

# To Our Clients and Friends

# Memorandum



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## *Proposed Changes to UK Tax Treatment of Partnerships and LLPs*

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HMRC published this week a consultation paper entitled “*Review of tax rules on partnerships: disguised employment and profit and loss allocation schemes*” following its announcements in the 2013 Budget, with a view to introducing new legislation in Finance Bill 2014.

The purpose of the consultation is to invite comments from industry members on how to tackle two areas of perceived UK tax avoidance, namely:

- the current treatment of certain members of a UK Limited Liability Partnership (LLP) as self-employed for UK income tax and national insurance purposes; and
- schemes involving manipulation of partnership profit and loss allocations to secure a tax advantage.

The consultation will close on 9 August 2013, and the changes would take effect from 6 April 2014.

### **Disguised employment – “salaried” LLP members**

Under the current rules, individuals who are members of a UK LLP are taxed as if they are self-employed partners of a traditional UK partnership, even if they are engaged by the LLP on terms similar to those of employees.

To create a level playing field between employees and LLP members who are considered “disguised” employees, the Government intends to change the employment tax rules by removing the presumption that all individual LLP members are treated as self-employed partners for UK tax purposes, and instead seeks to tax LLP members as if they were employees if the terms of their engagement are tantamount to employment. The proposals are, broadly, that LLP members would be treated as “salaried members” of the LLP if either (i) they would be treated for UK tax purposes as de facto employees under case law principles, or (ii) they do not share in the economic risks or rewards of the LLP. Under limb (ii) of this test, an LLP member will be a “salaried member” if he or she:

- a) has no economic risk;
- b) is not entitled to a share of the profits; and
- c) is not entitled to a share of any surplus assets on a winding-up.

These changes could affect professional service and asset management firms, for example, which are typically constituted as UK LLPs. It is not clear if these changes might affect the treatment of UK members of non-UK LLPs.

### **Schemes involving a manipulation of partnership profit and loss allocations**

HMRC has seen an increasing number of arrangements involving partnerships (i.e. UK and non-UK LLPs and partnerships) with mixed membership – for example, a company and several individuals – whose profit-sharing ratios are calculated in such a way as to reduce the overall tax paid by the partners/members.

Partners (and LLP members), all referred to here as “members”, are charged to tax on profits allocated to them under the partnership/LLP profit-sharing agreement applicable during the relevant period. The schemes of which the Government has become aware operate to (a) allocate profits to a member (e.g. a company) that pays a lower rate of tax, (b) allocate losses to a member that pays a higher rate of tax, or (c) allow members to reduce their profit entitlement in return for payment made by or benefits provided to other members who will be taxed more favourably on those profits.

To block the use of such arrangements, the Government intends to introduce rules to counteract the income tax advantage obtained by reallocating the profits to the tax-advantaged members as if the actual allocation had not occurred (or, if the partnership is loss-making, by denying the loss relief claimed by the partners).

The Government also intends to introduce measures to prevent schemes in which a member with certain tax attributes (e.g. a tax-exempt body) makes a capital contribution to the partnership for the benefit of, or makes a payment to, another partner without such attributes, in exchange for a transfer of a profit share from the latter, thus minimising the transferring member’s income tax liability without any real economic loss for that member. Such measures intend to tax the payment or the value of the capital contribution received by the transferring member as income.

These new rules would apply to profits and losses arising to partnerships and LLPs on or after 6 April 2014, without any grandfathering for arrangements entered into before that date.

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