricted” profits to the partnership. These are profits that represent variable remuneration under the AIFMD other than upfront profits that are received in cash. The legislation will impose a charge to tax on these profits at the additional rate of tax (45 per cent) to be paid by the AIFM partnership.
- 5.7 The balance of the variable profit (i.e. after tax has been paid) will be retained until a particular point (the "vesting date") when the performance of the individual against the criteria set out in the remuneration agreement is assessed by the partnership. If the restricted profits vest in the partner who originally allocated them to the partnership, this individual will be able to claim a tax credit against 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.
- 5.8 The upfront charge on the partnership applies only to income tax. No NICs charge will arise until the time when the remuneration vests in the individual partner. This reflects the fact that the upfront income tax charge is at the highest rate regardless of the circumstances of individual members.
- 5.9 The individual member to whom the profits ultimately vest will be required to pay Class 4 NICs at the vesting date as normally applicable to individuals subject to self assessment. This NICs charge will be based on the full amount of profits deferred, rather than the net amount that is distributed at the vesting date.
- 5.10 HMRC will welcome further comments and suggestions from the AIFM sector on the detailed design of this mechanism.

6. General Questions

- 6.1 The consultation document also asked a number of general questions and the responses to these questions are covered in this chapter.

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?*

- 6.2 Chapters 3 to 5 already set out the respondents' views on these questions and the Government's responses.

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?*

- 6.3 The main costs mentioned by some respondents were their costs of change including payment for changing existing arrangements. There might also be employer obligations if employment relationships are recognised for other than tax purposes, for example, additional employment rights and employer pension obligations. Almost all of these respondents said that they were unable to quantify these costs yet.
- 6.4 However, the AIFM sector representatives, when consulted on the design of the new mechanism, said that their incremental administrative costs would be negligible as they would already be required to record and process the information in order to comply with the regulatory requirements.

Government response

- 6.5 In general, the Government expects the impact on businesses and civil society organisations to be negligible. This is because the existing evidence indicates that the vast majority of partnerships will not be affected by the consultation proposals. Those partnerships affected are likely to be limited in number and they are primarily large professional or AIFM partnerships.
- 6.6 The Government notes that there will be some one-off costs as professions and taxpayers need to understand the new rules and communicate them to their partnership members or change their tax-motivated arrangements to comply with the new rules.

- 6.7 In this connection, the Government is grateful for the assessment provided by the AIFM sector representatives concerning AIFM partnerships.
- 6.8 The impact on individuals and households is also expected to be negligible. Those individuals who are affected members of partnerships will now be required to pay the correct amount of tax and NICs at broadly the right time. It is possible that there is a modest reduction in administrative burden for some individuals who will in future pay through PAYE rather than having to fill in a self assessment return.
- 6.9 This measure will equalise the tax and NICs treatment of alternative ways of employing staff and will also reduce distortions driven by tax planning. It may also result in an increase in labour costs and a decrease in post-tax profits levied on selected partnerships in certain industries. However, because of the limited number of partnerships affected, the Government expects the overall impact on the economy to be small.

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 [to the consultation document])? If not, what other types of scheme should be tackled?*

- 6.10 Almost all of the responses to this question agreed that the proposals would provide a comprehensive response.
- 6.11 Three respondents offered views on a range of structures that they believed would be used to work around the new partnerships legislation. These included partnerships of corporate members only, those which include a company as a subsidiary of the partnership rather than as a member, and arrangements to distort the allocation of tax-disallowable expenditure between individual and corporate partners. It was also suggested that partnerships might consider moving to these structures to preserve tax advantages they currently have.

Government response

- 6.12 As noted at paragraphs 4.24-4.27 above, the Government is acting to prevent the avoidance of the mixed membership rules by means of corporate-only partnerships.
- 6.13 The Government announced on 25 October that it would be taking immediate action to prevent tax advantages being obtained by partners as a result of adjustments being made under transfer pricing legislation for transactions between the partnership and subsidiary companies.
- 6.14 Overall, the rules on mixed membership partnerships should prevent distortions involving partnership allocations between companies and individuals in the circumstances described by these respondents.

Annex A: List of respondents

1. ACCA London
2. Addleshaw Goddard LLP
3. Agricultural Law Association
4. Akin Gump Strauss Hauer & Feld LLP
5. Alternative Investment Management Association Ltd
6. Anthony Thorne LLP
7. Armstrong Watson
8. Ashurst London
9. Association of Accounting Technicians (AAT)
10. Association of Partnership Professionals
11. Association of Taxation Technicians (ATT)
12. AVN Venus Tax LLP
13. Baker Tilly Tax and Accounting Ltd
14. Barber Harrison & Platt
15. BBH Partners LLP
16. BDO LLP
17. Begbies Traynor Group Plc
18. Bird and Bird
19. Bishop Fleming
20. Blick Rothenberg LLP
21. BlueBay Asset Management LLP
22. British Private Equity & Venture Capital Association
23. British Property Federation
24. Campbell Lutyens
25. Chartered Institute of Taxation
26. City of London Law Society
27. Clifford Chance LLP
28. Country Land and Business Association
29. Crowe Clark Whitehill LLP
30. Cushman & Wakefield LLP
31. David Kirk & Co
32. Deloitte LLP
33. Dentons UKMEA LLP
34. Disruptive Capital Finance LLP
35. Employment Lawyers Association
36. Engine Group
37. Ernst & Young LLP
38. Farming Group
39. Forum of Private Business
40. Francis Clark LLP
41. Frank Hirth plc
42. Franklin Underwood
43. Garbutt & Elliott
44. Grant Thornton UK LLP

45. Haines Watts
46. Harcourt Capital LLP
47. Harris & Trotter LLP
48. Hawsons Chartered Accountants
49. haysmacintyre
50. Herbert Smith Freehills LLP
51. Hillier Hopkins LLP
52. Hogan Lovells
53. HW Chartered Accountants
54. Institute of Chartered Accountants in England and Wales
55. Institute of Chartered Accountants of Scotland
56. Investment Management Association Ltd
57. Irwin Mitchell LLP
58. Jeff Lerner & Associates Chartered Accountants
59. Johnston Carmichael LLP
60. Kinetic Partners LLP
61. Kingston Smith LLP
62. KPMG
63. Law Society
64. Lawrence Graham LLP
65. Lewis Silkin LLP
66. Linklaters LLP
67. London Society of Chartered Accountants Taxation Committee
68. Managed Funds Association
69. Marshall Wace LLP
70. Max Fordham LLP
71. Mayer Brown International LLP
72. Mazars LLP
73. MHA MacIntyre Hudson
74. Moore Stephens LLP
75. National Farmer Union and The Farming Group
76. Norton Rose Fulbright
77. Partnership Counsel
78. Price Bailey LLP
79. PricewaterhouseCoopers LLP
80. Professional Contractors Group
81. Recruitment and Employment Confederation
82. Rees Page Solicitors
83. Reeves & Co LLP
84. Rosetta Tax LLP & CM Murray LLP
85. RSM Tenon
86. Ruffer LLP
87. S J Berwin LLP
88. S Three PLC
89. Saffery Champness
90. Sagars LLP
91. Sage UK Ltd
92. Scottish Land and Estates
93. Simmons & Simmons LLP
94. Sobell Rhodes LLP

95. Taxation Practical Service Ltd
96. TLT LLP
97. Triple Point Investment Management LLP
98. United Agents LLP
99. Wellden Turnbull LLP
100. Wilds Ltd
101. Winckworth Sherwood LLP

Note: HMRC received 8 written responses from individuals during the consultation period, but their names are not included in this list to protect their privacy.

Annex B: List of 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?