



Partnerships: A review of two aspects of the tax rules

Salaried Members Rules:
Revised Technical Note and
Guidance

21 February 2014

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1. Overview

A guide to this chapter

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1.1 Tax treatment of Limited Liability Partnerships

1. Limited Liability Partnerships (LLPs) incorporated in the UK combine the organisational flexibility of traditional partnerships with the benefit of limited liability for their members. In law, they are corporate bodies with greater resemblance to limited companies than to traditional partnerships. Specific tax legislation exists to ensure that they are treated as partnerships for tax purposes, rather than as companies.
2. In particular, the rule at section 863 of Income Tax (Trading and Other Income) Act (ITTOIA) 2005 (which has been in place since 2001) provides that any individual LLP member is treated as self-employed for tax purposes, subject to income tax and Class 4 national insurance contributions (NICs) on the partnership profit share. The rule was intended to treat LLP members in the same way as partners in traditional partnerships.

1.2 What is the issue?

3. In deeming all individual LLP members to be self-employed, the existing tax rules go further than simply aligning their status with that of individuals in a traditional partnership. An individual has to have the characteristics of a partner to be determined as such in a traditional partnership. However, in an LLP, an individual needs only be registered as a member.
4. Over the years, it has become evident that many LLPs have members who are engaged on terms similar to those of employees rather than traditional partners.

1.3 What do the new Salaried Member rules do?

5. Following consultation, legislation is being introduced in Finance Bill 2014 to address this inconsistency and to make the rules fairer across partnership types. This ensures that LLP members who are, in effect, providing services on terms similar to employment are treated as “employees” for tax purposes. Associated changes to the NICs legislation are being made under the NICs Bill 2013.

1.4 What do the new rules not do?

6. The Salaried Members rules apply only to LLPs formed under United Kingdom legislation (the LLP Act 2000).
7. These rules do not apply to general partnerships or limited partnerships that are formed under Partnership Act 1890 and Limited Partnership Act 1907 respectively.
8. In addition, they do not apply to entities outside the UK that have structures broadly equivalent to a UK LLP. The tax treatment in the UK of a foreign body akin to a UK LLP will depend on the nature of the entity. There are two categories for such entities:
 - The first possibility is that the entity is a person distinct from the members, and that the entity rather than the individual member is liable for any debts owed. The UK model is an example of this structure. These are referred to as "*opaque*".
 - The second is that the laws of the territory under which the entity is formed confer limited liability on its members if set conditions are met. These are referred to as "*transparent*".

These entities have different tax treatments:

- If the entity is *opaque*, it is treated in the same way as any other entity liable to Corporation Tax, with the members taxable as employees.
 - If it is *transparent*, the first issue to consider is whether it is a partnership for the purposes of UK law. If it is, then those who are not employees on first principles will be taxable as partners on their appropriate share of the profits.
9. The Salaried Member rules are tax rules. They are independent of employment law and vice versa.

1.5 The rules at a glance

10. The new rules will treat an individual member (M) of an LLP as an “employee” if three conditions are **all** met (as set out below).

1.5.1 *Disguised salary (Condition A)*

11. This is the key indicator for determining if an LLP member is a salaried member. The test is applied "looking forward" on the basis of the arrangement in force at the time that it is being determined whether the Condition is met.
12. The Condition is met if there are arrangements in place under which:
 - M is to perform services for the LLP; and
 - it is reasonable to expect that the amounts payable by the LLP in respect of M's performance of those services will be wholly, or substantially wholly, “disguised salary”.
13. In response to comments received on the draft legislation and guidance that were published on the Salaried Member rules on 10 December 2013, the Government will amend the legislation to make it explicit that the new rules apply where it is reasonable to expect that at least 80% of the amounts payable by the LLP for M's services will be disguised salary. Further references to “wholly and substantially” in the rest of this note should be read in light of this amendment.
14. Disguised salary is an amount that meets any of the following requirements:
 - it is fixed; or
 - it is variable, but varied without reference to the overall amount of the profits or losses of the LLP; or
 - it is not, in practice, affected by the overall profits or losses of the LLP.
15. A fixed amount is a predetermined sum which is not variable.
16. The second requirement is intended to ensure that disguised salary includes any reward for services determined without reference to the profits of the LLP. It is important to note that personal performance can be a factor in determining entitlement to a profit share.
17. The third requirement brings in potentially variable amounts that, for practical purposes, are highly unlikely to be affected by the profits of the LLP.
18. In some cases, LLPs pay their fixed share partners though a “fixed profit share”. For example, a number of junior LLP members each have a fixed profit share of £75,000 per annum. This fixed share is the first charge against profits.

Based on historical and projected performance, this aggregate entitlement is a small percentage of the firm's overall profits.

19. The amount is not a fixed amount because, if the LLP makes insufficient profits, the junior members would receive less than £75,000. However, on the facts, absent a catastrophic event, the junior members will receive £75,000. It is therefore reasonable to expect that they will obtain a reward which will not in practice be affected by the overall level of profits.
20. It should be noted that HMRC does not regard payments made on account of an expected profit share as disguised salary. These sums are only contingently paid and will later be tallied with actual profits (so as to give rise either to a right to further profit or a debt owed to the firm). In such a case, the reward for services is a profit share (with the drawings being the means by which the profit is accessed). Chapter 2 provides further details.

1.5.2 Significant influence (Condition B)

21. This condition is met if the mutual rights and duties of the members and the LLP do not give M significant influence over the affairs of the partnership.
22. Here, the legislation is referring to those individuals who do not have significant influence, i.e. those that merely work in the business rather than carry it on. Examples of those who do have a significant influence include those who are involved in the management of the business as a whole, or senior members of a firm who may have little interest in day-to-day management which they leave to others but their roles and rights mean that they can exert significant influence over the business as a whole.

1.5.3 Capital contribution (Condition C)

23. This condition is met if M's contribution to the LLP is less than 25% of the disguised salary and it is reasonable to expect that it will be payable in a relevant tax year in respect of M's performance of services for the partnership.
24. The capital contribution made by any member is likely to be well documented.
25. For individuals who are members at 6 April 2014, a firm commitment in place by 6 April 2014 to contribute capital within three months will be taken into account in determining whether Condition C is met.
26. Where an individual becomes a member on or after 6 April, a two-month period will be allowed to provide the capital, again subject to there being a firm commitment to contribute the capital from the day of becoming a member.
27. The proposals in paragraphs 25 and 26 above, which will be reflected in the revised legislation, are intended to ensure that members are not subject to PAYE for short periods of time while they arrange the necessary finance to make a contribution.

1.6. What will be required when an LLP member meets the conditions?

28. If all three conditions are met by any individual, then that individual is a Salaried Member and will be treated as an employee for tax purposes, subject to PAYE and to tax on any benefits in kind. There are also consequences to statutory payments (detail in [Chapter 4](#)).

1.7 A common sense approach to applying the conditions

29. The three salaried member conditions are intended collectively to encapsulate what it means to be operating in a typical partnership. Some of the tests will be more, or less, appropriate for particular LLPs, but it is only if all 3 conditions are met that the individual will be treated as a Salaried Member, with income tax and NICs treatment then applying as it would to an ordinary employee.
30. The conditions are intended to take into account the wide variety of circumstances applicable to particular LLPs whilst minimising any risks of unintended effects. [Chapter 2](#) sets out these conditions in detail and provides a range of examples and scenarios received from the recent consultation on the draft legislation and guidance held between 5 December 2013 and 4 February 2014. Additional examples are provided in [Annex](#) and they cover a number of points including specific issues arising from certain global structures relevant to large law firms.
31. As noted above, the test is a prospective one. Provided that the test is applied reasonably, the test is not revisited with the benefit of hindsight if it is found that any of the assumptions were incorrect.
32. It should be noted that general partnerships, such as small husband-and-wife partnerships, are unaffected by the Salaried Member rules, which only apply to LLPs.

1.8 Anti-avoidance provisions

33. The Salaried Member rules contain anti-avoidance provisions to counteract attempts to circumvent the new rules by means of artificial arrangements. [Chapter 3](#) provides more details of these provisions.

1.9 Further Information

34. The legislation will not be final until the Finance Bill 2014 receives Royal Assent. The non-statutory business clearance procedure¹ will apply following the enactment of the new provisions as part of Finance Bill 2014. Businesses can also contact their customer relationship managers or co-ordinators for advice or clearances after Royal Assent.
35. LLPs with Salaried Members will be required to operate PAYE in respect of those members from the date the legislation comes into force (6 April 2014). For this reason, although formal clearance cannot be provided in respect of draft legislation, HMRC has given businesses, in this technical note, an informal view of how it would apply to LLP members. Information about PAYE and other implementation matters is also provided in Chapter 4. Further information is available from customer relationship managers or co-ordinators during the interim period.

¹ Guidance on the general non-statutory clearance process is published on the HMRC website:
<http://www.hmrc.gov.uk/cap/nscg.htm>

2. Conditions & Examples

A guide to this chapter

- 2.1 Interpretation (for this note)
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- 2.6 When to apply Conditions A and B
- 2.7 Condition C – contribution to the LLP

- 2.7.1** *Applying Condition C at 6 April 2014*
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- 2.7.4** *What is the contribution?*
- 2.7.5** *Becoming, or ceasing to be, a member part way through the year*
- 2.7.6** *A change in the contribution part way through the year*

2.8 **Further examples**

2.1 **Interpretation (for this note)**

CTA 2009 means the Corporation Tax Act 2009

CTA 2010 means the Corporation Tax Act 2010

ITA 2007 means the Income Tax Act 2007.

ITEPA means the Income Tax (Earnings and Pensions) Act 2003.

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

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

NICs means National Insurance contributions.

SORP means the Statement of Recommended Practice Accounting by Limited Liability Partnerships.

2.2 **The Salaried Member test (new section 863B)**

The Salaried Member provisions are intended to apply to those members who are more like employees than partners in a traditional partnership, in order to address the existing inconsistency in the ways that LLPs and general partnerships are treated for tax purposes. The overall Government approach and these provisions taken together are similar to the wide-ranging tests that would be applied in determining whether a particular person was a partner in a traditional partnership. These new rules provide a more certain outcome as requested by many respondents to the Partnerships Review consultation² carried out between May and August last year.

The starting point is to look at the terms and conditions for that particular member. These will normally be set out in the LLP Agreement. HMRC has set out guidance on

² HMRC published the consultation document for the Partnerships Review Measure and the response to the consultation on GOV.UK on 20 May and 10 December 2013 respectively:
<https://www.gov.uk/government/consultations/a-review-of-two-aspects-of-the-tax-rules-on-partnerships>.

the LLP Agreement in the Business Income Manual at BIM82112³. There may, however, be other relevant documents including a specific agreement with a member, an arrangement relating to bonus or profit share, or any remuneration agreement.

The Salaried Member legislation sets out three conditions. If all three conditions are met, then the individual is treated for tax purposes as being employed under a contract of services and is not to be treated as a member of the LLP. These conditions are set out in detail in the following paragraphs with examples and scenarios (44 in total) that HMRC received during the formal consultation in 2013 and the consultation on the draft Finance Bill 2014 legislation held between 5 December 2013 and 4 February 2014.

2.3 Condition A - payment for provision of services (S863B (1)-(3))

Condition A is intended to identify those members who are working for the LLP on terms that are like those of employees; that is, they are paid for their services substantially without reference to the overall profitability of the firm.

This Condition requires the LLP to look at all arrangements between an individual member and the firm and to decide if as a result of these arrangements, it is reasonable to expect the member to receive remuneration for the services provided which is substantially fixed. There are two key elements to this Condition.

First, there must be arrangements in place as a result of which M is to perform services for the LLP in M's capacity as one of its members.

The meaning of "arrangement" and the circumstances in which the arrangement have to be revisited, are discussed in sub-sections 2.3.1 - 2.3.3 below.

Secondly, it must be reasonable to expect that the amounts payable by the LLP in respect of M's performance of those services will be wholly, or substantially wholly, disguised salary.

Guidance on what it is reasonable to expect is set out in sub-section 2.3.4, while the meaning of disguised salary is considered in section 2.4. This note also covers various other points relating to Condition A:

- What is meant by "provision of services" is discussed in sub-section 2.3.5.
- The importance of the capacity in which a partner is remunerated – see sub-section 2.3.6.
- The expression "wholly or substantially" is discussed in sub-section 2.3.7 (also see Chapter 1 (paragraph 13)).

³ See HMRC's guidance published on its website: <http://www.hmrc.gov.uk/manuals/bimmanual/bim82112.htm>

2.3.1 Arrangements

Condition A is satisfied if it is that there are arrangements in place as a result of which M is to perform services for the LLP as a member and it is reasonable to expect that M is to be rewarded for those services by a disguised salary.

2.3.2 What are “arrangements”?

“Arrangements” include any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable).

A broad and realistic view should be taken in deciding what constitutes the arrangement. This should take into account the commercial intentions and expectations of the parties, for example, the overall financial reward that the member expects to obtain when becoming a member or when negotiating terms with the LLP on how they expect to be rewarded.

Regard should be had to the financial position of the LLP and the terms and conditions under which the individual is to be remunerated, as well as any understanding between the individual and the partnership or its investors. The budget, cash flow forecast, financial projections and documentation provided to any bank may need to be considered as well as any arrangements (formal or informal) relating to the payment of bonuses or profit share allocations to the individual or others in a similar position.

As noted below, an arrangement continues until such time as the arrangement changes (at which point a new arrangement is created).

2.3.3 How long do arrangements have to be considered and when is the test applied?

Condition A is applied looking forward. Once an arrangement is made, and a reasonable view has been taken on the basis of the arrangement as to the status of the member for tax purposes, the view remains valid until such time as the arrangement changes (with the result that a new arrangement comes into existence). A change would occur when, for example, the individual’s remuneration arrangement changes or the firm’s remuneration policy is altered.

An extraneous event (such as a revised profit forecast) that affects the expectation of the parties to the arrangement, but which does not result in the arrangement being altered, would not result in the arrangement being revisited. By contrast, if the LLP or members reacted to such a change by altering the remuneration agreement, this would constitute a new arrangement and the position would then have to be reassessed.

Example 1

John is a member in an LLP which has entered into an agreement to develop a property over a three year period. The agreement provides that John will receive a fixed profit share of £100,000 per year for the first two years and then 50% of the profit from the development, expected to be £500,000 in total. This arrangement is not changed.

John is not a salaried member because, viewed at the outset and taking into consideration the whole three year period, the fixed amount payable to John is expected to be less than 80% of his total profit so Condition A will not be met.

If we look again at the example above and consider the position in year 3: assume that the property market slumps and the expected profit does not materialise. John leaves the LLP with nothing other than the fixed profit amounts from years 1 and 2.

Although, as events have turned out, John has received only a salary, this is only the result of an extraneous event. As the parties expected and intended for John primarily to be rewarded through a share in the overall profits of the LLP, John is not at any time a Salaried Member.

2.3.4 “Reasonable to expect” (S863B(1)(b))

Condition A is framed in terms of the amounts that it is reasonable to expect the LLP is to pay to the member for the performance of services. This is a question that should be answered by reference to the substance of the matter taking a realistic view of the facts. The reasonable expectations of the parties to the arrangement, inferred from their actions as well as any documented evidence, should be taken into account.

It is clearly reasonable to expect that an amount contractually due will be paid, but in many cases there will be a range of possible outcomes. Where this is the case, the legislation looks at the most realistic outcome: this is unlikely to be either the most optimistic or the most pessimistic possible result.

HMRC would expect the LLP to consider any material reasonably relevant to this question – this includes everything relevant to the individual's expectations (see, in particular, the matters referred to in sub-section 2.3.2 above).

The question of whether something will in practice be affected by the profits or losses of the LLP is considered in sub-section 2.4.11 below.

2.3.5 Provision of services (S863B(1)(a))

Condition A only applies where an individual is working for the LLP. This means that the Salaried Member provisions do not apply to:

- companies;
- individuals who do no more than invest money; or
- individuals who no longer perform services for the LLP but who continue to receive a profit share.

Example 2

This example illustrates why an LLP member who no longer provides services but has invested capital in the LLP, is not a Salaried Member.

X used to be an active member of JKL LLP but reduced his active work a number of years ago and has not provided any services to the LLP for a year. In recognition of his contribution to the partnership over his career, X remains a member of the LLP, continuing to receive a profit share.

X is not receiving a reward for working for the JKL LLP. X reports this profit allocation on the partnership pages of his tax return and pays income tax accordingly. This reward is not disguised salary.

Example 3

The following example looks at the case of someone on "gardening leave".

M is a member of the BYBY LLP. He has been approached by, and accepted, a more senior role with the Hello LLP.

Under the terms of the LLP Agreement, M will leave the BYBY LLP in three months' time. The Management Board agrees to commute M's expected profit share into a fixed sum, based on profit projections, and M is placed on "gardening leave" for three months.

The arrangement under which M is receiving the fixed sum does not involve the provision of services, and accordingly, Condition A is not met.

2.3.6 Capacity

The individual has to carry out services for the LLP as a member. The legislation does not apply to any reward that an individual member obtains for work performed for the LLP in a separate capacity, for example as part of a separate business. This income does not come from being a member of the LLP or from rights under the LLP agreement. This comes from other business dealings between the LLP and that individual and be taxed separately based on the nature of the arrangements.

Example 4

This example illustrates how a member can carry out work for the LLP in a different capacity which is not relevant to the Salaried Member legislation.

The B LLP is formed between the B family and a local developer to develop a plot of land. Kate B is a member of the B LLP, but under the LLP agreement, she does not need to work for the B LLP.

Kate B is an architect and engaged by B LLP to draw up plans in her capacity as an architect, for which she is paid an arm's length fee under a separate contract.

In this case, Condition A is not affected by the remuneration which Kate B receives from the LLP. Whilst Kate B is a member who performs services for the LLP, she does not perform those services as a member of the LLP. The B LLP has contracted for her to provide services as part of her profession as an architect and her reward from the LLP all arises to her in that capacity. From the point of view of B LLP, paying Kate B is no different to paying any other party that has provided services to the B LLP.

Example 5

The following example looks at another common situation, where a member is receiving rent from the LLP.

S owns a farm which he lets to a farming partnership, SSS LLP, of which he is a member. This rent is a commercial sum

Apart from his share of the profit from the farming business, he receives a rent from the LLP. The rent is not taken into account for the purposes of Condition A (and nor, if S were a Salaried Member for other reasons, would it form part of his earnings).

2.3.7 Wholly or substantially wholly (S863B(1)(b))(see Chapter 1/paragraph 13)

The test applied by subsection (1)(b) is whether it is reasonable to expect that the amounts which an individual receives will be 80% or more in the form of what is called a *disguised salary*.

For the purposes of the test, it is the remuneration payable in accordance with the individual's contract with the firm (or the profits for accounts purposes attributed to him or her) which is taken into account, not the amount that would be taxable as a result of the firm's profit sharing arrangements (if different).

2.4 Disguised salary (S863B(2))

This section of the guidance explains the definition of "disguised salary".

The legislation says that an amount is a disguised salary "if it -

- (a) is fixed,*
- (b) if it is variable, is varied without reference to the overall amount of the profits or losses of the limited liability partnership, or*
- (c) is not, in practice, affected by the overall amount of those profits or losses."*

2.4.1 What does disguised salary include?

A disguised salary comprises amounts that will not be affected by the overall profitability of the firm. It includes:

- a fixed sum such as a salary;
- payment on a piece work basis - by the number of units produced or jobs done – sub-section 2.4.8 discusses "personal performance".
- a bonus based on a member's personal performance without reference to the success of the business (also see sub-section 2.4.8);
- guaranteed payments – sub-section 2.4.7 describes guaranteed payments;
- non-refundable drawings – sub-section 2.4.4 provides more information on when drawings are treated as a disguised salary.

It does not include drawings if it is reasonable to assume that they are sums on account of a separate amount that is not itself disguised salary.

2.4.2 The overall profits

The legislation refers to amounts that vary or are in practice affected by the overall amounts of profits of the LLP. For this purpose, the overall profits are the profits of the LLP that are available for allocation amongst members (including any amounts which may be reflected in the income statement as members' salaries).

2.4.3 Benefits in kind etc

A reward package may include entitlement to monetary amounts and to non-monetary benefits. However, in determining whether there is disguised salary, the focus falls exclusively on amounts 'payable' in respect of the individual's services.

Many LLPs provide "benefits" to members, which would be taxable as benefits in kind, if the member were an employee. These "benefits" are not taken into account for the purposes of Condition A.

Although they are not taken into account in determining whether the condition is met, they will be taxable as benefits if the individual is a Salaried Member.

Example 6

The following is an example of benefits in kind.

P is a member of a large LLP. The LLP provides benefits to members, such as private health insurance and use of a car.

The value of "benefits-in-kind" received by P such as the insurance and car is not taken into account in deciding whether or not Condition A is satisfied. However, these benefits are taxable on P if P is a Salaried Member.

2.4.4 Drawings on account of profit share vs. disguised salary

It is common for members of LLPs to receive monthly payments on account (“drawings”) of their subsequent profit share. Typically, the amount of the monthly share will reflect the expected profit share so, for example, a member who is expected to be allocated a profit of £120,000 for the period of account may be paid drawings of £8,500 a month representing 85% of the expected profit. Such drawings are, nevertheless, a payment on account of expected profit and are subject to clawback should the expected profits not materialise.

The fact that a member is paid drawings on account of profits does not necessarily convert the payments into disguised salary. If the member’s reward is a genuine variable share of the overall profits, the manner of taking it does not convert it into something else. Genuine payments on account of a share of overall profits are not made by the payer in exchange for services, but are partial realisations of an anticipated profit based on the expectancy of a share in future profits.

On the other hand, the member may have been told that the drawings represent a priority minimum payment which could only be refunded in the event that the profits of the firm are insufficient to cover the drawings of that member and other members with the same preferential right to payment. If the reality is that the LLP always makes profits significantly greater than those minimum drawings (with that excess to be allocated to other senior partners), it is reasonable to assume that the member will retain the amounts and that those amounts will not in practice be affected by the profits (and that accordingly the payments constitute a real reward for services).

The distinction between these cases is subtle and requires consideration of what the payments are referable to. Drawings would not be considered to be disguised salary if they are genuine payments on account of an amount that is itself not disguised salary. In such a case, it would not matter whether the drawings were made on a prudent or optimistic basis since in either case they would not be disguised salary.

Alternatively drawings may themselves either represent a fixed entitlement or be payments on account of an amount that is itself disguised salary.

2.4.5 Profit share (S863B(2)(b))

Condition A is not met if it is reasonable to expect that the member has a reward package under which more than 20% of their reward for services will be a share of the overall profits.

A share of the profit of the business does not include an amount determined only by reference to the success of a particular part of the business, such as a shop or branch office, or only by reference to how well an individual's own client portfolio has performed. It must be a share of profit which varies by reference to the profits of the business as a whole.

Example 7

This example illustrates the allocation of profits among partners who do not receive fixed shares.

A, B and C are members of ABC LLP. A is allocated 2 points and B and C are each allocated 4 points. Regardless of the level of profits, A will receive 20%, while B and C will receive 40% each.

None of the members receive a disguised salary; they each have a variable interest in the overall profits of the partnership. This would be so even if the profits were highly predictable and did not vary from year to year.

There can be significant variations in the mechanism used to allocate the profits. It is important not to focus on how the mechanism is described; it may be called a percentage, worked out as points or units. If the shares or units which are awarded are amounts which might reasonably be expected to vary with the profits of the business as a whole, the individual is not receiving a disguised salary.

Example 8

This example illustrates the interaction between priority profit shares and the Condition A test.

A, B and C expect that their LLP will make a profit of about £100,000. At the start of the period, they award themselves 'salaries' of £20,000, £40,000 and £40,000 respectively and agree that the actual total profit will be shared in proportion to those "salaries". If the overall profits of the partnership are more or less than £100,000, then each partner will share in the deficit or surplus in proportion to their agreed salary.

It is important to take a realistic view of the facts and look at the substance of the agreement. Although they describe these sums as salaries, they are not in reality fixed amounts. Instead they have a method of sharing out the anticipated profits. The amounts are simply set out as a benchmark for allocating profits. The reality is that the members will receive a share of profits that varies by reference to the overall profits of the partnership. It is not relevant that the partnership has chosen to describe this arrangement by reference to a "salary".

Example 9

This example highlights that it is important to focus on whether, on **a realistic view**, the amount represents a share of the overall profits, so that the profit share that member gets will vary on the basis of the overall profits of the LLP.

In the ABC LLP, the profits are divided on the basis of units. Each year's profits are allocated by dividing total profits by the number of units in issue to determine the value of a "unit". There are no salaries, or guaranteed profits. Each member's profit share is calculated by reference to the profits and the number of units that they hold.

A is the senior member; he has been allocated units that reflect the time that he has been a member and the fact that he has the main client portfolio for the business.

R is semi-retired but has a large number of units, reflecting her equity investment in the business

P is a junior member, but has been allocated additional units because she has had an exceptionally successful year.

Q has only just joined the LLP. He has been allocated units that are expected to give him a profit of about 10% more than the salary he had been on as an employee. It is agreed that Q can draw a higher proportion of his expected profits share, in line with his "take home" as an employee, but he has no priority over the other members, and he is aware that in the event of a shortfall, he will have to repay the excess drawings.

All four are receiving profit shares, because the sum they receive is dependent upon the profits of the business. In other words, it is not:

varied without reference to the overall amount of the profits or losses of the limited liability partnership.

To illustrate this, consider how the share P receives may be affected by the profits of the LLP as a whole:

Due to a professional negligence claim, the value of a unit is much lower than last year. As a result, although P has had an exceptional year and has been allocated more points than last year, her share of the profit is £20,000 less than the previous year.

Although P may have more units than last year, what she receives is dependent upon the profits of the business as a whole. The LLP has not had a good year, so even though she has had an exceptionally good year, P actually gets less money than the previous year.

Some may find it helpful to think of the analogy of looking at the profits of the overall business as a cake.

What P receives is a slice of that cake. The proportion of that cake she receives depends on her own performance. However, the total amount of cake P receives depends both on the size of the slice and on the size of the cake.

If the firm has had a good year, then the cake is large and each slice is worth more. In this example, the firm has had a poor year, so the cake is small. P gets a bigger slice of a smaller cake. The amount she receives does vary with the profits and Condition A is not met.

Example 10

This example illustrates the position of an individual moving from Salaried Member to partner status.

Member F was a Salaried Member, with a fixed profit share of £100,000. Member F is promoted with effect from 1 April 2015. She will have a fixed profit share of £50,000 together with 10 profit units which the firm estimates will be worth an additional £75,000 based on budget. The firm has a very poor year, and as a result, she only receives £50,000, giving total profit share of £100,000.

Condition A is not met. Member F is not a Salaried Member from 1 April 2015. Member F may have had the same profit share as last year, but half of this was dependent on the overall profits of the business. Had the firm been as successful as forecast, then she would have a profit share of £125,000.

Example 11

This example illustrates the position of a partnership which is starting in business.

BBB LLP is a new fund management venture. The investors agree to provide seed funding of £1m while new investors are being sought.

B is a partner of BBB and is responsible for raising the funds. The partnership documentation says that he is entitled to a first preferential profit share of £100,000 each year including the first year, which will be paid irrespective of the profit and will not be refundable. He will also be entitled to a third of the total profits from year 3 onwards, which are expected to be substantial.

In year 3, the funds have not been raised and the partnership is dissolved.

B fails Condition A as the arrangements are not ones where it is reasonable to expect that B will be primarily rewarded by disguised salary. This was the outcome, but was not the intention and was not the outcome that was expected when the arrangement was entered into.

Example 12

This example looks at tranches of reward, where the profit sharing arrangements vary depending on the amounts of profits made.

P works for the UVW LLP. She has no salary, but has a 10% profit share for the first £1m profits, reducing to 5% above that figure. Profits may or may not exceed £1m.

P's profit share varies by reference to the actual profits. Whilst the percentage varies, it is all profit-related. P does not satisfy Condition A.

Example 13

This example considers how the legislation takes account of a theoretical but practically irrelevant prospect of a profit share.

Four people decide to set up a cafe together. Members A, B & C do not have any capital to invest so only put in £100 each. The fourth, Member D, provides the funding for the venture.

They agree that Members A, B & C will each have a salary of £25,000 a year. The agreement is that these are not repayable even if the profits are under £75,000 (and as such they are disguised salary).

Any loss would fall to Member D, who will receive the first £125,000 of profits after payment of salaries. Profits above that limit will be divided equally.

Members A, B & C all potentially have a share of the profits, the question is how realistic is that possibility?

For Members A, B & C to receive a variable profit share based on the overall profits of the LLP, the profits need to be in excess of £200,000. For Condition A not to be met, the profits would have to exceed £250,000.

If the business plan is based on an expectation of profits of between £100,000 and £150,000, then there is no reasonable expectation that the income of Members A, B & C will in practice be affected by the level of profits and Condition A is satisfied.

2.4.6 Bonus

It is a characteristic of a true partner in a business that he or she receives a share in the profits of the business. However, many individuals who are employees also receive profit-related payments which may be described as bonus or by some other label. The definition of disguised salary is intended to draw a distinction between amounts which are realistically a share of profits and other amounts such as those which are fixed or remunerate individual performance.

Example 14

This example looks at bonuses and remuneration committees.

J works for the ABC LLP. He will receive a salary of £100,000 plus a bonus determined by a remuneration committee, at their discretion.

For the purposes of this legislation, the question is about the terms governing the remuneration committee's exercise of its discretion in determining the bonus payable. If the bonus paid is genuinely a share of the profit of the business, it will not be considered as disguised salary

In this case, more information is needed to determine whether her award is determined as an additional share of the overall profits of the firm or not. What are the terms of reference for the committee?

If the bonus is an additional share of the overall profit of the business, the next question is how realistic is it that any profit share will be 25% or more of the fixed salary of £100,000 (such that less than 80% of the total rewards will be disguised salary). As stated above, those rewards that are unrealistic and are unlikely ever to be triggered are ignored.

2.4.7 Guaranteed payments/floors

A disguised salary comprises fixed amounts and amounts that are determined without reference to, or are not in practice affected by the overall level of profits or losses for the LLP as a whole.

As a result, a disguised salary includes any sum that the member will receive whether or not the LLP makes sufficient profit.

The clearest example of this would be where a member will receive that sum even if the LLP makes a loss. Such payments are referred to below as guaranteed payments.

Example 15

This example illustrates the treatment of guaranteed payments.

The MNS LLP makes a loss of £500,000. However, under the profit sharing arrangements, members A, B, C, D & E will all receive a profit share of £100,000 whilst F has a loss of £250,000 and K Ltd has a loss of £750,000.

The shares payable to members A to E are not affected by the fact that the LLP has made a loss and are disguised salaries. Members A to E satisfy Condition A.

The key point is not how the payment is described; rather that it is a sum that the member expects to receive and will not in practice vary with the profit even if it is expressed to be linked to profit.

Here are some examples of arrangements which will be regarded as guaranteed payments:

- *Member A is entitled to draw £10,000 a month. Under the terms of the agreement, he is not required to repay the money once drawn.*
- *Member B has a guaranteed profit of £120,000 a year.*
- *Member C has a priority draw on profits and will be paid £120,000 a year (but no more) unless profits are less than £120,000. When the arrangement is entered into, there is no practical likelihood that profits will be less than £120,000 (and the expectation of both parties is that the reward will be £120,000).*

It is reasonable to expect that the amounts payable to A, B and C for services to the LLP will be £120,000. Receipt of this sum is not in practice in doubt since only a commercially remote event could prevent such payment being made.

Their cases can be contrasted with Member D, who is simply entitled to a percentage of the profits. He has no priority entitlement to any sum. For much of the year, he draws out money from his current account (last year's undrawn profits). Towards the end of the year, it is agreed that the LLP will pay him £10,000 a month in anticipation of his profit share for the period. Member D does not have a disguised salary and fails Condition A.

Example 16

This example looks at an amount of profit that it is agreed that a member will receive even if the share allocated to that member would otherwise be lower.

D joins the ABC LLP. In his first year, he is guaranteed a total profit share of no less than £30,000. If his allocated share of the profits is less than this, then his share will be £30,000 and the shares of the other members reduced accordingly.

D's guaranteed profit share of £30,000 is disguised salary as it is fixed. Accordingly, unless it is reasonable to expect that ultimately D's share for the period will exceed £37,500, such that his overall return is not substantially wholly fixed, he will meet Condition A.

Example 17

This example illustrates a guaranteed payment for a new joiner.

S joins the K LLP. The arrangement under which she joins the LLP provides that, in her first year, she is to be awarded 20 profit sharing units at the beginning of the year, with a guaranteed minimum profit of £80,000. This is intended to reassure her that in her first year, she will be remunerated at least the amount she was paid at her previous firm. When the units are awarded, each unit is expected to give a profit share of £4,500. In the event, the profits are higher than anticipated so that each unit is worth £5,500, giving her an actual profit allocation of £110,000.

At the start of the period, S has a disguised salary of £80,000 and is expected to have a total profit share of £90,000, meaning that Condition A is satisfied. This is not reviewed with hindsight. Obviously, if the profits are expected to be in line with those for the current period then this is taken into account when the test is applied again.

Example 18

This example illustrates a bonus based on personal performance.

It is agreed between the firm and member C that she will receive £100,000 as her profit share for the year. She is allocated 20 profit sharing units at the

beginning of the year, which, based on budget, will be worth £80-100,000. At the year end, in accordance with the original arrangements, she is awarded a performance based bonus to make up for any shortfall and ensure that the total is £100,000.

Condition A is satisfied. The reality is that member C's remuneration is £100,000 and the amount will not vary with firm's profits.

2.4.8 Personal performance (S863B(2)(b))

Condition A will be satisfied where the individual member receives a payment that is based only on their own personal performance, rather than a share of the profits of the business as a whole.

A bonus based only on the performance of the individual is not a profit share. It is variable but is:

"varied without reference to the overall amount of the profits or losses of the limited liability partnership".

On the other hand, performance bonuses computed by reference to the firm's profits are not disguised salary.

Examples 19 & 20

The following two examples illustrate the distinction between rewards for personal or team success as opposed to share of a profit of the business.

The EEE LLP awards bonuses to junior members at the year end based on their personal performance, as a percentage of salary up to 25%. This amount is a bonus and is not varied according to the profits of the business.

The FFF LLP has an arrangement under which an amount equal to 20% of profits is set aside as a bonus pool for its junior members to receive in addition to their fixed remuneration of £50,000 per year. This is allocated after the end of the year according to the personal performance of the junior members. All the members have an equal chance of getting a bonus. Typically a bonus represents 30% or so of base pay but it may be more and it may be less. In practice, because the performance system ranks the members, it is likely that some will get up to £50,000 and some will get zero.

On the facts, the class of members concerned is to be rewarded by a disguised salary of £50,000 and a profit-related bonus that is, on average, 30% of that amount. Everyone has an equal chance of getting a bonus and the award system does not favour one individual over another. The arrangement in place is not one where it is reasonable to assume that a particular individual meets Condition A.

Varying the example, if the bonus pool mechanism of FFF LLP is not fixed at the beginning of the year (so no percentage of profit is earmarked), but is decided at the discretion of a remuneration committee, there is unlikely to be a reasonable

expectation of the amount at the beginning of the year and Condition A is likely to be satisfied.

Example 21

This example looks at where personal performance is reflected by the way the profits are allocated.

Members are allocated profit share units at or soon after, the beginning of the year. The allocation is based on their seniority and historical performance, with an additional award of units to reward senior management roles to be held during the year.

Condition A is not satisfied. Although the profit share units are allocated partly on the basis of personal performance, all that is happening is that the proportion of the profits going to each member is being set. How much each member will receive depends upon the amount of the overall profit.

Example 22

This example looks at how a team leader can be rewarded for the results of their team by the way the profits are allocated.

Towards the end of the year, the performance of the members is assessed and additional profit share units are allocated to members based on their performance during the year. This also takes into account the performance of the team for which they are responsible.

Condition A is not satisfied. Although the profit share units are allocated partly on the basis of personal performance, all that is happening is that the proportion of the profits going to each member is being set. How much each member will receive depends upon the amount of the overall profit.

To return to the cake analogy, their performance partly determines how large the slice is, but the actual amount of money depends on the size of the cake. A bigger slice of a smaller cake may be smaller than a larger slice of a bigger cake.

Example 23

This example looks at the “eat what you kill” model.

GGG LLP is a large professional partnership and operates a remuneration system under which each partner is paid a profit share according to the amount of fees he or she has brought in.

If this is an arrangement for the partner to be paid a share of profit, it will not be disguised salary. If it is an arrangement under which the partner receives a cash amount (for example, a proportion of billings), the partner will be a Salaried Member.

2.4.9 Payments linked to piece work or turnover

If a member is paid on a "piece work" basis, that is, on the basis of the number of tasks they perform or pieces of work they do, Condition A is satisfied.

A payment by reference to the number of tasks performed or by reference to turnover is variable but it is:

"varied without reference to the overall amount of the profits or losses of the limited liability partnership"

Example 24

This example shows the distinction between rewards based on personal efforts as opposed to the profits of the business

W LLP operates sites offering "hand car washes". The individuals who wash the cars are members of the LLP rather than being given contracts of employment. Member D washes cars at one of these sites. Member D is paid on a piece work basis; the more cars washed, the more he receives.

Member D will earn more if more cars come to be washed. However his income is based on his work, not the success of the business as a whole. Member D receives a disguised salary and Condition A is satisfied.

Example 25

This example looks at guaranteed payments and rewards that are not parts of the overall profits.

The XYZ LLP decides to expand into a new business area. A new member, P, is recruited to run the new business area.

As it is expected that the new business area will initially make a loss, P will receive a guaranteed profit share of £100,000 plus a percentage of the turnover of the new business area.

Neither the guaranteed payments (which may be called "guaranteed profit share") nor the payment based on a percentage of the turnover of that business area is based on the profits of the LLP as a whole. Condition A is satisfied.

2.4.10 Divisions of a business

If a member is to be rewarded by i) a fixed amount plus ii) a bonus calculated exclusively on the basis of the success of a particular branch or unit, then Condition A is satisfied.

On the other hand, if the member is to be rewarded on a basis that takes into account the overall profitability of the firm, then Condition A will not be met even if the reward also reflects personal performance or the performance of the division in which he or she works.

Example 26

This distinction is illustrated by the example below.

ABC LLP carries on a financial services business with two divisions; tax and audit. Hank and Mitch run the audit division and Toni and Jo run the tax division. All four are members in the firm. The two divisions keep separate accounts. It is reasonable to expect both divisions to be profitable.

Whether condition A is met depends on all the arrangements and a relevant factor will be what would happen in the event of a loss being made by either business.

If, for example, the LLP agreement provides that each division is insulated from the results of the other (profits or losses), then all the members meet Condition A.

Alternatively the remuneration package may provide that the profits and losses of each division are to be aggregated (after deduction of common overheads) so as to give to a single figure of net profit for the overall business, which is then shared between the divisions, with those shares then being further allocated to the individuals in each. Such shares may take into account personal and divisional performance as well as other factors, but with none of the members having a fixed entitlement to any of the divisional shares.

In this latter case, none of the members meets Condition A. Each division receives a share of profits allocated by reference to performance and each individual then receives a share of that share. Thus the amount that each individual receives varies with reference to the overall profits of the business (and is in practice affected by the amount of those profits).

2.4.11 Caps

Sometimes a member's share of the profits may be "capped". This means that the member will receive a percentage of profits, but only so long as the profits do not exceed a certain figure.

The result is that the member's share of profits is capped at a certain monetary amount. This may mean that the member's reward is not *in practice affected by the overall amount of the firm's profits*.

Example 27

This example looks at how the legislation applies where there is a monetary maximum share or "cap" on a member's share.

E joins the DEF LLP. It agrees that her profit share will be calculated as a proportion of the total profits of the LLP, but her share cannot exceed £100,000.

If it is realistic to expect that the cap will not be engaged, then the member's reward will in practice be affected by the level of the firm's profits and will vary by reference to

them. If the LLP expects that her profit share would be between £120,000 and £150,000 so realistically she will always receive £100,000, it would imply that her total reward was not, in practice, a variable share of total profit but was simply a fixed sum meeting Condition A.

Example 28

This example illustrates that a cap that limits the return for services to a payment that will, in practice, be highly likely to be paid gives rise to a disguised salary even though there is a theoretical risk that the payment will not be made.

AA LLP is a UK firm that has set up a business in Australia and is highly profitable. AA LLP cannot operate directly in Australia for legal reasons. Instead, the business in Australia is operated through a general partnership AA GP. The two firms work closely together.

A, B & C are individuals who are members of AA LLP. The only other member of AA LLP is Z Ltd which is also a partner in AA GP.

A, B & C have each been told that they will receive £100,000 fixed salary, subject to there being sufficient profits. Any profits in excess of this amount are to be allocated to Z Ltd which will distribute the amounts to the AA GP in Australia, for the benefit of the Australian partners. Profit projections show that profits of AA LLP are likely to be significantly in excess of £1m per annum.

A, B and C meet condition A. Their return is to be £100,000, which will not in practice be affected by the amount of the firm's profits.

2.5 Condition B – significant influence (S863B(4))

The legislation states:

“Condition B is that the mutual rights and duties of the members of the limited liability partnership, and of the partnership and its members, do not give M significant influence over the affairs of the partnership.”

A partnership is a group of people who are carrying on a business in common with a view to profit. In short, the partners are the business.

Condition B stipulates that the mutual rights and duties of the members of the LLP, and of the LLP and its members, do not give M significant influence over the affairs of the LLP. It is in essence looking at the role played by the individual in the business.

As the LLP is a body corporate governed by the agreement between the members, it allows members considerable flexibility in how they organise the affairs of the LLP.

This guidance looks at the scenarios that have been put to HMRC during the consultations, but in the final analysis, the question to ask is whether the individual

has a significant influence over the activities of the LLP as a whole. Put simply, can it be said that the individual is the business rather than merely working for the business?

2.5.1. Significance of size

Condition B is likely to be particularly important for the members of smaller LLPs.

Example 29

This is an example of how Condition B applies to the facts of the case, where the written agreement does not reflect the current position

The Family Farm LLP has as members, a couple, A & B, and their adult son, X. The LLP Agreement has not been amended since before X was admitted. The way that the LLP operates in practice is that A, B and X all have a say in the running of the business, with A having a casting vote.

Although the written agreement was not amended when X was admitted, the implied terms of the agreement under which X was admitted was that he would have a significant say in the business. As a result, Condition B is not satisfied and X is not a Salaried Member. The fact that A has a casting vote does not mean that only he can meet condition B. More than one person can have significant influence and that influence can be exerted in different ways.

Example 30

This is an example of how the legislation applies to a small LLP where all the members have a say:

B LLP is a professional legal partnership with ten members. All members have equal rights and participate equally in the management of the business. They meet each month for meetings at which the major business decisions are discussed and made. All members attend these meetings and all are entitled to speak.

All of the members fail condition B as they have a significant influence over the business.

It is unlikely that this condition will exclude many members of very large partnerships, since, in such cases, it is likely that only a minority of individuals have significant influence over the affairs of the whole partnership.

There is no line in the sand as to the number of members which can exist consistent with all of them having significant influence – this will vary from firm to firm depending on how they conduct their business and who is influential. However, members of an LLP management committee which has influence over the affairs of the firm as a whole might be expected to fail Condition B as explained below.

2.5.2 What type of influence is relevant to the test?

The purpose of Condition B is to exclude from being Salaried Members, those individuals who have a real say in the business. The test is applied on the basis of a realistic view of the facts.

All relevant information must be considered in applying this condition including agreements between the partner and the firm, the LLP Agreement and any contracts between the firm and its investors. As explained in the Business Income Manual (see footnote 3), the LLP Agreement includes not only the written agreement but also verbal or implied agreements.

The following are examples of the kind of decisions which might be involved in appropriate cases. This is not intended to be a prescriptive or definitive list and it is not necessary that the same people are involved in all the decisions. Nor would having significant, or even controlling, influence over just one of them necessarily mean that the member has significant influence over the firm as a whole:

- appointment of new partners
- deciding where the firm conducts its business
- deciding the firm's areas of business
- strategic decisions
- deciding on business acquisitions or disposals
- management of key contracts relating to the firm generally (e.g. with the bank)
- appointment of key personnel
- allocation of roles to key staff
- decisions on important financial commitments
- formulating the firm's business plan
- approving major new clients or investments, especially where this is a regulatory requirement (see sub-section 2.5.3 below)
- deciding the firm's marketing strategy.

As noted above, members of the board or management committee of a large professional firm are likely to have the requisite level of influence over the affairs of the business.

By contrast, merely being able to vote, or to express a view, on such matters would be unlikely, in itself, to constitute significant influence.

Sometimes, an individual who has no apparent role in the management of the business may wield considerable influence. If, on a realistic view of the facts, the members defer to the views of that individual, then the individual can fail Condition B.

Example 31

This example illustrates an influential individual who is not a manager of the business.

T was the founder of the firm. Officially she is semi-retired and plays no role in either the management or the strategy of the business. In reality, if T indicates

her views on the strategy of the business, and the strategy board will almost invariably follow her guidance. T is still associated with the firm and if she was to disassociate herself from the firm, it would be catastrophic for business.

Although T officially has no role, she continues to set the direction and strategy of the firm. T continues to hold significant influence and fails Condition B.

2.5.3. Significant influence functions of financial businesses regulated by Financial Conduct Authority (FCA)

The Financial Services and Markets Act 2000 says that a significant influence function, in relation to the carrying on of a regulated activity by a firm, means a function that is likely to enable the person responsible for its performance to exercise a significant influence on the conduct of the firm's affairs, so far as it relates to the regulated activity.

A person carrying out such a function in relation to an authorised firm must be an FCA-approved person.

The context of the FCA significant influence function test is different from that of the significant influence rule in the Salaried Member legislation. However, HMRC would accept that the following FCA “significant influence functions” are likely to result in the individual exercising them having significant influence for the purposes of Condition C: CF3 (chief executive function) and CF8 (apportionment and oversight function).

On the other hand, CF4 (partner function) merely means that the individual has to be FCA-approved by virtue of being a member of the LLP (and as a result of which the FCA presumes the individual to have influence). Whether this in practice results in the individual having significant influence over the affairs of the LLP as a whole is a question of fact. In cases where the firm's activities consist wholly or almost wholly of regulated activities and the individual in question significantly contributes to the firm's major decisions (management, strategic or investment-related), then it is likely that HMRC would accept that this constitutes significant influence for the purpose of Condition C.

Example 32

This example looks at an example of whether someone who fulfils a function required by a regulatory body can satisfy Condition B.

X is a member of XYZ LLP, a regulated asset manager. X is a key portfolio manager, but not on the managing committee of XYZ LLP.

X is authorised by the FCA and holds Controlled Function CF4 for FCA purposes, which is listed as a ‘significant influence’ function. In addition, X makes significant investment decisions in relation to one of the funds under management.

X fails Condition B because of his significant influence over the LLP.

2.5.4 Hierarchy of members

The terms under which people become members will vary. The point was made by a number of respondents to the consultation on the draft legislation that for practical and commercial reasons, there is a point at which businesses will introduce members with different powers. Hence it is common for there to be a hierarchy of membership.

The question is: what are the terms of each class of membership? This should be shown by the LLP Agreement, including the appropriate documentation under which an individual became a partner. Under the documentation, some partners may be given more influence than others to decide matters relating to the management of the business.

Example 33

This is an example of a firm with different rights given to different partners.

Legal Eagles LLP is a professional legal firm with 20 members. They meet each month for meetings at which the major business decisions are discussed and made. All partners attend these meetings and all are entitled to speak. Junior partners are entitled to attend these meetings (though not to vote).

On the facts, the junior partners satisfy Condition B.

Suppose that the way that the firm conducts its business differs from that in the written agreement:

It has become the practice of the firm that votes are never taken and all decisions are made by consensus.

The test is applied on a realistic view of the facts. In this example, the written agreement does not reflect the entire agreement, the implied agreement is now that all members have an equal say. All members fail to satisfy Condition B.

2.5.5 Delegated powers

Some LLPs delegate a role such as management to a part of the membership.

The LLP Agreement usually indicates what and how powers are so delegated.

If the members of the management committee effectively run the LLP, then Condition B will not be satisfied in respect of those members. Condition B will be satisfied for the remaining members, who are potentially Salaried Members.

Against that, if the role of the management committee is largely administrative, then that would not satisfy Condition B.

Administrative decisions might include (please note that this is not a definitive list):

- payment of and issuing invoices

- detailed HR questions and those relating to non-key staff
- completing tax returns
- dealing with suppliers
- accounting
- management of premises
- dealing with routine compliance

Example 34

This is an example of an influential individual in the course of retiring.

Up until 1 June 2014, E was the managing partner of GH LLP, a large professional services firm. Upon reaching the age of 60, E decided that she wanted to retire. F was appointed as the new managing partner, but F and the other members were keen to retain E's experience in order to mentor F and provide a smooth transition.

E agreed to carry on as a member for a further year, becoming the firm's chairperson. She would continue to be an integral member of the management committee in this period, providing direction to F and the other members, albeit reducing her hours at work.

E would withdraw her capital from the firm over the course of the year in order to purchase a second home in the south of France. It was also agreed that her profit share would largely be fixed for this period, even though it had been entirely variable up until 1 June 2014.

Will E be a Salaried Member in her final year with the firm?

Although it seems that Conditions A and C of the test could be met in light of her move from a variable to a fixed profit share and the withdrawal of her capital, the circumstances are that she will clearly have significant influence over the affairs of the partnership for the whole of this period. Therefore, Condition B will not be met, meaning that Conditions A and C will not need to be considered; E will not be treated as a Salaried Member.

Although this example looks at a management committee, there are other aspects that may be delegated. For example, a firm may delegate to a particular group of members the power to decide the strategy of the firm. This can also mean that this group has significant influence.

Example 35

This example illustrates how controlling the strategy of the business as opposed to the managing of the business can give significant influence.

The TUV LLP is an investment manager. The four senior investment managers take no part in the day to day running of the firm, but set the investment strategy, deciding which markets the firm will invest in and reviewing the

performance of the various funds, and taking action where they see the firm underperforming.

The four senior investment managers control and direct the firm's activities. They have significant influence and fail Condition B.

2.5.6 Part of a business

The test applies to the business as a whole. If an individual runs part of the LLP, such as a specific branch or shop, but has no say in the business as a whole then Condition B will be satisfied and the individual can be a Salaried Member.

2.5.7 Indirect influence?

The test is whether that member has influence. Indirect influence, such as by being a director of another member, is not taken into account. Such indirect influence does not derive from the rights or duties of the individual as a member of the LLP.

Example 36

This example illustrates the position where there is a corporate member.

T is a member of the STU LLP and also a director of STU Ltd, the corporate member. Under the LLP agreement, control of the STU LLP is vested in the corporate member.

In her own right, T does not have significant influence. STU Ltd, of which she is a director, does have significant influence but this "indirect" influence is not taken into account. T therefore satisfies Condition B.

2.5.8 LLPs that are parents of a group

Where an LLP is parent of a company or group of companies, then the question arises as to what is significant influence over the LLP as opposed to the group.

Example 37

This example illustrates management of a group.

The four senior members of the INT LLP hold monthly meetings at which they make strategic decisions for the group as a whole.

Other members will attend to report on the performance of subsidiaries or sectors, but the four senior members each hold 24% of the vote.

The four senior members are acting as the group's head office and have significant influence over the activities of the LLP and fail Condition B.

2.5.9 LLPs that are members of groups

The test in Condition B is whether that individual, as member, has significant influence over that LLP.

The test is applied on the basis that whilst they may take the views of a parent body into account, the members will exercise the powers and duties placed upon them under the LLP Agreement.

Example 38

This example looks at who has significant influence when the LLP is effectively a subsidiary in a group.

The FOR LLP consists of individuals A, B & C, an unconnected corporate member FOR Ltd, and individual D, an employee of FOR Ltd. The strategy of the LLP is decided by the four individuals. On issues of importance to the FOR Group, FOR Ltd will indicate its views to the individual members.

The four individuals together decide the investment strategy. Although they will take into account the views of the FOR Group, their duties to the LLP mean that they have to make the decisions. All four individuals fail Condition B and are not Salaried Members

It is understood that D has been appointed as representative of the FOR Group.

Although representing the Group, D is not its agent and holds significant influence in his own right. This can be contrasted with the position where FOR Ltd was also a member and D used their vote in a representative capacity.

2.6 When to apply Conditions A and B

For individuals who are members at 6 April 2014, the test needs to be applied at that point.

For individuals who become members after 6 April 2014, the test needs to be applied at the date on which they become members.

Once the tests have been applied, then they do not need to be applied again until the arrangements change.

Example 39

This looks at where there is a change in circumstances but from a practical point of view the test does not need to be re-applied:

A currently satisfies Condition A, as he receives a disguised salary. A negotiates a pay rise so that his salary rises by £5,000.

There is no need to test to see if Condition A continues to be satisfied. The pay rise will not affect whether the test is satisfied.

Example 40

This example looks at an example of where the test needs to be re-applied:

B currently satisfies Condition A, she receives a disguised salary. B negotiates revised conditions, so that she surrenders £10,000 and instead receives 5 units. At the end of the period, the residual profit is divided by the number of units that have been awarded. In effect, each unit represents a part of the residual profit.

More of B's reward is now calculated by reference to the profits of the LLP. Condition A needs to be re-tested.

2.7 Condition C – contribution to the LLP (S863B(5))

The legislation states:

“Condition C is that, at the time at which it is being determined whether the condition is met (the relevant time), M’s contribution to the limited liability partnership is less than 25% of the amount given by subsection (6).”

Condition C looks at the level of investment in the LLP by that member. Has the member made a significant investment in the business so they have a real risk resting on the success or failure of the business?

The test is whether the amount contributed is less than 25% of the disguised salary expected to be payable for the whole tax year. If the member has contributed less than 25%, then Condition C is satisfied and that member may be a Salaried Member.

Following responses to the consultation on the draft legislation, Condition C is being amended. Rather than an adaption of ITA07/S108, the rules on what constitutes capital are being incorporated into the Salaried Member legislation.

A more significant change is that for members in place on 6 April 2014 and for new members, provided they are committed to provide the capital, the legislation will allow for a period for them to obtain loan finance (see the following two sub-sections).

2.7.1 Applying Condition C at 6 April 2014

The test first has to be applied at 6 April 2014.

Following the publication of the draft legislation, a number of firms may have decided to reorganise their capital, but may experience difficulty in obtaining loan finance for a large number of individuals by 6 April 2014. To avoid the position where individuals are treated as employees for a short period whilst they obtain finance in order to invest capital, the legislation is being amended.

Condition C will not be satisfied if:

- at 6 April 2014, there is an unconditional requirement for that member to provide the capital; and
- the capital is contributed within 3 months from 6 April 2014.

If the member does not contribute the capital within 3 months, then their position has to be reviewed.

2.7.2 Applying Condition C to new members

Individuals becoming members may also experience delays in obtaining loan finance to invest as capital so the basis on which Condition C is applied to new members is being amended.

Condition C will not be satisfied if:

- at the point at which the individual becomes a member there is an unconditional requirement for that member to provide the capital; and
- the capital is contributed within 2 months of becoming a member.

If the new member does not contribute the capital within 2 months, then their position has to be reviewed. For how to apply the test, please see Example 42 below.

2.7.3 Applying Condition C to existing members

The test for Condition C is applied at the start of the tax year and the test is re-applied if there is a change in the year (as set out in the legislation):

“If in a tax year.

(a) there is a change in M's contribution to the limited liability partnership, or

(b) there is otherwise a change of circumstances which might affect the question of whether condition C is met,

the question of whether the condition is met is to be re-determined at the time of the change.”

There is no need to retest if Condition C was not previously met and all that has happened is that the individual has increased their contribution.

2.7.4 What is the contribution? (S863B(11))

The amount of capital contribution is based on the amount that the individual has invested as capital at that time in accordance with the LLP Agreement.

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

As part of the LLP agreement, the amount of capital contributed cannot be varied by the member alone, any variation has to be by agreement of the members.

The capital is not the same as the assets of the LLP which includes everything with a money value and obviously varies from day to day.

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

In summary, the capital does not take into account:

- sums that the individual may be called upon to pay at some future date;
- undrawn profits unless by agreement they have been converted into capital;
- sums that are held by the LLP for the member, for example, sums held in a taxation account; or
- amounts of capital that are part of arrangements to enable the individual to “avoid” being a Salaried Member where there is no intention that they have permanent effect or otherwise give rise to no economic risk to the member.

Example 41

This is an example of the treatment of some different types of “capital contribution” and their effects on Condition C.

P has:

- *£10,000 contributed as capital in accordance with the LLP Agreement;*
- *£50,000 long term “loan”. Interest is paid on this, but otherwise the amount is held on terms comparable to the capital, e.g. the loan is only repayable when P resigns, or the LLP is wound up. The amount is treated for tax purposes as a share of the profit;*

- £30,000 as a short term loan for a two year term;
- £25,000 undrawn profits – that can be withdrawn at any time; and
- £25,000 in a tax reserve current account to pay the tax on P's profit share.

P is entitled to withdraw the short term loan, undrawn profits and the sum in the tax reserve current account, whilst he remains a member. These are not part of the capital contributed. P cannot withdraw either the sum described as capital or that described as a “loan”. Regardless of the terminology used in the agreement, these are both intended for the long term financing of the firm. They act as partnership capital. P has capital of £60,000.

However, giving a guarantee is not partnership capital.

2.7.5 Becoming, or ceasing to be, a member part way through the year (S863B (13)-(15))

Condition C is applied on the basis of the level of disguised salary for the tax year (S863B(6)).

If an individual becomes a member part way through the tax year, then the amount of the contribution is reduced to reflect the number of days in the tax year that the individual will be a member.

If the test is applied at a time when it is expected that the individual will cease to be a member before the end of the tax year, then the amount of the contribution is reduced to reflect the number of days in the tax year that the individual is expected to be a member.

Example 42

This example looks at where an individual becomes a member part way through the year.

M is appointed a member three months into the tax year. His reward package means that he will be due a fixed amount of £40,000 for the rest of the tax year (his “disguised salary”). The terms of his membership mean that he had to make a capital contribution of £12,000.

At first sight, M's contribution may appear to be at least 25% of his disguised salary ($12,000/40,000 \times 100 = 30\%$).

However, he will only be a member for nine months of the current tax year. His capital contribution is, therefore, reduced to reflect the period of the year that he will be a member: $12,000 \times (9/12) = £9,000$.

When the test is applied using this reduced figure ($9,000/40,000 \times 100 = 22.5\%$), Condition C is satisfied.

2.7.6 A change in the contribution part way through the year

A change in the amount of the contribution may require the test to be reapplied.

A member may increase their contribution during the tax year. This increase could mean that, viewed in isolation, Condition C is not met from the time the increase is made. However, the legislation sets out an additional requirement that must be met: it must be reasonable to assume that at no later time in the tax year will the Condition be met.

This means that it must be reasonable to expect that the increase will be a permanent one that will not later be reversed in the tax year.

In addition, the increased contribution is reduced on a pro rata basis where the increase occurs part way through a tax year.

These additional requirements are intended to prevent individuals from flipping between employee and partner status through short term changes to their capital contributions.

There is no need to retest if Condition C was not previously met and all that has happened is that the individual has increased their contribution.

Example 43

This example illustrates how the test is applied when the capital contribution is reduced.

A is a member of the ABC LLP. At the start of the tax year, Condition C is not met as A has disguised salary of £450,000 and has made a capital contribution of £120,000 in accordance with the LLP Agreement. Therefore, A's contribution is more than 25% of his disguised salary.

Circumstances change and the members agree that A can reduce his capital contribution to £40,000 to enable him to fund a divorce settlement.

Condition C needs to be re-determined as there has been a change in A's capital contribution.

A now has a capital contribution of less than 25% of his disguised salary ($(£40,000/£450,000) \times 100 = 8.8\%$). Condition C is now satisfied. Whether A is now a Salaried Member will depend upon whether he satisfies Conditions A and B

Example 44

This example illustrates how the test is applied when the capital contribution is increased.

J is a member of KLM LLP. At 6 April 2014, her capital contribution is £20,000. She is expected to receive disguised salary of £100,000 in the 2014/15 tax year. As J's capital contribution is less than 25% of her disguised salary. Condition C is met.

On 6 January 2015, J increases her capital contribution to £25,000. It is expected that the contribution will remain at this level for the rest of the tax year. As there has been a change in the contribution, Condition C needs to be re-determined.

As the change is an increase in the capital contribution, the contribution is reduced on a pro rata basis, before comparing this to J's disguised salary for the whole tax year.

J's capital contribution is deemed to be £6,250 ($£25,000 \times 3/12$). As this amount is still less than 25% of her disguised salary, she continues to meet Condition C for the rest of the tax year.

In contrast, if J increased her capital contribution to £100,000, instead of £25,000, then the contribution would be treated as being £25,000 ($£100,000 \times 3/12$). As this amount is equal to at least 25% of her expected disguised salary in the tax year, she will not meet Condition C from 6 January 2015.

2.8. Further examples

There are further examples in the [Annex](#). These examples look at the way in which the Salaried Member test is applied as a whole, rather than looking at the way that the separate conditions apply to the individual, and are based upon scenarios put to HMRC during the development of the legislation. They are used to highlight a number of points. They also highlight specific issues arising from certain global structures particularly relevant to large law firms.

3. Anti-Avoidance Provisions

A guide to this chapter

3.1 Anti-Avoidance

3.1.1 *Avoidance arrangements*

3.1.2 *Financing arrangements*

3.1.3 *TAAR examples*

3.1.4 *Use of intermediaries*

3.2 Interaction with mixed membership partnership legislation

3.1 Anti-Avoidance (new section 863C)

The anti-avoidance legislation is intended to prevent people using artificial structures or arrangements to place members outside the scope of the Salaried Member provisions.

It is not avoidance if the terms under which an individual is a member change and they become a member on genuine terms comparable to a partner in a traditional partnership.

The legislation also prevents the misuse of the Salaried Member provisions as part of a scheme or arrangement to avoid the impact of the mixed membership partnership provisions.

3.1.1 *Avoidance arrangements (S863C(1))*

In deciding whether an individual is a Salaried Member, no regard is to be had to any arrangements the main purpose, or one of the main purposes of which, is to secure that the individual (or that individual and other individuals) is not a Salaried Member.

In applying this test (Targeted Anti-avoidance Rule (TAAR)), HMRC will take into account the policy intention underlying the legislation, which is to provide a series of tests that collectively encapsulate what it means to be operating in a typical partnership. HMRC would not consider that genuine and long-term restructuring that causes an individual to fail one or more of the conditions to be contrary to this policy aim.

3.1.2 *Financing arrangements*

An individual will fail condition C if the individual has made a contribution 25% or more of any disguised salary payable in the tax year.

The capital contribution requirement is fairly prescriptive and HMRC would accept that a genuine contribution by the individual to the LLP (within the meaning of section 108 ITA 2007), intended to be enduring and giving rise to real risk, will not trigger the TAAR.

Such a contribution may be obtained through a loan from a third party, typically a bank. The firm might itself arrange the loan through a partnership facility. Provided that the debt will then be that of the individual partner, this manner of obtaining the funding will not trigger the TAAR.

It would of course be a question of fact as to whether a main purpose of the arrangement was to secure that the individual was not a Salaried Member, but it is likely that HMRC would consider the TAAR to be in point if the contribution is provided as part of an arrangement where the following features are present (noting this is not an exhaustive list):

- It derives from a non-recourse or limited recourse loan.
- The funds derive from the firm itself (for example, this is made of a loan from the LLP to the individual or from a bank as part of an arrangement where there is to be a reduction in the firm's indebtedness to the bank).
- The LLP loans the money back to the individual (assuming that section 108 ITA 2007 applies to the contribution in the first place).
- The firm, rather than the individual member, pays or otherwise bears the cost of the interest on the loan.
- An individual is to be brought into the LLP for a fixed term assignment and it reasonable to assume that the capital contribution has been made so that the individual fails the test for the duration of that assignment.

3.1.3 TAAR examples (4)

Example 1

This example describes a non recourse loan.

W is a junior member of the ABC LLP and she has only invested a nominal capital. Conditions A and B are satisfied. W receives a non-recourse loan to raise her capital so that Condition C is not satisfied. In reality, the money makes its way back in a circle to the lender.

The main purpose of the loan is to enable W to avoid being a Salaried Member. The additional capital is ignored, Condition C is satisfied and W is a Salaried Member.

The position would be unchanged if the arrangements were put in place for one or one hundred members. A main purpose is to enable a member, or a number of members, avoid being a Salaried Member.

Example 2

This example covers a genuine capital contribution.

P has been an employee of the DEF LLP. She has reached that point in her career where she is offered membership.

In order to become a member, P needs to invest in the LLP. She has some capital of her own, and the LLP arranges with the Bank for her to have a normal commercial loan to cover the balance. An undertaking is given that on P's retirement from DEF LLP, the firm will pay back the loan directly out of P's capital account and, if necessary, any undrawn remuneration, with full recourse against P if these amounts prove insufficient.

These arrangements have substance and will not trigger the TAAR.

They have not been put in place to enable P to avoid being a Salaried Member. P faces genuine risk, she has invested in the DEF LLP and she does owe money from the bank, which she will need to repay and, in the interim, she will have to pay interest.

Becoming a full member, on terms akin to those of a partner in a traditional partnership, is not avoiding being a Salaried Member.

Example 3

This example shows an individual joining an LLP for a short-term engagement with no intention of being a partner.

A is an associate in a US law firm Adsf GP. He is to be seconded to the UK "subsidiary" entity Adsf LLP for a two year period to provide general legal support. During this period, he will be rewarded almost wholly by disguised salary.

He and the LLP agree as part of his terms of engagement as a member that he must contribute capital of 30% of the disguised salary which will be repayable immediately after the end of the two years. The firm is extremely well-capitalised and there is no real prospect of the capital being at risk. He is also given voting rights on matters which are expressed to be significant, but in reality he is a junior member with no significant influence over the firm's affairs.

Neither the capital nor A's involvement with the firm is intended to be enduring. His connection with the firm is like that of an employee on secondment rather than a partner, and there are from day one arrangements for his departure after a set period. On the facts, HMRC would look to apply the TAAR.

3.1.2. Use of intermediaries (S863C (2) and (4))

If an individual works for the LLP and, to avoid being a Salaried Member, enters into arrangements so that someone else, such as a company, becomes a member and receives amounts due to the individual then:

- the individual is treated as a Salaried Member,
- the sum paid to the actual member in relation to the individual's services is treated as being paid to the individual, and
- the sum is treated as employment income of the individual.

Example 4

This example shows the circumstances where TAAR applies.

J realises that he would be a Salaried Member. With the agreement of the LLP, he introduces as a member J Ltd. J Ltd receives the reward package that had been agreed for J.

These arrangements have been entered into to avoid the impact of the Salaried Member legislation. J is deemed to be the member, with the result that the sum due to J Ltd is treated as payable to J..

The LLP must account for PAYE and NICs on the amounts paid to J Ltd for the services of J. So if £100,000 was invoiced by J Ltd, the LLP must deduct the appropriate amounts of PAYE and NICs and account for secondary NICs on that £100,000.

3.2 Interaction with mixed membership partnership legislation

The Salaried Member legislation does not apply where an individual would otherwise be a Salaried Member because of arrangements that have a main purpose of securing that the mixed membership partnership legislation does not apply (new section 850C).

4. Implementation Matters

A guide to this chapter

4.1 Deductions in respect of Salaried Members

- 4.1.1 *Trades & properly businesses*
- 4.1.2 *Investment companies*
- 4.1.3 *Disallowable expenses*

4.2 Returns

- 4.2.1 *Self-employment*
- 4.2.2 *Employment*
- 4.2.1 *Employment – the LLP's position*

4.3 Capital assets

4.4 Further information

4.1 Deductions in respect of Salaried Members (S94AA, S272, and CTA/S92A & S210)

If a member is a Salaried Member, then the costs of employing that individual are expenses of earning profits in the same way as the costs of employing any other individual.

This means that they are allowable deductions in the same way and the same period as the expenses in respect of any regular employee.

Where the costs of employing the Salaried Member would not be deducted in arriving at the profits of the LLP under the normal accounting practice (SORP), a specific statutory deduction is available for tax purposes as explained below.

4.1.1 *Trades & property businesses*

For a trade or property business where the sum is not treated by the SORP as a deduction in arriving at the profits, and it is not otherwise disallowable under general rules, then a statutory deduction is allowed in arriving at the profits of the LLP in the period when the sum is paid.

4.1.2 *Investment companies*

This section looks at the position where the profits of the LLP are calculated as for an investment company (section 1259 CTA 2009).

If costs of employing a Salaried Member would be expenses of management of a company's investment business but are not referable to an accounting period, they are treated as referable to the accounting period in which they are paid. The availability of a deduction for the payment is then subject to the normal management expenses rules.

4.1.3 Disallowable expenses

A Salaried Member is treated as an employee for tax purposes and not as a partner. Where the LLP has any expenses that are treated as disallowable for tax purposes, then these are taken into account in arriving at the taxable profit shares of those treated as partners for tax purposes.

4.2 Returns

As the Salaried Member is not treated as a partner for tax purposes, they are not included on the Partnership return for a period when they are a Salaried Member.

If the circumstances of an individual changes and they are treated as a partner for part of the period, then they need to be included in the return for that part period.

This means that an individual who is found to be a Salaried Member would be on the Partnership Return for the period up to 5 April 2014, and they would be treated as ceasing as a partner on that date.

Example 1

This example considers how to deal with the returns for the LLP and the effects on the individual member under the new rules.

M has been a member of ARC LLP since 1 July 2010. ARC LLP commenced trading in 2001 and has had an accounting date of 30 June throughout.

Prior to 6 April 2014, ARC LLP carries out a review of its membership as a result of the new Salaried Members rules.

The review shows that M satisfies all three conditions and so M will be a salaried member as of 6 April 2014.

The nominated member will include M on the partnership return as a partner for the period up to 5 April 2014. ARC LLP will then treat M as an employee and operate PAYE from 6 April 2014.

The position for M is considered in the following two sub-sections. The position for the LLP is set out at sub-section 4.2.3 below.

4.2.1 Self-employment

For tax purposes, M will cease to be a partner of ARC LLP on 5 April 2014. This means that her basis period for her 2013/14 tax return will follow the cessation rules

and run from the day after the previous basis period ends to the date M ceases to be a partner. A just and reasonable apportionment of profits earned from 1 Jul 2013 to 5 Apr 2014 should be included. M can also claim overlap relief in this final period.

M's self assessment returns will be as follows:

Tax Year	Basis period	Profits £	Overlap period	Overlap profits/relief £
2010/11	1 Jul 2010 – 5 Apr 2011	60,000		
2011/12	1 Jul 2010 – 30 Jun 2011	79,000	1 Jul 2010 – 5 Apr 2011	60,000
2012/13	1 Jul 2011 – 30 Jun 2012	81,000		
2013/14	1 Jul 2012 – 5 Apr 2014	140,000		60,000

4.2.2 Employment

As of 6 April 2014, M will be an employee of ARC LLP for tax purposes. Her entitlement under the LLP agreement is treated as coming from an employment. ARC LLP will need to account for PAYE on amounts paid or credited to M, including her monthly drawings and any amounts in respect of her variable profit share. ARC LLP will also be liable to make employer's Class 1 NICs. M will not need to complete a tax return for 2014/15 (unless she has other income that needs to be reported through Self Assessment) as she will have paid her income tax and NICs through PAYE.

4.2.3 Employment – the LLP's position

Any sum paid to the Salaried Member is treated as remuneration subject to deduction of PAYE and employee NICs. The LLP will be treated as the "employer" and secondary contributor for employer NICs and statutory payments.

If the LLP currently has employees and is operating PAYE, then the following link is useful as it sets out what the LLP has to do when it is decided a member is a Salaried Member: <http://www.hmrc.gov.uk/payerti/employee-starting/new-emp-info.htm>

If the LLP does not currently have any employees, then it will need to set up a PAYE scheme. Please follow this link to see what is required: <http://www.hmrc.gov.uk/payerti/getting-started/register.htm>

Information about how to operating PAYE in real time (RTI) can be found in the following link: <http://www.hmrc.gov.uk/payerti/index.htm>

If the LLP provides a Salaried Member with a car, there will be benefits in kind implications. Benefits in kind are to be treated in the same way for employees and Salaried Members – see this link about the obligations: <http://www.hmrc.gov.uk/payerti/exb/forms.htm>

As the LLP is secondary contributor for NICs, they are also responsible for the operation of the regimes relating to statutory payments, statutory maternity pay, statutory sick pay, statutory adoption pay and statutory paternity pay. Details of the LLP's obligations can be found at: <http://www.hmrc.gov.uk/payerti/employee/statutory-pay/index.htm>

4.3 Capital assets

Where, after applying the tests in sections 863A and 863B, an individual is treated as a Salaried Member, the legislation applies to treat all amounts received by that individual as employment income subject to the applicable income tax rules under ITEPA. Class 1 and 2 NICs may also apply.

A Salaried Member is subject to the same rules on taxable benefits received as any other employee.

This treatment does not include any amounts received by a Salaried Member in respect of capital assets of the LLP that would not be taxable as employment income if received by an employee. Examples include dividends from shares held by the firm.

The interest received by a Salaried Member when becoming a member of the LLP is not itself considered to be a benefit for income tax purposes.

4.4 Further Information

This note represents an informal view of HMRC on how the legislation would apply to LLP members who are Salaried Members. Non-statutory clearances will be provided in respect of the legislation after the Finance Bill 2014 receives Royal Assent (the link to the guidance is included in footnote 1).

LLPs with salaried members will need to operate PAYE in respect of those members from 6 April 2014 when the legislation comes into force. Businesses can contact their customer relationship managers or co-ordinators for further information including how to proceed with a clearance.

Annex : General Examples and Global Structures

A guide to this Annex

(A) General Examples (4)

(B) Global Structures (8 examples)

- 1.1 Overseas members
- 1.2 Profits from the UK LLP
- 1.3 Global profits
- 1.4 Cost plus basis
- 1.5 Performance of services
- 1.6 Capital of LLP
- 1.7 Significant influence

(A) General Examples

The examples in this Annex look at the way that the Salaried Member test is applied as a whole, rather than looking at the way in which the separate conditions apply to the individual.

To ensure that the examples are as realistic as possible, they have been based upon scenarios put to HMRC during the consultations. They are used to highlight a number of points.

Example 1 (Condition A)

This example shows that professional qualifications are not relevant to the question whether Condition A is met.

50 people currently work for the A LLP, of whom forty-five are listed as members.

The A LLP business plan is inclusive, recognising that everyone working for the business is contributing to the success of the business; hence once it is clear that the individual is going to stay with the business, they are invited to become a member.

Of the forty-five members, 15 are professionally qualified, five of whom qualified in the last 5 years whilst 3 other members are working for their professional qualifications. The remainder have no intention of becoming professionally qualified.

The Salaried Member test is **not** concerned with experience or professional qualifications. It looks at the role that individual plays in the business.

Under the LLP agreement each member is entitled to an equivalent to statutory sick pay, maternity/paternity leave, holiday entitlement and termination rights.

Although these may make the partner look like an employee, they are **not** taken into account in the Salaried Member test.

Each member receives a profit share. The proportion varies from member to member, but everyone knows that if the business makes less profit they will have less income and if it makes a loss they get nothing.

All the members, from a secretary to the founders, know that their income from year to year depends on the level of profit. If the firm makes a loss, then they have no income for the year. This means that Condition A is not satisfied. No member of the A LLP is a Salaried Member and no further action is needed.

The fact that the various members draw sums during the year does not change this, provided that the sums are simply drawings in advance of profit shares.

Example 2 (Conditions B & C)

This example looks at a similar LLP but also takes in Conditions B & C

B LLP is similar to A LLP, but only the five senior members receive profit shares, the rest have non-refundable drawings and a nominal profit share, so that 90% of their income is disguised salary and they will meet Condition A.

The B LLP is largely a people business using rented accommodation. However, it does need capital. Each of the members has made a contribution, varying with their position in the firm, but starting at £1,000.

Whether Condition C is satisfied depends upon the amount contributed by the member. Condition C will be satisfied unless the capital is at least 25% of the expected disguised salary for the tax year.

If in the case of B LLP, all members satisfy Condition C.

Each of the members has a share of the proceeds in the event of winding up.

This is not a factor in the Salaried Member test.

Management of B LLP is delegated to a Management Board, consisting of 9 members who are professionally qualified (these include the 5 senior members who receive profit shares), and the Office Manager, also a member of the LLP, who has no professional qualifications. The other members have no real say in the business.

The ten members of the Management Board do not satisfy Condition B. They are not Salaried Members. The fact that the Office Manager is not professionally qualified does not matter; the key is that the role gives the individual significant control.

Example 3 (Conditions A & B)

This looks at an example of an LLP controlled by its founders and the transfer to a new generation. This results in a change in their remuneration structure and their ability to influence the firm's affairs.

C LLP was founded by two individuals, A & B. A & B are entitled to the residual profits, make all the major decisions and they have invested all but a nominal amount of the capital.

The other members receive a fixed monthly sum plus an annual discretionary bonus, typically 20% to 30% of their annual fixed compensation.

The other members are all Salaried Members, satisfying Conditions A, B & C. Whilst the bonus is sometimes more than 20% of the reward package, this is set without reference to the profits of the firm but is instead based wholly on their own fixed compensation. In addition, the individuals have no real influence and no capital contribution.

After a while, as had been the intention, C & D, two of the junior members, start to take on elements of the work done by A & B.

As their terms have changed, the test needs to be applied again to C & D.

C & D will receive a lower monthly sum, and instead will receive a share of the profits. A reasonable estimate is that about 25 to 30% of their reward package will be in the form of a profit share. They will also take part in all major decisions.

C & D have sacrificed an entitlement to salary in exchange for the opportunity to participate in the business in much the same way as A & B the senior partners, even if as junior partners they are substantially rewarded by a fixed profit share. Conditions A and B are no longer met so C & D are no longer Salaried Members.

Example 4 (Condition B)

This example looks at junior members and how one member makes the transition to a more senior position.

The XYZ LLP typically has about 100 members.

Existing employees can be invited to become junior members. As a junior member, they initially introduce £4,000 as capital and receive "4 units". The unit is the measure by which residual profits are allocated. As a comparison, the senior partner has 150 units.

The term "unit" is not material; it is simply the method of allocating the residual profits.

Junior members are awarded a fixed guaranteed profit share, plus the profit from their units. For a junior member, the profit share under the unit system will be no more than 5% to 10% of the total package.

The firm's management power is centralised in a management board formed by the senior members.

The junior members satisfy all three conditions, they have less than 10% of their reward package as a variable profit share, nominal capital only and no real say.

Catherine has been a junior member but is being promoted. She will sit on the management board and have a significant influence over the running of the business. In addition, she will receive more units but it is still reasonable to expect that less than 20% of her reward package will be variable.

Catherine has accepted an opportunity to participate in the business in much the same way as a senior member, even if, as a relatively junior member, she is still substantially rewarded by a fixed profit share. Catherine would still satisfy Condition A but she is not a Salaried Member as she now does not satisfy Condition B.

(B) Global Structures

This section looks at the position of UK LLPs that form part of structures that cross international boundaries ("global structures").

The Salaried Member legislation is applied to the individual as a member of that LLP. It does not take into account income from other parts of the structure, influence in other parts of the structure or capital invested in other parts of the structure.

As the disguised salary test is focused on the UK LLP, it is important that the financial transactions between the UK LLP and other members of the transnational structure are conducted on an arm's length basis.

Example 5 (Condition A)

This example illustrates a firm doing business with an associate overseas (and the effect of the arm's length principle).

The members of ABC LLP are A, B and Y Ltd, a subsidiary of Swiss Co.

The only customer of ABC LLP is Swiss Co. The profits of ABC LLP are determined on an arm's length basis reflecting its contribution to the global profits and losses of Swiss Co. As a result, ABC LLP could be profitable when Swiss Co is loss-making or vice versa.

The profits of ABC LLP are allocated to A and B in line with variable profit sharing arrangements within ABC LLP's LLP agreement.

A and B fail Condition A. They share only in the profits of ABC LLP which have been calculated on a normal commercial basis.

Example 6 (Condition A - no performance of services)

This example illustrates a profit share paid to a UK partner by an overseas firm.

ABC LLP is associated with a US partnership ABCUS LLP (formed under the law of Delaware). A B and C are partners of ABC LLP and so is ABC US LLP. A B and C are partners of ABC US LLP which also has a further 10 partners. All profits of ABC LLP are paid to ABC US LLP and shared by its partners along with the other profits of the firm. A B and C receive a share of the global profits.

A B and C are not Salaried Members as they do not have any income in their capacity of partners of ABC LLP. However, ABC LLP is a mixed membership partnership and the mixed membership partnership rules (new sections 850C to 850E) need to be considered.

1.1 Overseas members

Where a member is resident does not affect the Salaried Member legislation. If a member satisfies the three conditions then he or she is a Salaried Member.

Example 7

This example shows that residence is not a factor in deciding if someone is a Salaried Member.

D is French resident member of the UKF LLP. She works in the Paris Office and receives a salary of £75,000, has no say in the running of the LLP and has contributed no capital to the LLP.

D is a Salaried Member and treated for UK purposes as an employee. The fact that she is French resident does not alter her status for the purposes of the Salaried Member legislation. The normal employment income rules will determine to what extent she is taxable on her income in the UK. Her French tax status is a matter for the French tax authorities.

1.2 Profits from the UK LLP

The test is applied to the profit share from the UK LLP.

In some cases, it may be intended that the members of a global business are to be rewarded on the basis of global profits (this reward will reflect the contribution of local offices to the generation of those profits).

Those global profits may be the aggregate of the profits of the UK LLP plus profits earned outside the UK from a related (so-called *paralle*) partnership. The parallel partnership may exist because the laws of the relevant foreign territory will not permit the LLP to operate there.

To ensure that profits can flow between the LLP and foreign partnership, there will be at least one member common to each entity (sometimes referred to as a “valve partner”); this member may draw out profits from the foreign partnership to top up the payments to be made to the members of the UK LLP (or may receive additional amounts from the UK partnership to top up the valve partner’s profit share). Amounts received from the UK LLP will fail Condition A if they are variable by reference to the profits of the UK LLP.

It should be noted that this guidance only relates to the treatment of amounts under the rules relating to treatment of Salaried Members. The tax position of this kind of arrangement generally involves other issues which are not covered in this guidance.

1.3 Global profits

Example 8

This example shows that where the size of the global profit cake varies by reference to the UK LLP’s profits then the reward derived by the members of the UK LLP may still be affected by the level of the UK LLP’s profits.

Z is an Australian law firm with an LLP “subsidiary” operating in London, which is highly profitable. Z LLP cannot operate directly in Australia for legal reasons. Instead, the business in Australia is operated through a general partnership Z GP.

The two firms work closely together and the members of the Z LLP are to be rewarded by reference to the global profits of Z (including the LLP).

There is a member Y who is a member of both Z LLP and Z GP whose role is to act as valve partner.

The UK profits are expected to be a sizable proportion of the global profit, but it is highly likely that the valve partner (Y) will be used to transfer profits from the Z LLP to Z GP in Australia.

The members of Z LLP fail Condition A because:

- their reward for services is not a fixed sum;
- their reward for services is affected by the amount of the UK profits (even though it is also affected by the profits of Z in Australia); and
- their reward will in practice be affected by the amount of the Z LLP profits.

1.4 Cost plus basis

If the profits of the UK LLP are calculated on a cost plus basis, then Condition A is satisfied as the level of profits vary with the rewards to the members rather than the members receive a reward that varies with the profits of the LLP.

Example 9

This is illustrated in the following example.

P and Q are members of P&Q LLP which is a fund manager associated with a US firm. All fund management fees are paid directly to the US firm.

P and Q provide services to the US firm and agree at the end of the year that based on the profits of the US firm, £300,000 will be allocated to P&Q LLP as their remuneration, in addition to an amount equal to the costs of the business of £500,000. The LLP has agreed a 'costs plus' basis with HMRC and therefore the profit taxable in the UK will also include an additional £80,000 (i.e. a 10 per cent mark up on costs including the members' remuneration).

The £300,000 is not in practice variable by reference to the overall amount of the profits of the UK firm because it is set according to the profitability of the associated firm. Therefore it is disguised salary. Similarly, the additional £80,000 varies according to the members' remuneration and other costs, not the profits of P&Q LLP. P and Q meet Condition A.

Example 10

This example shows that profit shares from other members of the structure are not taken into account.

AA LLP is a UK firm that has set up a business in Australia. AA LLP cannot operate in Australia for legal reasons. Instead, the business in Australia is operated through a general partnership AA GP. The two firms work closely together. A, B & C are individuals who are members of both AA LLP and AA GP.

The Salaried Member legislation looks at the role of the member in the UK body only. In this case, only the position of the AA LLP and not the AA GP will be considered when deciding whether A, B & C are Salaried Members.

Depending upon profit levels in the two firms, A, B & C may draw profits from either body depending on the relative profits of the two firms.

How are the members to be rewarded by the UK LLP?

At the start of the year, the AA LLP must look at the individuals and decide if Condition A is going to be satisfied:

A & B work for AA LLP, they each receive a salary of £100,000 plus a proportion of the profits of AA LLP. On the basis of the business plan for the combined operation, they are expected to receive profit shares of £250,000 each from AA LLP; in addition, A is expected to receive £25,000 from AA GP.

Ignoring the share that A expects to receive from AA GP, A & B do not satisfy Condition A and are not Salaried Members.

1.5 Performance of services

C is based in Australia but she receives a profit share from the UK where AA GP makes insufficient profits. AA works full time as a member of AA GP, not for AA LLP.

In this case, C does not receive her profit share for working for AA LLP; hence she is not a Salaried Member as she does not receive a sum for working for the UK LLP.

Example 11

This example illustrates profits earned by a partner in a UK firm from an overseas firm.

Z is a member of XT UK LLP, the UK arm of a global business with its headquarters in the US. Z receives a fixed amount from XT UK LLP. Z also receives a share of the global business' profits by virtue of being a member of XT US LLP, the US parent entity.

The share of the profits she receives is expected to be more than 20% of the total amount she receives from the global business.

The Salaried Member legislation is applied at the UK LLP level. It considers the role of Z in XT UK LLP, not the global body. Z receives a fixed amount from XT UK LLP, hence she satisfies Condition A.

The amount Z receives from XT US LLP is not taken into account in deciding whether or not she is a Salaried Member. The status of Z in XT US LLP is decided under the partnership test at BIM82005⁴.

1.6 Capital of the LLP

The legislation looks at the UK LLP in isolation. As a result, capital invested in another member of the structure is not taken into account, even if the UK LLP receives funding from that body.

Example 12

This example shows how HMRC would look at the LLP in isolation.

The ABC US LLP is the worldwide "parent" of the ABC firm, which operates in the UK through the ABC UK LLP and which it funds through a mixture of capital and loans.

A is a member of a US LLP, who is seconded to work in the UK, becoming a member of the UK LLP.

A has capital invested in ABS US LLP but not ABS UK LLP.

⁴ See HMRC's guidance published on its website: <http://www.hmrc.gov.uk/manuals/bimmanual/BIM82005.htm>

As the test applies to the UK LLP in isolation, A satisfies Condition C as he has contributed no capital to ABS UK LLP.

1.7 Significant influence

The significant influence condition, Condition B is applied at the level of the UK LLP.

The test is applied on the basis of the rights and duties under the LLP Agreement. Whilst the board of the body at the head of the structure may express their views and it is reasonable for the members of the UK LLP to take those views into account, ultimately the influence rests with those members of the UK LLP identified in the LLP Agreement, subject to the management being carried out in accordance with the agreement.