Partnerships: A review of two aspects of the tax rules

Technical Note and Guidance
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Contents

1	Introduction	3
2	The Salaried Members Legislation	4
3	Partnerships with Mixed Membership	24
4	Alternative Investment Fund Managers: Deferred Remuneration Etc	41
5	Transfers of Assets and Income Streams through Partnerships	54

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1. Introduction

On 20 May 2013, HM Revenue and Customs (HMRC) issued a document[1] consulting on the detailed design of the change proposals to tackle tax loss in the areas below:

a) **Disguised employment in Limited Liability Partnerships (LLPs)**

New legislation will be introduced to tax individual LLP members who are in substance employees of the LLP ('Salaried Members') as employees.

b) **Tax-motivated allocation of business profits & losses in partnerships**

New legislation will be introduced to remove the tax advantages gained through tax-motivated:

i) profit allocations to non-individual partners;
ii) loss allocation to individual partners; and
iii) transfers of assets or income streams through partnerships.

The legislation now published also includes new provisions to deal with certain tax consequences of the Alternative Investment Fund Managers Directive (AIFMD) (2011/61/EU). The consultation closed on 9 August 2013.

All four pieces of legislation – disguised employment, mixed membership partnerships (profits/losses), AIFMD and asset disposals - will be included in the Finance Bill 2014 and will take effect from 2014/15. To prevent avoidance, certain provisions in the mixed membership rules come into force from the date they were first published (5 December 2013). The full set of draft legislation was published on 10 December along with a consultation response document, explanatory notes and this note.

This note provides guidance on the legislation and explains how it will work by reference to practical examples. It will, in due course, form the basis of guidance to be included in HMRC Manuals.

HMRC invites comments on this guidance, including in particular further practical examples which it would be useful to incorporate.

Following the extensive consultation already undertaken, the Government would not expect to make significant changes to the published legislation, although comments on technical details would be welcome.

However, in relation to the Salaried Members legislation, HMRC would welcome comments on whether there are further scenarios the guidance should cover or on any clarifications that should be included in the legislation itself. In particular, HMRC would welcome comments on whether Condition C (capital contributions) of the Salaried Member legislation can be simplified, whilst continuing to deliver the policy objectives.

[1] HMRC published a consultation document, *Partnerships: A review of two aspects of the tax rules,* on GOV.UK website: https://www.gov.uk/government/consultations/a-review-of-two-aspects-of-the-tax-rules-on-partnerships

2. The Salaried Members Legislation

A guide to this chapter

2.1. What is this about?
2.2. Interpretation
2.3. Overview
2.4. The test and conditions
2.5. General examples
2.6. Anti-avoidance
2.7. Deductions in respect of salaried members
2.8. Returns
2.9. Capital assets

2.1. What is this about?

As was explained in the consultation document, there is evidence that LLPs are increasingly being used and marketed to avoid employment taxes.

LLPs set up under UK legislation are bodies corporate that combine the organisational flexibility of traditional partnerships with the benefit of limited liability for their members.

The policy intention when LLPs were introduced was that they would be treated for tax purposes as if they were traditional partnerships rather than being subject to corporation tax as would be normal for a body corporate.

This means that individual members are taxed on their share of the profits of the LLP, in the same way that individual partners in a traditional partnership are taxed.

However, the rules on who can be a member of an LLP are wider than those for a partner in a traditional partnership. Consequently a number of LLPs have adopted reward strategies for their members that are modelled on those for employees rather than partners.

The result is that many LLPs have members engaged on terms more closely resembling those of employees, who work for the business, than of traditional partners, who carry on the business.

The Salaried Member legislation is being introduced so that those members who are effectively in the position of employees will be taxed as employees whilst those members who are in a position equivalent to partners will continue to have the same tax treatment as partners.

2.2. Interpretation

CTA means the Corporation Tax Act 2010

ITA 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.

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

2.3. Overview

This section gives an overview of when a member of a LLP is treated as an employee for tax purposes.

The Salaried Member test consists of three conditions which, if met, deem the member to be an employee (a Salaried Member) for tax and national insurance purposes.

Condition A considers the manner in which the individual is rewarded for his or her performance of services to the LLP. A Salaried Member will have a reward package that is largely that which an employee would have. This means they will be substantially remunerated through a fixed salary or a variable bonus based on their performance, rather than a share of the profits of the overall business; for more detail on this point, see section 2.4.2 below.

Condition B ensures that an individual will not be a Salaried Member if he or she has a significant say in the running of the business as a whole; see section 2.4.3 below.

Condition C looks at the capital contribution made to the LLP by the individual. A partner in a traditional partnership risks losing money if the business fails. To reflect this, an individual will not be a Salaried Member if he or she has invested an amount of money in the LLP that is at least 25% of their expected income from the LLP, which is fixed or variable income for a tax year as described under Condition A. For further information on this, see section 2.4.5 below.

To summarise, if an individual is a member of an LLP and:

- the reward for their performance of services as a member of the LLP is fixed, or variable without reference to the firm's profits, rather than a share of the profits of the LLP as a whole,
- they have no significant say in the running of the business as a whole, and

- they have no significant money investment in the business.

then that individual is a Salaried Member and will be treated as an employee, subject to PAYE and to tax on any benefits in kind.

There is anti-avoidance legislation on Salaried Members to counteract attempts to circumvent the new rules. An overview of this legislation is at section 2.6 below.

2.4. The test and conditions (S863B)

2.4.1. How does it work?

The Salaried Member provisions are intended to apply to those members who are more like employees than partners in a traditional partnership. The overall approach of these provisions is intended to be similar to the wide-ranging tests that would be applied in determining whether a particular person was a partner in a traditional partnership, but differences will occur as the provisions apply a mechanical approach to the most significant factors in order to provide a more certain outcome.

The starting point is to look at the terms and conditions for that particular member. These will be set out in the LLP Agreement. HMRC has set out guidance on the LLP Agreement in the Business Income Manual at BIM82112.

In looking at whether a member is a Salaried Member, the agreement between the member and the LLP by which that member joined the LLP (including the agreement constituting the LLP if it is different), will be important together with any side agreements that the member has entered into.

The Salaried Member legislation sets out three conditions. In order for an individual to be classified as a Salaried Member, **all three conditions** must be satisfied.

The Salaried Members rules only apply to LLPs formed under the LLPA. They do not apply to general partnerships or to limited liability partnerships formed under the law of jurisdictions outside the UK, even if the firm is operating in the UK. In these cases, the general law (and not the Salaried Members legislation) will apply to determine the status of an individual as an employee or partner.

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

The Salaried Member provisions are intended to apply to those members who are more like employees than partners in a traditional partnership.

Condition A is the most significant of the three Conditions that determine whether an individual is a Salaried Member. It is intended to identify those members who, at first sight, are working for the LLP on terms that are like those of employees; that is, they are paid for their services without reference to the overall profitably of the firm.

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

The Salaried Member provisions only apply where an individual is working for the LLP.

This means that the Salaried Member provisions do not apply to:

- companies; or
- individuals who do no more than invest money.

b. Capacity

In addition, the individual has to carry out that work 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.

There is anti-avoidance legislation that counters artificial attempts to separate the work of the member from the LLP: see section 2.6 below.

Example 1:

> *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 satisfied. 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 .

c. Wholly or substantially wholly (S863B(1)(b))

Condition A is met if the member is working for the LLP and it is reasonable to expect that the payment for their services will be wholly or substantially wholly in the form of what is called a "*disguised salary*".

Substantially wholly is not defined in the legislation. In practice, HMRC would consider Condition A to be met if 80% or more of the amounts payable to the individual for services to the LLP are expected to be in the form of a disguised salary.

d. Reasonable to expect (S863B(1)(b))

It is important to note that the condition is framed in terms of the amounts that it is reasonable to expect the LLP to pay to the member. This is a question that should be answered by reference to the substance of the matter taking a realistic view of the facts.

Those rewards that are unrealistic and are unlikely ever to be triggered are ignored.

The question of when something is realistic is considered at point k below.

e. Disguised salary (S863B(2))

The legislation sets out what is a disguised salary:

> *"An amount is "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."*

A disguised salary comprises amounts that are independent of 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 - for more information on "personal performance", see point g;
- a bonus based on a member's personal performance rather than the success of the business - for more information on "personal performance", see point g;
- guaranteed profit - for more information on guaranteed profits, see point j;
- non-refundable drawings - for more information on when drawings are treated as a disguised salary, see section point j.

Example 1A:

> *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 what are the terms governing the remuneration committee's exercise of its discretion in determining the bonus payable. If the bonus is paid out of shares of the profit, then that is a share of the profit for the purposes of the legislation.

In this case, more information is needed - what are the terms of reference for the committee? How realistic is it that any profit share will be 25% or more than the fixed salary of £100,000 (such that 80% of the total rewards will be).

f. Profit share (S863B(2)(b))

Condition A is not met if it is expected that the member will be largely rewarded by a share of the profits of the business carried on by the LLP.

A share of the profit of the business does not include a bonus by reference to the success of a particular sector, such as a shop, or how well an individual's own client portfolio has done. It is by reference to the business as a whole.

g. Personal performance (S863B(2)(b))

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

A bonus based 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"*

This guidance looks at examples to illustrate the distinction between rewards for personal or team success as opposed to share of a profit of the business.

h. Performance pay

If a member is paid a fixed amount plus a bonus on the basis of the success of a particular branch or unit (but has no further reward), then Condition A is satisfied.

i. 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"*

Partners carry on a business in common and receive shares of the profits, not shares of the turnover.

Example 2:

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 2A***:**

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 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.

j. Guaranteed profits and drawings

A disguised salary includes both fixed amounts and amounts that are determined without reference to the level of profits or losses for the LLP as a whole.

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

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. It may be theoretically possible that a member is required to repay part of their drawings, or that the firm may make a loss, but if these are unlikely events, they will be ignored.

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

- *Member A is entitled to draw a salary of £10,000 a month.*
- *Member B is entitled to draw £10,000 a month. Under the terms of the agreement, he cannot be required to repay the money once drawn.*
- *Member C has a guaranteed profit of £120,000 a year.*
- *Member D is entitled to draw £10,000 a month. Realistically D will not be asked to refund this sum.*

The reality is that all four members are entitled to £120,000; the level of profits does not affect this part of their reward package.

Example 3:

> *A is a member of the ABC LLP. Part of his reward package is that he is allowed drawings of £10,000 a month. Under the terms of the agreement he does not have to refund this, even if the LLP makes a loss.*

A is treated as receiving a disguised salary of £120,000 as he will receive this irrespective of the profit of loss.

> *B is also a member of the ABC LLP. B can draw £10,000, but this is only an advance on his profit share. If the profit, after payment of non-refundable drawings of other members, is insufficient he will need to repay money to the LLP. If his share of profit is in the end more than £10,000 he will be entitled to a further payment.*

B's drawings are not a disguised salary. The timing of payments is not relevant to Condition A.

k. Practical likelihood (S863B(2)(c))

The Salaried Member provisions look at the expected amounts payable to that individual member. It is important to identify the real package on offer.

If the agreement provides for a member to receive a share of the profit or loss but it is not reasonable to expect that those terms will have any practical effect, then these terms are ignored.

Example 5:

> *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.*
>
> *Any loss would fall to Member D, who will receive the first £125,000 of profits after payment of salaries. Profits above that 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 profit share at all, the profits need to be in excess of £200,000.

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 be significantly affected by the level of profits and Condition A is satisfied.

I . Apply the test on the facts at that time

The test depends on how realistic the allocations are at the time of the agreement.

If we look again at example 5:

> *The business plan suggests that it is realistic that Members A, B & C will receive sufficient profit share so that they are not Salaried Members. However, heavy rain washes part of the road away restricting access, so turnover is a fraction of forecast. Members A, B & C only receive their salaries and no profit share.*

The test is not revisited with the benefit of hindsight. Although as events have turned out they have received only a salary, this is only the result of a chain of unforeseen events. As they expected and intended to mainly have a profit share, they are not Salaried Members.

2.4.3. 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 in section 863B (4) 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.

Condition B is in essence looking at the role played by the individual in the business. Put simply, can it be said that the individual is the business rather than merely working for the business?

The affairs of the partnership to be considered are more than voting for the managing committee or the firm’s accounts and look at whether there is significant influence over the business, as a whole, rather than individual components of the business.

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

Example 6:

> *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.

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.

a. Hierarchy of members

The terms under which people become members will vary. It is not uncommon for there to be almost 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.

b. Management committee

Some LLPs delegate 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.

Example 7:

> *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 B will not need to be considered; E will not be treated as a salaried member.

c. 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 may be a Salaried Member.

2.4.4. 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 there is a change of circumstances that mean that the result may change.

Example 8:

> *A currently satisfies Condition A, 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 9:

> *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.

2.4.5. 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.

a. The time at which it is determined whether Condition C is met

The initial time at which the test in Condition C is applied is set out at sub section (7), which states:

> *"The question of whether condition C is met is to be determined.*
> > *(a) at the beginning of the tax year 2014-15 or, if later, the time at which M becomes a member of the limited liability partnership;*
> > *(b) after that, at the beginning of each tax year."*

The test is also applied if there is a change in the year, subsection (8) states:

> *"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.

b. What is the contribution? (ITA/S108 and ITTOIA/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.

- It does not take into account sums that the individual may be called upon to pay at some future date.

- It does not take into account undrawn profits unless by agreement they have been converted into capital.

- It does not take into account sums that are held by the LLP for the member, for example, sums held in a taxation account.

- It does not take into account amounts of capital that are part of arrangements to enhance the amount of capital 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 10:

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 (ITA/S108(5)(C)). P cannot withdraw either the sum described as capital or that described as a "loan". These are both intended for the long term financing of the firm. P has capital of £60,000.

c. 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 (subsection (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 11:

M is appointed a member three months into the tax year. His reward package means that he we 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 x 100 = 30%).

However, he will only be a member for 9 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 x (9/12) = £9,000.

When we apply the test using this reduced figure (9,000/40,000 x 100 = 22.5%), Condition C is satisfied.

d. A change in the contribution part way through the year

As mentioned under point (a) above, 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, with the result that Condition C is from that time no longer met. However, the Condition will continue to be met unless it is reasonable to expect that the Condition will remain not met for the rest of the tax year. 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 incurs part way through a tax year.

2.5. General examples

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

To ensure that the examples are as realistic as possible, they have been based upon the scenarios put to HMRC as part of the consultation over the summer.

Example 12:

It is important to look at the specific facts.

> *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 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.

Example 13:

B LLP is similar to A LLP, but only the 5 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 £1000.*

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 reward package for the tax year.

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 10 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.

So in two similar businesses, no member of A LLP is a Salaried Member as all receive only profit shares.

Only 10 members of B LLP are not Salaried Members, the five who both receive profit shares and have control and five others who have significant control.

Example 14:

> *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 the first charge.*

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 a discretionary bonus, not linked to the profits. 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 15:

> *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.*
>
> *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 real say in 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 is not a Salaried Member as she now does not satisfy Condition B.

2.6. Anti-Avoidance (S863C)

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.

2.6.1. Avoidance arrangements (S863C(1))

In deciding whether an individual is a Salaried Member, any arrangements are ignored where they have been put in place with a main purpose of ensuring that someone is not a Salaried Member.

This applies whether the arrangements have been put in place for one, or for a group of members.

Example 16:

W is a junior member of the ABC LLP and she has only a nominal capital invested. 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 17:

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 been put in place to enable P to become a full member of the DEF LLP. They have not been put in place to enable P to evade being a Salaried Member. P faces genuine risk, she has invested in the DEF LLP and does owe the Bank money, 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.

2.6.2. 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 18:

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, the result is that the sum due to J Ltd is treated as payable to J, and PAYE should be operated accordingly.

2.6.3. 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 (S850C).

2.7. 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.

The result is 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 normal accounting practice (SORP), a specific statutory deduction is available for tax purposes as explained below.

2.7.1. 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.

2.7.2. Investment companies

This section looks at the position where the profits of the LLP under CTA09/S1259 are calculated as for an investment company.

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.

2.8. 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 that they are a Salaried Member.

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

2.9. 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 National Insurance contributions (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, such as 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.

3. Partnerships with Mixed Membership

A guide to this chapter

3.1. What is this about?
3.2. Interpretation
3.3. Excess profit allocation:
- 3.3.1. Overview
- 3.3.2. Introduction – Key features
- 3.3.3. When does the legislation apply?
- 3.3.4. Non-individual partners
- 3.3.5. Appropriate notional profit
- 3.3.6. Enjoying the profit
- 3.3.7. The profit shares
- 3.3.8. The relevant tax amount
- 3.3.9. Deferred profit arrangements
- 3.3.10. Reallocating the profit
- 3.3.11. Payments from the non-individual to the individual
- 3.3.12. General examples
- 3.3.13. Interaction with AIFMD deferral arrangements
- 3.3.14. Anti-avoidance
- 3.3.15. Commencement

3.4. Excess loss allocation
- 3.4.1. Overview
- 3.4.2. When do the loss restrictions apply?
- 3.4.3. Which losses are affected?
- 3.4.4. What is the effect of the restrictions?
- 3.4.5. Transitional Provisions

3.1. What is this about?

One attraction of partnerships and LLPs is that they are seen as offering greater flexibility than other business structures, such as limited companies. Sometimes individual partners/members try to use the flexibility of partnerships and LLPs to obtain a tax advantage, using mixed membership partnerships. Draft legislation published with this note counters the following tax-motivated arrangements:

a) Excess profit allocation

Individual members may reduce their tax liability by diverting all or part of their profit share to a non-individual member who will pay less tax on that profit share, usually a company. The rules allow the profit sharing arrangements agreed by the partners/members to be over-ridden so that individual members are taxed on profits that have been diverted in such circumstances. The legislation does not apply to mixed membership partnerships in which the individual and non-individual partners are genuinely acting at arm’s length.

b) Excess loss allocation

Tax avoidance arrangements may be entered into with a view to individual members being allocated losses of the partnership in order for them to be able to claim relevant loss relief to reduce their total tax liability. The rules ensure that relief for the losses will be restricted in such cases.

This part of the note explains how these provisions work.

3.2. Interpretation

All terms included in section 2.2 (Salaried Members Legislation: interpretation) apply.

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

AIFMD’ means the Directive on Alternative Investment Fund Managers (Directive 2011/61/EU).

FCA means Financial Conduct Authority.

Non-individual means any person other than an individual. It includes an individual acting as trustee.

3.3. Excess profit allocation

3.3.1. Overview

This section provides an overview of the legislation.

The legislation applies where there is a mixed membership partnership or LLP.

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

a. Summary of when the legislation applies

The legislation applies where the partnership or LLP makes a profit for tax purposes, a profit share is allocated to a non-individual partner and either:

- the profits represent deferred profit of an individual member (“A”), or
- an individual partner (A) meets the “power to enjoy” condition set out in section 850C(18) to (20) in relation to any element of the profit share allocated to the non-individual partner (“B”)..

For further information on this point, see section 3.3.6.

In both cases, it must be reasonable to assume that A’s profit share is less than it would be apart from the profit deferral arrangements or the circumstances that lead to

the power to enjoy condition being met, and that, overall, less tax is paid because of the allocation of profits to the non-individual.

b. Summary of what the legislation does

Instead of being taxed on their profit shares as allocated), the shares are adjusted so that:

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

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

In cases other than deferred profit arrangements (for which it is not relevant), the maximum additional profit that the individual can be taxed on is the difference between the appropriate notional profit for the non-individual and the profit allocated to that non-individual (the non-individual's "excess profit"). For further guidance on what is the appropriate notional profit, see section 3.3.5.

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

If the profit shares of a number of individuals have been allocated to the same non-individual member, then the difference between the excess profit is reallocated amongst the individual partners on a just and reasonable basis. This would, in practice, depend on the facts but, in the absence of evidence that some other basis of apportionment is appropriate, the starting position would be that the excess profit should be reallocated in the same proportions as the actual allocated profit shares in that period.

For examples on how the legislation works, see section 3.3.12.

For guidance on what to do when the money passes from the non-individual to the individual, see section 3.3.11.

There is anti-avoidance legislation which applies where people try to avoid this legislation by the use of intermediary structures, see section 3.3.14.

3.3.2. Introduction – key features (S850C)

The excess profit allocation rules apply where profits are diverted from the individual member to a non-individual member.

The guidance on when the legislation applies can be found at section 3.3.3.

The guidance on calculating the amount of profit that is re-allocated is at section 3.3.10.

The reallocated profits are taxed on the relevant individual member(s), but the profits remain in the hands of the non-individual member. The legislation allows for the profits to pass from the non-individual member to the individual without further tax being due. For guidance on this, see section 3.3.11.

For examples on how the legislation works, see section 3.3.12.

Guidance on how this legislation interacts with the legislation on AIFMs can be found at section 3.3.13.

There are provisions that prevent people from avoiding the impact of the legislation. The guidance on this can be found at section 3.3.14.

Guidance on commencement provisions is at section 3.3.15.

3.3.3. **When does the legislation apply?** (S850C (1)-(5))

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

The legislation applies where:

- in a period of account, a partnership has a taxable profit;
- a share of the profit is allocated to a non-individual member;
- Condition X or Y is met; and
- as a result, an individual member's profit share and the relevant tax amount is lower than it would be had the profits been allocated to that individual instead (see section 3.3.8).

The legislation sets out Conditions X and Y as follows:

> *"Condition X is that it is reasonable to suppose that -*
> *(a) amounts representing A's deferred profit (see subsection (8)) are included in B's profit share, and*
> *(b) in consequence, both A's profit share and the relevant tax amount (see subsection (9)) are lower than they would otherwise have been.*
>
> *Condition Y is that -*
> *(a) B's profit share exceeds the appropriate notional profit (see subsections (10) to (17)),*
> *(b) A has the power to enjoy B's profit share (.A's power to enjoy.) (see subsections (18) to (20)), and*
> *(c) it is reasonable to suppose that -*
> > *(i) the whole or any part of B's profit share is attributable to A's power to enjoy, and*
> > *(ii) both A's profit share and the relevant tax amount (see subsection (9)) are lower than they would have been in the absence of A's power to enjoy."*

In brief, Condition X applies where amounts representing the individual member's deferred profit are included in the non-individual member's profit share (see section 3.3.7).

.
Condition Y applies where:

- the non-individual member's profit share exceeds its appropriate notional profit (see section 3.3.5 below);
- the individual member has the power to enjoy the profit share allocated to the non-individual member (see section 3.3.6 below); and
- it is reasonable to suppose that the non-individual member's profit share is, in part at least, attributable to the individual member's power to enjoy it (see section 3.3.7 below).

There are also anti-avoidance provisions to counter arrangements designed to circumvent the rules. For guidance, see section 3.3.14.

3.3.4. **Non-individual partners** (S850C (6))

A non-individual partner is simply anyone other than an individual.

As a result, the term non-individual partner includes companies, partnerships, LLPs and individuals acting as trustees.

Example 19:

> *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, with a number of individuals being members of both AA LLP and AA GP.*

AA LLP is not a mixed membership partnership. All the members are individuals. The legislation does not distinguish between a member resident in the UK and one resident abroad.

Example 20:

> *The INV LLP has a property business. It has 15 individual members, including X. In addition to being an individual member, X is also a member as Trustee of the XXX Settlement.*

The INV LLP is a mixed membership partnership as it has 15 individual members and X in his capacity as trustee of the XXX Settlement.

a. **Alternative Investment Fund Managers (AIFM)** (S863D)

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

For further information, see the AIFM guidance at Chapter 4.

3.3.5. Appropriate notional profit (S850C (10)-(17))

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

The appropriate notional profit is made up of two elements:

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

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

The appropriate notional return on capital is simply a commercial rate of interest on the capital contributed. This is not a specific rate as the appropriate commercial rate will vary:

- The commercial rate will reflect the level of risk involved.
- Where the level of capital varies during the relevant period of account, the notional return must be calculated from time to time and on these varying amounts.

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

Example 21:

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

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

b. The appropriate notional consideration for services (S850C (15))

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

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

If any services provided involve other members of the partnership, then the value of these services is not included in arriving at the notional return (Section 850C(16)).

Example 22:

> *Continuing with the example 21 above, B Ltd is a member of ABC LLP and provides advertising services for ABC LLP. The work is carried out by A, who is also a member of ABC LLP. B Ltd provides no other services to ABC LLP.*

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

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

3.3.6. Enjoying the profit (S850C(18))

For the legislation to apply, the individual has to be in a position to enjoy the profit that has been allocated to the non-individual member.

The test for whether the individual can enjoy the profits allocated to the non-individual member is widely drawn.

A person has the power to enjoy profits of another if either of two conditions is met:

- the parties are connected, or
- any of the enjoyment conditions are satisfied.

a. Connected parties (S850C(18)(a))

The individual is in a position to enjoy the profits of the non-individual partner if they are connected persons within the definition at ITA07/S993, other than simply being connected through being partners.

Example 23:

> *A and A Ltd are the members of A LLP. A controls A Ltd.*

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

If they are only connected under ITA07/S993(4) (as partners in the same partnership), then the individual is not in a position to enjoy the profits under the connected person test.

Example 24:

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

A and B Ltd are only connected by being fellow partners in the AB partnership. As such, they are not connected and the excess profit allocation rules do not apply.

b. Enjoyment conditions (S850C (19))

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

Example 25:

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

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

3.3.7. The profit shares (S850C(3)(c))

In cases where profit deferral arrangements are in place, the legislation will apply if it is reasonable to assume that the individual member's share of the firm's profit is smaller than it would otherwise have been as a result of those arrangements.

In cases where the power to enjoy condition is met, then it must also be reasonable to suppose that the profits of the non-individual partner are higher because of the individual's power to enjoy them.

The individual may have an interest in the non-individual partner but this may be so small that it is clear that the profit share has not been altered as a result.

Example 26:

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

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

If the particular facts show that any economic connection between the individual and non-individual members does not result in profit being shifted from the individual partners to the non-individual, the mixed membership partnership legislation will not apply.

One example is where the non-individual partner has been carrying on the trade for many years before it is transferred into an LLP.

Example 27:

> *Oldco Ltd had been trading for many years. A few years ago P, the owner of Oldco Ltd decided that he wants to retire He set up an LLP, whose members are P, Oldco Ltd and a number of individuals whom he hoped would take over the business.*
>
> *Oldco Ltd receives the profit share agreed when the business was transferred to the LLP. This share reflects its founding role in the business and is based on the fact that it contributed the business to the LLP.*
>
> *P receives a small personal profit share that is commensurate with the work he does.*

The facts show that Oldco Ltd receives a profit share reflecting the fact that it transferred its business to the LLP (and that the same profit share would have been received by Oldco Ltd if P fully withdrew from the business, including as an LLP member). Looking at these facts, the legislation would not apply.

3.3.8. Relevant tax amount (S850C(2)(b))

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

a. Relevant tax amount (S850C(9))

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

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

Example 28:

> *The PQR LLP only has individuals as members, so it is not a mixed membership partnership.*
>
> *The members decide to ring-fence a new business venture. They set up Sub LLP. The members of Sub LLP are PQR LLP and those individual members of PQR LLP involved in the project.*
>
> *Profits allocated by Sub LLP to PQR LLP are in turn allocated to the members of that firm all of whom are individuals resident in the UK.*

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

3.3.9. Deferred profit arrangements (S850C(2))

The mixed membership partnership legislation also applies where profits are not allocated to the individual, but instead are held back for whatever reason, and are initially allocated to a non-individual member instead, with the result that the tax paid in that period is lower than it would have been if the profits had been allocated to the individual.

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

Example 29:

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

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

The AIFMD, its (non-tax) legislation and the FCA rules may prevent AIFMs from accessing their profit shares. There are special provisions for the deferred profit shares of these individuals. For guidance on this, see Chapter 4.

3.3.10. Reallocating the profits (S850C (4))

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

a. Increase in the individual's profit share

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

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

In cases other than deferred remuneration arrangements, there is a limit to the amount by which the individual's profit share can be increased.

This limit is the amount by which the non-individual partner's profit share exceeds their appropriate notional profit, i.e. the excess profit. For guidance on the appropriate notional profit see section 3.3.5.

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

Often the same non-individual partner will be allocated the profit shares proper to a number of individual partners, for example, where there are deferred profit arrangements for a group of individuals.

Where the same non-individual partner is allocated the profit shares proper to a number of individual partners, the limit by which a particular member's share can be increased is the amount by which that individual's share is lower than it would have been absent the power to enjoy or the existence of profit deferral arrangements.

However, the total amount to be reallocated to individuals cannot exceed the excess of non-individual member's actual profit share over its appropriate notional profit return. If the total exceeds this amount, then the profit that can be reallocated is split between the individual members on a just and reasonable basis. As noted above, in the absence of other detail, the starting position would be that the excess profit should be reallocated in the same proportions that those individuals have actually been allocated profit shares in that period.

b. Adjustments to non-individual's profits (S850C(5) and CTA/S1264A)

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

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

3.3.11. Payment from the non-individual to the individual (S850E)

Although profits may be reallocated for tax purposes, the reality is that the relevant profit share was allocated to the non-individual member. At some point, the money will need to pass to the individual. The legislation provides a rule to prevent the same profits being taxed twice.

If under an agreement:

- the non-individual makes a payment, or series of payments, to the individual out of the profit share allocated to the non-individual, and
- the payment, or series of payments, does not exceed the additional amount that the individual was taxed on,

then the payment is not taken into account for calculating the income of either the individual or non-individual.

The sum is not treated as a distribution for tax purposes (S850E(2)(b)).

This rule does not apply if the payment is part of a scheme or arrangement one of whose main purposes is to obtain a tax advantage.

Example 30:

> *A and his company A Ltd are members of the ABC LLP. A has been taxed on £50,000, which had initially been allocated to A Ltd. A Ltd makes a payment of £45,000 to A.*

The sum is paid from the profits allocated to A Ltd; it is less than the sum on which A was taxed.

The sum is ignored for tax purposes; it is not treated as A's income.

3.3.12. General examples

This section provides examples of how the mixed membership partnership rules apply.

Example 31:

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

The individual members are in a position to enjoy the sums allocated to their company.

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

Example 32:

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

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

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

3.3.13. Interaction with AIFM deferral arrangements

The mixed membership partnership legislation is applied before the profit deferral arrangements legislation applicable to Alternative Investment Fund Managers described in Chapter 4 of this note.

Example 32A:

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

The mixed membership partnership legislation applies and this £100,000 is re-allocated to X.

Example 32B:

> *The firm has made an election so that "relevant restricted profits" can be allocated by individual members to the firm*
>
> *The individual allocates their deferred profits of £100,000, allocated to them under the profit allocation rules, to the firm. As the firm is treated as an individual, there is no re-allocation from the firm back to the individual under the mixed membership partnership rules.*

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

3.3.14. **Anti-avoidance** (S850D)

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

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

- the individual (A) carries out work for the partnership or LLP,
- at that time A is not a member/partner
- a non-individual is a member/partner and receives a profit share

- it is reasonable to suppose that A has "the power to enjoy" the profit share allocated to the non-individual or that the profit share includes deferred profits in relation to A; and
- it is reasonable to suppose that A would have been a partner in the absence of the excess profit allocation rules.

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

The "reasonable to suppose" test (i.e. that A would have been a partner but for the excess profit allocation rules) is treated as met if the non-individual member is itself a partnership.

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

Example 33:

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

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

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

Their share of the firm's profit, determined under the mixed membership rules, is chargeable to income tax for the tax year in which the relevant period of account ends. Assuming this period straddles the 6 April 2014 (the date the legislation comes into effect), then this period is split into two notional periods with the latter having a commencement date of 6 April 2104. Only the profits attributable to this latter period will actually be re-allocated to X, Y & Z.

Example 34:

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

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

3.3.15. Commencement

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

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

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

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

3.4. Excess loss allocation (ITA/S116A and S127C)

3.4.1. Overview

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

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

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

3.4.2. When do the loss restrictions apply? (ITA/S116A (3) and S127C (3))

The legislation states that:

> ***"127C Excess loss allocation to partners who are individuals***
> *(1) Subsection (2) applies if -*

(a) in a tax year, an individual ("A") makes a loss in a UK property business or an overseas property business as a partner in a firm, and
(b) A's loss arises, wholly or partly -
(i) directly or indirectly in consequence of, or
(ii) otherwise in connection with, relevant tax avoidance arrangements.
(2) No relevant loss relief may be given to A for A's loss".

These restrictions apply when:

- an individual makes a trading or property business loss as a partner in a firm;
- which arises, wholly or partly, as a consequence or in connection with tax avoidance arrangements to which the individual is a party, a main purpose of which is to secure that losses are allocated or arise to the individual, rather than a non-individual; and
- with a view to the individual obtaining relief for the loss.

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

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

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

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

3.4.3. **Which losses are affected?** (ITA/S116A(6) and S127C(6))

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

3.4.4. **What is the effect of the restrictions?** (ITA/S116A(2) and S127C (2))

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

Example 35:

An LLP has 100 individual members and 1 company member. Each of the individual members introduces capital of £40,000 and the company member provides capital of £60m (total capital £100m). The LLP spends the £100m on an asset that qualifies for 100% upfront tax relief generating a £100m tax loss (but not an accounting loss) in the first year of business but with a significant income stream in later years. The profit sharing agreement provides that:

- *In year 1, all the profits or losses are allocated to the individual members; and*

- *In year 2 onwards, all or most of the profits are allocated to the company member.*

The LLP agreement is written so that the individuals can claim the loss relief. It is clearly one of the main purposes. The excess loss allocation legislation (S127C) prevents the individual obtaining relief for these losses.

3.4.5. Transitional Provisions

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

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

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

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

4. Alternative Investment Fund Managers: Deferred Remuneration Etc.

A guide to this chapter

4.1. What is this about?
4.2. Interpretation
4.3. Overview of AIFM mechanism
4.4. Introduction – key features
4.5. Who is in the scope of the mechanism?
4.6. Interaction with excess profit allocation rules
4.7. Election and profit allocation to the AIFM firm
4.8. Effect of allocation
4.9. Relevant restricted profit: variable remuneration
4.10. Relevant restricted profit: ESMA guidelines
4.11. Vesting: meaning of 'vest'
4.12. Vesting: remuneration in the form of cash
4.13. Remuneration in the form of instruments
4.14. Vesting statements

4.1. What is this about?

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

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

The new AIFM provisions will allow the AIFM partnership or its delegate to elect to pay the tax rather than the individual member. The member then gets a tax credit when the remuneration vests but the member will be liable to Class 4 NICs.

This part of the technical note explains how these provisions work. For a summary of the mechanism, see section 4.3 below.

4.2. Interpretation

All terms included in interpretation sections (2.2 and 3.2) in the last 2 chapters apply.

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

AIFM Regs means the Alternative Investment Fund Managers Regulations 2013 (S.I.2013/1773).

CGT means capital gains tax.

“Deferred remuneration”, “restricted profits” and “variable remuneration” are explained in section 4.9 below

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

FA means Finance Act 2004.

“Instruments” is explained in section 4.13 below.

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

“Partner” includes a member of a Limited Liability Partnership who is not a ‘Salaried Member’.

SPD12 means the Statement of Practice 12 (CG57400)

TCGA means Taxation of Chargeable Gains Act 1992.

TMA means Taxes Management Act 1970.

“Vest” and ”Vesting” are explained in section 4.11 below.

4.3. Overview of mechanism

This section gives an overview of how the mechanism works.

The mechanism will be introduced for the 2014/15 tax year. It will permit members of AIFM partnerships or their delegates to allocate certain “restricted” profits to the partnership. These are profits that represent variable remuneration under the AIFMD other than upfront profits that are received in cash.

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

The balance of the variable profit (i.e. after tax has been paid) will be retained until a particular point (the "vesting date"). If the restricted profits vest in the partner who originally allocated them to the partnership, this individual will be able to claim a tax credit against the tax paid by the partnership upfront. The individual can then set the

credit against tax liabilities or obtain a repayment of the tax, depending on his or her circumstances at the time of vesting.

The upfront charge on the partnership applies only to income tax. No NICs charge will arise until the time when the remuneration vests in the individual partner. The treatment of NICs will be covered in separate NICs guidance to be published. Further information about the mechanism may also be published as required.

The key features of the mechanism are set out in section 4.4. below.

4.4. Introduction - key features

This section introduces the **key features** of the mechanism as set out below along with links to the key topics for this part of the note:

- any partner in an AIFM partnership can allocate all or part of their ”relevant restricted profit” to the firm which elect to use the mechanism (see sections 4.7-4.8 below). Relevant restricted profit is deferred remuneration (within the meaning of the AIFMD) together with any remuneration which is awarded in the form of instruments that must be retained for at a period of at least 6 months (see sections 4.9, 4.10 & 4.13);

- it will charge tax at the additional rate of income tax (currently, 45%) on that income, with no reliefs or allowances to be available to set against it (see section 4.8);

- where the relevant restricted profit ultimately vests with the partner who initially allocated it to the partnership, this is treated as taxable income of the partner in the relevant tax year. Credit will be available for the tax initially paid by the partnership on the profit, and any overpayment of tax may be repaid (see sections 4.11 and 4.12); and

- for capital gains tax purposes, the partner is treated as receiving any securities at a base cost equivalent to the amount of remuneration they represent, net of tax. The same amount is treated as the disposal consideration (see sections 4.13.3 and 4.13.4).

If the deferred remuneration does not vest in the partner who originally allocated the amount to the firm, the payment will be treated like any other partnership distribution. There will be no further tax liability and no entitlement to recover the tax paid on that element of the deferred remuneration (see section 4.12(c)). A power is provided in the AIFM legislation to make regulations if required.

4.5. Who is in the scope of the mechanism?

4.5.1. Which partnerships are eligible? (S863D)

The mechanism applies where an election is made by a partnership which is an AIFM firm with an AIFM trade. For election, see section 4.7.

An AIFM firm is defined as a trade which involves, by reference to AIFM Regs:

- wholly or mainly, managing one or more AIFs, or
- wholly or partly, carrying out one or more functions of a person who is managing one or more AIFs as that person's delegate, or as the sub-delegate of a delegate of that person.

4.5.2. Which partners are eligible? (S863E)

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

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

The meaning of "relevant restricted profit" is discussed in section 4.9.

4.6. Interaction with excess profit allocation rules (S863F(9))

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

One of the excess profit allocation rule, S850E permitting certain adjusting payments under the excess profit allocation rules to be made without tax consequences, is ignored for the purposes of this provision (S863F(9)).

4.7. Election and profit allocation to the AIFM firm (S863D(2))

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

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

The AIFM firm that elects under section 863D to use the mechanism and prescribed information is required. A partner is not required to make a return of income which is allocated to the partnership until the income vests.

4.8. Effect of allocation

4.8.1. Partnership (S863E)

Where a partner has allocated relevant restricted profit to the partnership, the partnership is liable to account for income tax on that profit (S863E (3)-(4)). The allocated profit is excluded from the partner's profit in that period of account.

For this purpose, the AIFM partnership is treated as if it were itself a person who is a member in the AIFM partnership (including LLP). The usual rules then apply to the AIFM firm, including the self assessment requirements and the obligation to pay tax by instalments (S863E (3)-(4)). The AIFM firm will be required to submit a return on its own behalf for the purposes of the mechanism as well as the partnership returns for self assessment purposes.

Income tax is payable on the full amount of the profit allocated to the AIFM firm without any allowances or reliefs such as personal allowances and relief for losses from prior years (S863E(4)(b)).

The rate of income tax applicable is the additional rate of tax (Section 863E(4)(d)).

4.8.2. Partner (S863E)

Any deferred remuneration which is relevant restricted profit and is validly allocated to the partnership is excluded from the partner's profit for that period of account and is accordingly not subject to income tax in the partner's hands until it vests (S863E(3)(a)).

A partner will not be subject to income tax on remuneration within the mechanism which does not vest. The tax consequences where remuneration does not vest are set out in section 4.12.

This treatment applies to deferred remuneration in cash or instruments. Upfront remuneration in the form of cash is not eligible for the scheme. Upfront remuneration in the form of instruments with a retention period of at least 6 months is eligible to be included in the scheme (S863E(6)). See section 4.13 below for more information on the treatment of remuneration in the form of instruments.

4.9. Relevant restricted profit: Variable remuneration (S863E)

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

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

"Variable remuneration" and "deferred remuneration" have the same meaning as in the ESMA Guidelines (S863E(9)).

It is also a requirement that the variable remuneration is awarded in accordance with arrangements which are consistent with the ESMA guidelines – see section 4.10.

The treatment of deferred remuneration in the form of cash is described in section 4.12. The treatment of deferred remuneration in the form of instruments is described in section 4.13.

4.10. Relevant restricted profit: ESMA Guidelines (S863E(7))

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

a. The ESMA Guidelines - Definition

The ESMA Guidelines are defined in S863H as the Guidelines on Sound Remuneration Policies under the AIFMD issued by the European Securities and Markets Authority on 3 July 2013 (ESMA/2013/232).

b. What the guidelines say

The ESMA Guidelines broadly require firms managing cumulative assets exceeding certain limits, to defer 40-60% of the variable remuneration of key staff by up to 3-5 years and pay at least 50% of that variable remuneration in units or shares of the funds they manage, or equivalent ownership interests, rather than cash. The application of the rules is subject to a 'proportionality' limitation, based on size, internal organisation, and the nature, scope and complexity of activities.

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

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

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

c. Application of ESMA Guidelines

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

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

4.11. Vesting: meaning of "vest" (S863F (8))

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

4.12. Vesting: remuneration in the form of cash

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

For the position in relation to variable remuneration in the form of securities, see section 4.13.

In principle, the partner is taxed at the time when the variable remuneration vests, as described below in this paragraph. For the meaning of "vest", see section 4.11. The income is also treated at that time as partnership income for pension purposes. (FA/S189(2B)).

a. Partner still carrying on the trade (S863F(2))

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

"Relevant tax year" means, in the case of cash, the tax year in which the vesting occurs (S863F(5)).

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

The amount treated as profit is the amount received on vesting, grossed up by the income tax payable by the AIFM firm on that amount (S863F(5)). A refund of the tax

credit may be available if the partner has unused allowances and reliefs for the year of vesting after they have been applied against other taxable income of that year. If the rate of tax has gone up, further tax will be payable. If the rate has gone down, tax may be repayable (S863F(6)).

b. Partner no longer carrying on the trade (S863F(2))

Where variable remuneration vests in a partner at a time when the partner no longer carries on the AIFM trade (whether as a partner in the AIFM firm or otherwise), the amount is treated as income received in the relevant tax year chargeable to income tax under Chapter 18 of Part 2 of ITTOIA.

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

c. What happens if remuneration does not vest?

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

- no further income tax is payable beyond the tax already paid or payable by the AIFM firm;
- no one is eligible to claim or recover credit for that tax; and
- no NICs payment will be collected on the profits which do not vest.

4.13. Remuneration in the form of instruments

4.13.1. AIFMD requirements and definition (S863 (6) & (9))

The ESMA Guidelines require 50% of variable remuneration to be paid in the form of instruments. The tax legislation provides specifically for the treatment of instruments with a retention period of not less than 6 months and those forming part of deferred remuneration (S863E(6)(b)). Other instruments will be taxed in accordance with the usual rules (normally, as profit of the period of account in question).

For the purpose of the scheme, 'instruments' has the same meaning as in the ESMA Guidelines (S863E(9)). These define instruments as 'units or shares of the AIFs managed by the AIFM or equivalent ownership interests (including those AIFs issuing only unit-linked instruments), subject to the legal structure of the AIFs concerned and their rules or instruments of incorporation, or share-linked instruments or equivalent non-cash instruments.'

4.13.2. Remuneration in the form of instruments: income tax
(S863E(6))

For the definition of “instruments”, see section 4.13.1 above.

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

Where a valid election has been made, such remuneration in the form of instruments can be allocated to the partnership and excluded from the partner’s return in the same way as with remuneration in the form of cash. See sections 4.7 and 4.8.

A partner will be subject to tax on the remuneration when the right to the instruments vests. The same principles apply as for remuneration in the form of cash. See section 4.12 above.

Example 36 (Remuneration in the form of cash and instruments):

Facts

TDH LLP is an AIFM firm (S863E), consisting of three members, T, D and H Ltd. The LLP has been trading for many years and draws up accounts to 31 December in each year.

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

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

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

A - If no election is made by TDH LLP:

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

on account rules). The actual tax liability will depend on T's other income and reliefs.

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

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

2014-5

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

TDH LLP must make a return and pay income tax on the £800,000 for the year 2014/15 as if it was an individual partner in the firm. TDH LLP should also file its partnership tax return separately in accordance with provisions to be introduced in secondary legislation. Assuming that the additional tax rate is 45%, the total tax payable by the LLP will be £360,000, due on 31 January 2016. The LLP will also need to make payments on account for the year 2015/16, of which £180,000 is payable on 31 January 2016 and £180,000 is payable on 31 July 2016.

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

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

2015/16 onwards

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

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

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

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

4.13.3. Remuneration in the form of instruments: partner's CGT position (TCGA/S59B and S59C)

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

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

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

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

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

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

4.13.4. Remuneration in the form of instruments: partnership's CGT position (TCGA/S59B and S59C)

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

In other cases, the capital gains tax position of AIFM partnerships will follow the general principles set out in SP D12. Assets are treated as being disposed of or acquired by partners for consideration equal to their market value at the time of the allocation. Guidance is included in HMRC's Capital Gains Manual at paragraph CG57400 (SPD12).

Where S59C of TCGA applies (see section 4.13.3 above), there will be a similar effect for the company concerned.

Example 37 (remuneration in the form of instruments):

Facts

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

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

Income tax treatment

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

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

Capital gains tax treatment

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

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

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

X's base cost (to be used in computing her gain or loss on any subsequent disposal) is determined by adding amounts equal to the consideration received by P and S to the cost of X's own one-third share: (2 x £91,666) + £91,666 = £275,000 (rounding errors corrected).

If X sells the units shortly after the vesting date (30 April 2018) whilst they are still worth £5 each, she will realise a chargeable gain of:
(£5 x 275,000) – (£320,833) = £1,054,167.

4.14. Vesting statements (S863G)

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

- the amount of the allocated profit, or the part of it representing the part of the variable remuneration, gross of the income tax for which the AIFM firm is liable in respect of the allocated profit or the part of it;
- the amount of the income tax for which the AIFM firm is liable; and
- so much of that amount as has been paid by the AIFM firm when the vesting occurs.

The partner can enforce a duty to comply with a request under this section (S863G(3)).

5. Transfers of assets and income streams through partnerships

A guide to this chapter

5.1. What is this about?
5.2. Interpretation
5.3. Overview
5.4. When will the legislation apply?
5.5. What is the effect of the legislation?
5.6. What date does the legislation come into effect?
5.7. Examples

5.1. What is this about?

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

5.2. Interpretation

All terms included in the interpretation sections of the last three chapters apply.

5.3. Overview

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

- the transferee is a company and the transferor is an individual,
- the transferee has losses to use whereas the transferor does not,
- the transferee and transferor are subject to different rate of tax, or

- transferor and transferee are subject to differing tax computational rules in relation to the asset or income.

Where there is a disposal of an asset or income stream through or by a partnership and a main purpose is to secure an income tax or corporation tax advantage, the rules will impose a charge to tax on income on the person making the disposal.

The legislation will not apply where the disposal by or through a partnership is from a member to the member's relative.

5.4. When will the legislation apply?

(ITA/S809AAZA & S809DZA for income tax and CTA10/S757A & S779A for corporation tax)

The legislation will apply where:

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

The legislation does not apply where:

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

5.5. What is the effect of the legislation?

(ITA/S809AAZB & S809DZB for income tax and CTA10/S757B & S779B for corporation tax)

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

5.6. What date does the legislation come into effect?

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

5.7. Examples

Example 38 (Transfer of income streams):

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

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

*Example 39 (Transfer of assets**):***

> A company, J Ltd, contributes an asset with an unrealised gain (of a type which if realised would give rise to a charge to tax on income), such as an intangible fixed asset, to a partnership on a tax neutral basis. A new partner, K Ltd, joins the partnership, making a capital contribution equal to the value of the asset. The partnership sharing arrangements are manipulated so that K Ltd had nearly all rights to capital or income until the asset is disposed of, whilst J Ltd has the right to all other partnership assets.

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