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Taxation of Partnerships and LLPs

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Introduction

The Finance Act 2014 introduced a number of changes affecting the taxation of partnerships and LLPs and came into effect on 6 April 2014. The changes have been adopted by new sections being inserted in the Income Tax (Trading and Other Income) Act 2005.

The changes came about as the result of an HMRC consultation published in May 2013 on changes to two aspects of the partnership tax rules: (i) salaried partners; and (ii) mixed memberships, following the Government's announcement in the 2013 Budget that it was proposing to change the tax rules in line with its principles and objectives for fairness and flexibility in the tax system.

In addition to the above, the Finance Act 2014 also introduced a statutory mechanism for partnerships and LLPs operating as AIFMs under the AIFMD permitting members to allocate certain restricted profits to the partnership or LLP.

The above three changes introduced by the Finance Act 2014 can be summarised as follows:

1. Tax-motivated allocation of profits or losses in mixed membership partnerships

The Finance Act 2014 has introduced legislation to counter tax-motivated allocations of business profits or losses in partnerships and LLPs where the partners include both individuals and companies.

There are two parts to the legislation, namely:

(i) measures aimed at mixed membership partnerships where partnership profits are allocated to non-individuals in circumstances where an individual member may still benefit from those profits; and

(ii) measures aimed at cases where partnership losses are allocated to an individual member, instead of a non-individual member, to enable the individual member to access certain loss reliefs.

With regard to (i), the legislation has introduced measures which re-allocate the excess profits allocated to a corporate member to an individual member instead where the following conditions are met:

(a) the corporate member has a share of the firm's profits;

(b) the corporate member's share is excessive;

(c) an individual member has the power to enjoy the corporate member's share or there are deferred profit arrangements in place; and

(d) it is reasonable to suppose that the whole or part of the corporate member's share is attributable to that power or arrangements set out in (c).

Where the rules apply, the individual member's profit allocation will be increased on a just and reasonable basis.

The legislation also includes provision for excess profits to be re-allocated to an individual who is not a member if it is reasonable to suppose (i) that the individual would have been a member but for the new rules and (ii) that the whole or part of the corporate member's share is attributable to that individual's power to enjoy the corporate member's share or to deferred profit arrangements.

With regard to (ii), legislation has been introduced to deny certain income tax loss reliefs and capital gains relief for a loss allocated to an individual member. This will be the case where the individual member is party to arrangements, the main purpose(s) of which is to secure that some or all of the loss is allocated to the individual member, instead of the corporate member, with a view to the individual obtaining relief.

2. Treatment of salaried members

The Finance Act 2014 has not removed the long held presumption that a partner or member is self-employed for tax purposes, but targets 'salaried members' i.e. those members working for an LLP on terms that are tantamount to employment. The Act has introduced provisions to change the treatment of a salaried member from that of a member to that of an employee where the following three conditions are met:

(i) there are arrangements in place under which the member will perform services for the LLP and it is reasonable to expect that at least 80% of the total amount payable by the LLP to the member will be 'disguised salary'. Payments are disguised salary if they are fixed, or if variable, variable without reference to or in practice unaffected by the overall profits and losses of the LLP;

(ii) under the terms of the agreement between the members and the LLP, the member has no significant influence on the affairs of the LLP; and

(iii) the member's contribution to the LLP is less than 25% of the total amount of the disguised salary which it is reasonable to expect that the LLP will pay to the member in the relevant tax year.

All three conditions have to be met for the rules to apply. The rules also apply to an individual providing services to the LLP via a corporate member of the LLP.

HMRC has provided extensive guidance in relation to the salaried members' rules and for the purposes of (i) above, arrangements include any agreement, understanding, scheme or transaction or series of transactions (whether or not legally enforceable). Further, the requirement for the member to perform services for the LLP means that individuals who do no more than invest money or who no longer perform services for the LLP but who continue to receive a profit share (for example, a member placed on gardening leave or a former member receiving an annuity) will not be subject to the salaried member provisions. In addition, the member must provide services to the LLP in his capacity as a member of that LLP and not in another capacity, such as an independent consultant, for example.

With regard to (ii), HMRC considers the following decisions to be relevant in indicating significant influence: the appointment of new partners, decisions regarding where the firm conducts its business, its area of business, acquisitions or disposals, appointment of key personnel, allocation of roles to key staff, strategic decisions and decisions on important financial commitments, management of key contracts, formulating the firm's business plan, approving major new clients or investments and deciding the firm's marketing strategy. HMRC's guidance states that merely having a vote on these matters is not necessarily enough to demonstrate significant influence, but that significant influence is likely to sit with the members of the management committee, although this may not always be the case. There is specific guidance in relation to FCA controlled functions, in that CF3 (chief executive function) and CF8 (apportionment and oversight function) will be regarded as having significant influence.

Where the rules apply, an individual member will be treated as an employee for tax purposes and will be required to pay the appropriate tax and NI contributions accordingly. Employers NI contributions will be payable by the LLP and the costs of employing the salaried member will be deductible from the LLP's profits.

3. AIFMs and deferred remuneration

The AIFM statutory mechanism allows partners and members of partnerships and LLPs which are AIFMs to allocate certain 'restricted' profits to the partnership or LLP. These are profits that represent variable remuneration under the AIFMD other than upfront profits that are received in cash, which the individual is unable to immediately access because of requirements under the AIFMD to defer certain remuneration of key staff.

The legislation provides as follows:

(i) it allows any partner or member to allocate all or part of their 'relevant restricted profit' to the firm. Relevant restricted profit is held to be deferred remuneration (within the meaning of the AIFMD) plus any remuneration which is awarded in the form of instruments that must be retained for a period of at least 6 months;

(ii) where profits are allocated in this way, the partnership or LLP will pay tax at the current additional rate of tax on that income, as though it was the firm's profit, with no reliefs or allowances to be available to be set against it;

(iii) where the profits vest and the individual is able to access them, these will be treated as taxable income of the individual for that tax year with an associated credit of the tax already paid by the partnership or LLP;

(iv) if the profits do not vest in the individual, the payment will be treated like any other partnership distribution. There is no mechanism for the tax to be repaid; and

(v) where the deferred remuneration is awarded in the form of instruments which vest in the individual, the individual is treated as acquiring the instruments for an amount equal to the deferred profit net of income tax paid.

The AIFM firm has to elect for these provisions to apply within six months of the end of the accounting period for which the election is to apply. The relevant partner or member may only allocate all or part of their deferred remuneration to the firm upon such an election being made. The mechanism applies in respect of profits arising from the tax year 2014 – 2015 onwards.

In January this year, HMRC published forms and guidance for partnerships and LLPs wishing to elect for the AIFM mechanism to apply. The two returns consist of the special return and a vesting form. The special return confirms, among other things, amounts allocated to the AIFM partner and the amounts vesting in the tax year, while the vesting form must be used by firms to notify HMRC of a vesting event. The form allows HMRC to check that amounts allocated to the AIFM partner have either vested in an individual member or have expired without vesting and that these events have been taxed correctly.

Next steps

All of these changes are due to come into effect on 6 April 2014, with the exception that the anti-avoidance rules concerning profit allocation set out in paragraph 1 are intended to apply from 5 December 2013.

The tax changes will affect the agreements which partnerships currently have in place and we recommend that firms review their partnership deeds with lawyers as soon as possible.

Cummings Law is able to advise on any necessary changes which need to be made.

If you would like to discuss this further, please contact Claire Cummings at Claire.Cummings@cummingslaw.com or on 020 7585 1406.

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