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TAXATION OF SALARIED MEMBERS: AN UPDATE FOR ASSET MANAGERS

For more information, please contact the following member of Katten's **Tax Planning practice**.

Sanjay Mehta
+44.0.20.7776.7623
sanjay.mehta@kattenlaw.co.uk

Background

Last summer, HM Revenue & Customs (HMRC) published proposals for major changes to the UK's rules on the taxation of partnerships. The primary aim of the proposals was to counter arrangements which HMRC regarded as tax avoidance—in particular:

(1) *disguised employment* – the appointment of an individual as a member of a UK Limited Liability Partnership (LLP) who could more appropriately be regarded as an employee of the LLP (Salaried Member Rules); and

(2) *mixed member partnerships* – the use of tax-motivated profit and loss allocation schemes by partnerships seeking to utilise the different tax attributes of partners (for example, corporate and individual members) (Mixed Member Rules).

HMRC consulted with the public on the above areas (as well as certain other avoidance arrangements in the context of partnerships), following which it published draft legislation and guidance in December 2013. The response to those drafts from affected industry sectors (principally asset managers and professional service firms) was substantially negative, not least because the draft rules were surprisingly different from HMRC's original suggestions and they were generally thought to be unclear. There was also widespread concern about the ability of affected partnerships to make any necessary structural and constitutional adjustments within the compressed timeframe available (most of the rules will be effective on 6 April 2014).

As regards the Salaried Member Rules, HMRC has responded to the concerns expressed by taxpayers by producing an updated version of its guidance (as well as revised legislation to be included in the Finance Bill 2014). The revised guidance is significantly more helpful to asset managers and other LLPs, but it still has some unsatisfactory aspects and leaves some issues unresolved. There may be further (hopefully helpful) changes to the draft legislation and guidance in the coming weeks. This client advisory addresses some of the implications for asset managers. This advisory will therefore be relevant to asset managers that may be considering whether to restructure their current LLP arrangements, as well as those considering the suitability of the LLP for new launches. However, in any particular case, the decision about how to proceed will also need to take into account the potentially significant impact of the new Mixed Member Rules, if they apply to the relevant manager. The Mixed Member Rules and accompanying guidance may be subject to further refinement before April.

How do the Salaried Member Rules operate?

An individual member of an LLP will be treated as a Salaried Member (i.e., an employee for UK tax purposes) if ***all*** of the "Conditions" summarised below are satisfied.

Condition A – it is reasonable to expect that at least 80 percent of the individual member's remuneration for services to the LLP will be disguised salary—i.e., it will be an amount which is either fixed or which, in practice, does not vary by reference to the overall profit or loss made by the LLP.

Condition B – the individual does not have a significant influence over the affairs of the LLP.

Condition C – the individual's capital contribution to the LLP is less than 25 percent of the disguised salary that it is reasonable to expect that the individual will receive that year.

A Salaried Member will be taxed as an employee, with the result that the LLP will need to deduct and account for UK income tax at the source (under the Pay As You Earn system) and the LLP will itself be required to pay Employer's National Insurance Contributions (NICs) at 13.8 percent (i.e., an additional cost to the LLP as the employer). Also, any benefits in kind received by the individual would be potentially taxable as employment benefits. Subject to the normal restrictions, such payments made to a Salaried Member should be tax deductible for the LLP.

What is the overall effect of the Salaried Member Rules?

The use of the LLP by hedge fund managers in the UK (including the UK arm of US managers) has become common. In addition to being a vehicle which combines flexibility with corporate features, one material benefit has been that Employer's NICs do not apply to partner profit shares. In many cases, this has simply been a legitimate and uncontroversial consequence of using the LLP. However, HMRC became frustrated with increasingly widespread arrangements involving junior staff of LLPs being "dressed up" as LLP members, with a view to achieving NICs savings. The challenge with introducing the Salaried Member Rules was always going to be to find a set of rules that promoted good corporate and tax practices by countering tax avoidance without creating too much uncertainty or making the rules unworkable in practice.

The overall effect of these rules will be that asset managers will need to re-visit the question of whether the LLP is still appropriate for their business. If it remains so, the next question will be what changes are required in order to make the LLP "fit for purpose"— including amendments to financing arrangements, the constitutive documents (including LLP Agreements and Deeds of Adherence or Admission), and possibly also the composition of the LLP membership. With little time left to make any necessary changes, this will be a high priority matter for many asset managers.

A more realistic approach to the assessment of disguised salary (Condition A)

HMRC has tried to respond to the disquiet and confusion caused by the original guidance on Condition A. One key point is where the line is drawn between what constitutes a distribution of partnership profit and what HMRC regards as merely disguised salary. HMRC's original guidance attempted to create a "bright line test", but the approach taken was far too restrictive. For example, HMRC had originally suggested that any reward for personal performance was indicative of disguised salary. This approach has now been softened—for example, there is now a recognition that certain bonus pool arrangements do not constitute disguised salary (HMRC uses an analogy of how partners might be given a "slice of the cake").

Greater clarity on significant influence (Condition B)

This Condition has received relatively little attention from commentators and observers, compared to Conditions A and C. However, in some cases, Condition B will provide asset management LLPs with a legitimate means of ensuring that some or all of its individual members are not Salaried Members without changing compensation structures (although the Mixed Member Rules may require the latter, if those rules apply).

One helpful development in this area is that HMRC's revised guidance is clearer and also now includes a greater number of relevant examples of what constitutes "significant influence".

As you would expect, HMRC say that the answer will always depend on a realistic view of the facts taken as a whole. However, an individual's involvement in the following (non-exhaustive) list of decisions will generally be taken as indicating significant influence:

- appointment of new partners;
- deciding where the firm conducts its business;
- deciding the firm's areas of business;
- strategic decisions;
- deciding on business acquisitions or disposals;

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

The above items can be contrasted with administrative matters, such as processing invoices, human resources matters relating to non-key staff, completing tax returns, accounting, management of premises, dealing with suppliers and routine compliance matters. Oversight or decision making in these areas will generally not constitute significant influence.

Specifically in relation to significant influence functions within a Financial Conduct Authority (FCA)-regulated business, there is further, more focused guidance. Whilst the guidance explicitly notes that the FCA's test of "significant influence functions" arises in a different legislative context to the Salaried Member Rules, HMRC recognises that there will be overlap between the regulatory and tax regimes. In that regard, HMRC has helpfully indicated that the functions carried out by persons falling within FCA classifications CF3 (chief executive) and CF8 (apportionment and oversight function) are also likely to result in those persons having a significant influence for the purposes of Condition B in the Salaried Member Rules. An individual who falls within CF4 (partner function) will need to be considered on their particular facts—such a person can also be treated as having a significant influence if they significantly contribute to major business decisions (whether management, strategic or investment related).

Flexibility on capital contributions (Condition C)

At one stage, there had been some concern that capital contributions made prior to 6 April with the purpose of ensuring that Condition C was failed (Condition C Capital Contribution) would be vulnerable to attack under the anti-avoidance provisions in the Salaried Member Rules. However, there is now greater comfort that this should not happen, provided that (practically speaking) the arrangements do not insulate the member from risk or cost in relation to the contribution. So, for example, arrangements involving non-recourse or limited recourse loans, circular funds flows (contribution is loaned by or derived from the LLP itself) or the firm bearing the interest cost of any loan would all suggest that Condition C still applies and that the individual is a Salaried Member.

One practical concession offered by HMRC (for this year only) is that it will accept arrangements whereby an existing LLP member unconditionally commits to make its Condition C Capital Contribution prior to 6 April, provided that the actual contribution is made by 5 July 2014. A similar two-month grace period applies for new LLP members.

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Katten Muchin Rosenman UK LLP

www.kattenlaw.co.uk

125 Old Broad Street • London EC2N 1AR
+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax

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