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HM Revenue and Customs Consultation

Partnerships: A Review of Two Aspects of the Tax Rules

Response from the Employment Lawyers Association

9th August 2013

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INTRODUCTION

i. The Employment Lawyers Association ("ELA") is an unaffiliated group of specialists in employment law, including those who represent both employers and employees. It is not our role to comment on the political merits or otherwise of proposed legislation; rather we make observations from a legal standpoint.

ii. ELA's Legislative and Policy Committee consists of barristers and solicitors (both in private practice and in-house) who meet regularly for a number of purposes, including considering and responding to proposed new laws.

iii. Various of our members engage in advising clients on employment status issues and a number of our members have dual LLP/partnerships and employment practices, hence our response to the Public Consultation. The Government has invited views on a wide range of issues concerning employment status and more technical proposed changes to the tax rules. Since ELA is a body of employment lawyers, not tax specialists, we have confined our answers to those questions where our members have significant professional knowledge. We have not responded to questions 6 to 12 which address profit and loss allocation in LLPs. Our comments are divided according to the question numbers in the consultation document.

iv. A working group was set up under the Chairmanship of Anne Pritam, Stephenson Harwood LLP and Tessa Livock, Lawrence Graham LLP ("the Working Group") to consider and comment on the HMRC's Consultation on the proposed changes to the partnership tax rules. A full list of the members of the working group is attached.

Executive Summary

The working group has considered chapter 2 of the Consultation dealing with employment status of partners/disguised employment as well as the general questions 13 to 15. The working group has not dealt with questions 6 to 12 dealing with profit and loss allocation in mixed member partnerships.

Members of the working group held differing views on the relative usefulness and workability of the two elements (conditions 1 and 2) of the proposed definition of salaried member. All members, however, agreed that if HMRC proceeds with introducing a definition of salaried member who will be subject to income tax and national insurance contributions, the proposed definition should be framed more clearly and should better reflect and not conflict with the existing legal tests for employment status.

ELA's view is that without clarification, the introduction of a test based on the proposed definition of "salaried member" will give rise to considerable confusion in relation to an area of law which is already difficult. Comprehensive guidance for LLPs with clear examples will be essential to avoid considerable uncertainty and the potential for litigation. ELA would welcome the opportunity to comment on draft guidance and members would be happy to meet with HMRC to discuss the content to be included in any guidance if that would be helpful.

Chapter 2 – Disguised Employment

1. Question 1: - Whether the current definition of "salaried members" set out in 2.19 is appropriate to catch those members who should be subject to employment taxes and thereby provide a more equitable tax and NIC treatment?

1.1 This two stage test introduces an additional layer, in effect a second bite at the cherry for HMRC, in determining whether LLP members are in fact 'salaried members' and thus employees. The phrasing of question 1 also suggests that HMRC is of the view that there are currently members who should be subject to tax and national insurance as they are not LLP members in the true sense.

1.2 At our answer to Question 3, we suggest a way of reversing the tests which may be more equitable and logical. We consider here how the tests (in either order) would interface with existing legal authorities.

1.3 There is, however, an existing legal test to determine who qualifies as a genuine LLP member and who is in fact an employee or worker. ELA queries whether a further and different test for tax purposes (which may be at odds with established employment law authorities) is required. If HMRC concludes it is, we set out proposals for a different approach at our answer to Question 3.

1.4 S 4(4) of the Limited Liability Partnership Act 2000 ("LLP Act") define LLP membership and has been further developed by case law.

Section 4 (4) of LLP Act :-

A member of a limited liability partnership shall not be regarded for any purpose as employed by the limited liability partnership unless, if he and the other members were partners in a partnership, he would be regarded for that purpose as employed by the partnership.

1.5 In the recent case of *Clyde & Co LLP, John Morris v Krista Bates Van Winkelhof [2012] EWCA Civ 1207* (which is currently on appeal to the Supreme Court) the Court of Appeal considered the existing test, using factors such as the fact that the Claimant had signed a deed of adherence and bound herself to the members' agreement. She also had significant rights of participation in the running of the business and had been held out in various ways as a member of the firm. Whatever particular arrangements may have been made about her obligation to commit capital to the partnership, the terms of the deed of adherence and the members' agreement to which she had voluntarily become a party made it clear, in the Court of Appeal's view, that she would have been treated as a partner if the firm had been operating under the 1890 Act.

1.6 The courts thus look at a number of factors when determining partnership status and this extends beyond pure financial risk, capital, profit sharing and the implications of a winding-up. Other considerations include management responsibilities.

1.7 An earlier case on the issue of member status, *Martin Tiffin v Lester Aldridge LLP* [2012] EWCA Civ 35 also followed this multifactorial approach. The Court of Appeal upheld the ET and EAT's dec*isions that Mr Tiffin (a fixed shar*e partner) was a partner and not an employee. While the full equity and fixed share partners' respective commercial interests in the firm were materially different, the character of the interests in the firm of these two classes of the LLP's members was nevertheless essentially the same:

i) All had to contribute capital;

ii) All had a prospect of a share of profits depending upon the performance of the LLP in any particular accounting year (it made no difference that the basic fixed share return of the fixed share partners was guaranteed because those partners' points allocation also gave them a true interest in and share of the firm's profits);

iii) All had a prospect of a share in the surplus assets on a winding up;

iv) All had a voice in the management of the affairs of the LLP.

1.8 Additionally, the relevant contrast drawn by the members' agreement was not between the full equity partners and the fixed share partners but between those two classes of partner on the one hand and the salaried partners on the other – with the members' agreement making it clear that the latter are employees (who made no capital contribution; had no share of the profits; no share in surplus assets on a winding up; and no voice as of right in relation to the management of the firm).

1.9 The test proposed by HMRC in its consultation document focuses in particular on firm profits whilst taking no account of management responsibilities or other factors that the case law has grappled with.

1.10 ELA also sees the potential for unintended consequences to arise where for example a particular member of an LLP which does not generate high profits over a number of years does not meet the 5% profit sharing threshold, even though in all other respects the other elements of the test are met.

2. Question 2: - Is there a simpler alternative for delivering the same policy objectives whilst reducing uncertainty and preventing avoidance?

2.1 ELA members suggested a number of possible alternatives to the change proposed in the Consultation. The first alternative is to stick with the existing legislation which has at its heart the presumption of self-employment at Section 10 of the 2000 Act but to improve the guidance some of which has given rise to uncertainty and unintentionally perhaps provided considerable comfort to professional practices when appointing new fixed share members or converting existing salaried partners (who they regarded as employees) into fixed shared members. For example, HMRC Guidance (BIM 72115) states: "*It is the persons who are registered as members of the LLP who carry on the business. ...if an LLP carried on a trade then each registered partner is taxable on the income they derive from the LLP as self-employed trading profits notwithstanding the fact that the registered member may have been a salaried partner (an employee) in a predecessor general partnership".*

2.2 A second alternative would be to introduce only the proposed "targeted anti-avoidance rule" (TAAR) to reinforce the existing legislation and HMRC Guidance (or indeed the proposed revised Guidance). This would avoid the need to amend the existing law.

2.3 Both of these simple alternatives will serve to reinforce the intention behind the existing legislation of creating a legal entity that would allow professional partnerships in particular to operate with limited liability, while maintaining the partnership ethos, i.e. the flexibility for enterprising professionals to organise their own internal structure, and to participate in the ownership and running of the business. In the vast majority of professional practices (certainly solicitors and accountants) members are an important source of working capital. That is why Parliament thought it more appropriate for LLPs to be taxed as a partnership than as a company. But Parliament envisaged that the same rationale could be applied to "start-up businesses and multi-disciplinary businesses". Whilst it was recognised by the then Government in 2000 this would give rise to a risk of LLPs being used for purposes for which they were not intended, it is clear that Parliament intended that "measures" might be introduced in the then 2001 Finance Bill to combat unintended tax avoidance "*without undermining the commercial certainty of taxation as a partnership for those businesses for whom the entity was intended*".

2.4 The presumption of self-employment is just that: a presumption. Reduction of uncertainty over employment status and the prevention of avoidance can be achieved by targeted investment in those branches of the judiciary and the enforcement agencies with particular responsibility for implementing the existing law. In that regard, the consultation document cites at paragraph 2.14 the Court of Appeal decision in *Tiffin –v- Leicester Aldridge* [2012] EWCA Civ 35 as being helpful but the more recent Court of Appeal decision in *Clyde & Co LLP & Another –v- Krista Bates van Winkelhof* [2012] EWCA Civ 2007 clarifies further the relevant factors to take into account and the correct test to be applied in determining employment status (see our response at (1) above). HMRC Guidance should be up to date and sufficiently sophisticated to deal with the subtleties of the differences between genuine self employed and employment status. ELA would be pleased to review and comment on any draft guidance.

2.5 A further simpler alternative to repeal and complete replacement of the presumption of self-employment in Section 10 might be an amendment to it so that the

presumption is retained in relation to a narrower, more limited and defined range of businesses, trades or professions in order better to reflect Parliament's original intention (see paragraph 2.3 above).

2.6 Alternatively or in conjunction with this, in light of the *Tiffin* and *Winkelhof* decisions, the focus should perhaps be on s 4(4) of the 2000 Act which may be ripe for amendment to clarify its meaning and purpose.

2.7 Another radical alternative is wholesale reform of the income and corporation tax structure (on which ELA, as a body of employment lawyers rather than tax specialists would not be qualified to comment in detail). This would require reconsideration of the different tax regimes (income tax, CGT and corporation tax) and the relationship between each type. Currently we have personal income tax and corporation tax regimes with complicated reliefs from capital gains tax in particular, but no separate dividend tax. The National Insurance charge is both a personal tax and an employer's tax which does not apply to dividends or repayment of claimed unpaid capital sums on deferred consideration. In short, the current income tax, capital gains tax and corporation tax regimes allow for various arrangements that achieve significant tax avoidance but do not, of course, constitute tax evasion.

3. Question 3 – Are the conditions as currently framed clear enough or are there other criteria that you consider should be added that would more clearly achieve the policy aims?

3.1 We note HMRC's approach to the first condition that, whether a member of an LLP was an employee would be determined by reference to the "normal tests" set out in the Employment Status Manual (***ESM***), and that the intention is for the first condition to provide a "relatively straightforward test". We do not agree that the test set out by the first condition is "relatively straightforward" in any sense as is clear from our answer at (1) above. It seems to us that HMRC is confusing familiarity with ease. The multi-factorial approach to determining "employee status" set out in the ESM reflects the long and complicated line of case law in this area. This is evidence that in all but the most extreme cases, this kind of judicial fact-finding exercise will not be easy for an LLP member to carry out. For example, the difficulties are illustrated by the recent decisions of tax tribunals applying the IR35 legislation, and the Supreme Court's decision in *Autoclenz Limited v Belcher & Ors* [2011]. The framing of the first condition may be "clear enough", but HMRC should acknowledge that its effect, determining employee status by standing back and "painting a picture" of all the facts in a particular case, is not so.

3.2 The view of some of our members is that the second condition could be seen as a refreshing contrast to the first condition. The second condition adopts most of the more focused test clarified by the Court of Appeal in *Tiffin v Lester Aldridge* [2012] EWCA Civ 35, which the court used to determine whether a partner in the LLP was an employee. Rather than having this as the second, fallback condition, some of our members have suggested it may be a better and more certain approach to have this as the first condition. Should such an approach find favour, the further criteria of "subordination" and "control" prominently present in the 'partner/employee' line of case law could be included as part of this condition. This could form a relevant and more concise 'first line' test which may be easier to apply. The determination of employee status under the ESM using the "normal tests" would then fall to be the second, 'catch-all' condition instead. This would then go some way in mitigating the problems with the (current) first condition highlighted above.

3.3 Lastly, we take this opportunity to comment on the lack of a harmonised approach between the employment tribunals and tax tribunals to deciding questions of employee status. Although in recent times, HMRC has been careful to use all the indicators set out by the employment decisions, and tax decisions are now regularly cited by the employment courts, the risk that the two sets of courts will start from the same criteria, but apply them differently, still persists. Part of the specific policy objectives of this particular tax change is to ensure that low-paid individuals who are in reality "employees" are not being deprived of their rights under the employment legislation. We do not feel it would be appropriate for HMRC to maintain, in this respect as it does generally, that the employee status for the purposes of tax law has no bearing on employment law status. Hence we would welcome a commitment from HMRC to apply the tests, however they are eventually enacted, in a manner that is consistent with employment law and to bring HMRC guidance into line with that (see further our comments on HMRC guidance at (3) above).

4. Question 4: - Is there an alternative to the proposed TAAR which would prevent attempts to sidestep the rules? How could a TAAR be expressed so as to ensure that it has the desired effect but does not apply inappropriately?

4.1 The proposed TAAR will provide that "*in determining the tax status of the LLP member, no account would be taken of certain arrangements the main purpose, or one of the main purposes, of which is to prevent the first or second conditions from being met".*

4.2 In our view a TAAR in addition to a removal of the presumption of self-employment should be unnecessary and may become rather circular, that is, if the LLP member concerned is genuinely a partner in accordance with current law and/or further to any new conditions which may be introduced further to this consultation, it should be irrelevant whether the individual's motivation for being an LLP member was (wholly or mainly) driven by tax considerations since the tax treatment reflects the commercial deal between the member and the other members.

5. Question 5 - Guidance will be issued to indicate how the test will be applied. We would welcome views on any specific scenarios or points the guidance should cover.

5.1 ELA welcomes clear guidance and would be pleased to review and comment on any draft guidance. ELA recommends that more detailed examples be given to make clear how the amendment to the legislation is intended to apply to LLP members. In particular, the examples set out at page 7 of the Consultation should be expanded to address factors relevant to the multi-factorial test for employment status including financial risk, corporate governance and management, career progression and salary. Below are detailed comments on the examples given at page 7 of the Consultation ("the examples/Example 1, 2 3 and 4").

5.2 **Condition One**

i) <u>General test; financial criteria are not determinative.</u>

The examples given focus on the financial aspects that would be considered at both stages of the test: the financial risk and the basis of payment.

However, the test of partnership is widely stated at s. 1(1) of the Partnership Act 1890 as "*the relation which subsists between persons carrying out a business in common with a view of profit*". As confirmed in *Tiffin* profit-sharing is neither necessary nor sufficient; s. 1(3). Turning to the second question, the usual test of employment status is multi-factorial and no one factor is determinative. Therefore, the simple fact of financial risk and/or profit sharing will not be decisive at either stage. This must cast some doubt on the correctness of Example 1.

ELA recommends the inclusion of an example of a LLP member who bears financial risk but would not be regarded as a partner and satisfies the test of employee set out in existing law.

Given that it is intended the legislation does not apply to fixed-share partners (paragraph 2.13), it would be very helpful if this was elucidated by way of example.

Likewise, it would be helpful if Example 1 was clarified so that the various elements of the definition of "salaried member" were considered – what is it that makes Member A an employee under Condition 1? Alternatively, if Member A is an example of a non-employed Salaried Member under Condition 2 it would be helpful to clarify this.

ii) Corporate Governance

The extent to which a member is involved in the management of the firm will be a helpful indicator both of whether he would be regarded as a partner or not. In *Tiffin*, the fact of any right of involvement, however small, was held to be incapable of being ignored. This is a factor that should thus be taken into account. Voting rights will also be a useful guide to the reality of the member's involvement in the governance of the firm.

Similarly, a member's potential liability in the event of a suit may be informative of how that member is to be regarded.

Recommendation: guidance should include an example of a LLP member with voting rights and who attends management meetings independently of his job functions, but who may not have made a capital contribution or be entitled to share of profits.

iii) Career Progression

The manner in which someone is selected for partnership appears to be highly relevant (paragraph 2.13 of the Consultation document). Consideration of this factor in particular may assist in furthering the stated objectives of the legislation. It may also assist in underlining the point that Condition 1 examines factors beyond the provision for financial risks and rewards of LLP membership. For example, where the member is required to be a LLP member as a condition of engagement, that would point strongly in favour of the member being a "salaried member". This would be particularly so for the low paid and other groups vulnerable to exploitation (part time workers, shift workers).

Where LLP membership is offered to wide ranges of workers without particular regard to seniority, experience, skill or future intentions, that may be highly indicative of those members being "salaried members".

On the other hand, where LLP status is offered on a selective basis and is regarded within the business as conferring a special status or recognising achievement, this may be indicative of the sort of LLP member not to be regarded as an employee or "salaried member", even where they may bear little or no financial risk (paragraph 2.13 of the Consultation).

Recommendation: the guidance could usefully include examples showing the relevance of career progression.

iv) Payment by way of salary

It is important to note that there is nothing in the second condition of the currently proposed definition that limits the term "salaried member" to those paid by way of salary.

The basis of payment is one of the factors set out in the ESM and forms [put] of the test of employment considered by the employment courts. However, as no one factor is determinative, this opens the possibility that LLP members paid by drawings could nevertheless be regarded as employees.

Recommendation: the examples should make clear the circumstances in which a member paid by drawings would be regarded as an employee.

5.3 **Condition 2**

The examples currently given address the second condition and only relate to participation in profit and loss. Consideration could be given to widening these examples to include more marginal cases, in particular fixed share partners.

The Consultation suggests condition 2 will only apply where Condition 1 is not met. This will be so where either:

i. the member is to be regarded as a partner; or

ii. the member is not to be regarded as a partner AND is not to be regarded as an employee.

The result of this is that Condition 2 applies only to those who are not employees under the multi-factorial test.

Recommendation: Given this surprising outcome, that a non-employed worker is to be taxed as an employee, it would be helpful to have an example in order to clarify that this is indeed the intention of the legislation. We have suggested an alternative approach to the proposed definition of "salaried member" in the answer to question 3 (above) which may assist in avoiding this outcome.

13. Question 13: - Would there be situations that are not in line with the Government objectives? If so, the Government would welcome detailed explanation of why you believe these situations fall outside the intended target

areas and, if possible, any suggestions on how these situations may be effectively excluded from the legislation?

13.1 As set out above, the focus of Condition 2 in the proposed definition of "salaried member" on financial risk means there is a risk that LLP members who would be regarded as partners if the LLP were a general partnership under the Partnership Act 1980 might be "salaried members" and therefore taxable as employees. This is not in line with HMRCs stated aim that the proposals:

"*are not intended to apply to members who are in essence partners of a traditional partnership that is now carried on as an LLP"* (paragraph 2.13)

13.2 Please refer to the answers to questions 1 and 3 which contain suggestions from ELA's members around how the problems with the proposed definition of "salaried member" might be addressed.

13.3 In addition, ELA members raised the following general concerns around the impact of the proposals.

i) Assessment of the impact

ELA members expressed concern as to whether HMRC has given full consideration to:

- the size of employer National Insurance employer contributions that will be placed on LLPs if large numbers of members are considered to be employees;
- whether those LLPs will be able to afford to pay the additional National Insurance employer contributions;

ELA recommends HMRC consider taking steps to offset, delay or stagger payment for those LLPs who may not be able to initially afford such a large increase in employer National Insurance contributions.

ii) Foreign business

ELA members suggested HMRC may wish to give further consideration as to whether the tax rules may discourage foreign businesses (particularly those with the potential to create work opportunities and taxable profits) from locating themselves in the UK under an LLP structure and the loss of revenue arising from this loss of business.

iii) Alternative Business Structure (ABS) status

Some ELA members have expressed a concern that the new tax rules may dissuade corporate investors from investing in LLPs with ABS status as corporate LLP members.

14. Question 14: Do you agree that the legislation can help the government to meet with the wider objective of fairness without adversely effecting the flexibility of the partnership structure?

14.1 In ELA's view, it is important to retain the ability to allow genuine risk takers and business owners to set up their businesses under an LLP structure. If the effect of the proposed changes is to discourage the use of an LLP structure for appropriate business models that would be an unfortunate outcome.

14.2 A number of ELA members do not believe that the proposed legislation would clarify the existing position and that an attempt to enshrine insignificant risk/profit share etc for the purpose of the second condition proposed may detract from the holistic application of the current approach to determining the status of LLP members.

General Questions

15. Question 15 - Can interested parties offer views on any other likely costs that partnerships and their partners may incur in order to implement the changes?

15.1 Limited liability partnerships will need to review relationships with LLP members. ELA anticipates in most cases LLPs will take legal and financial/tax advice in order to assess the likelihood that existing members might be re-categorised as "salaried partners" under the new rules giving rise to national insurance liabilities in respect of certain LLP members.

15.2 It is not clear how firms will deal with the risk that LLP members may be re-categorised as "salaried members" (or employees) for tax purposes.

15.3 The relationship between LLP members is usually governed by a LLP agreement. This is a contractual document between the LLP and all the LLP members. Even if firms decide that certain members are at risk of being "salaried members" in accordance with the proposed definition, the contractual relationship between the LLP members will remain the same unless the parties agree to changes to the LLP agreement.

15.4 LLPs will be faced with difficult and time-consuming business decisions about whether an individual should be held out as a partner if he/she has failed the HMRC tests – as a question of risk management, given exposure to claims for employment protection, will partners have to be "publicly" and hence potentially humiliatingly returned to employee status for all purposes? If so, further costs will arise for LLPs which will then have to give costly employee entitlements to individuals recruited as or promoted to partnership – including insurance covers, maternity/paternity/parental leave and pay.

15.5 Possible steps/measures LLPs may take are:

i) seeking to ensure that all LLP members are traditional partners rather than "salaried members" under the new classification by reviewing the terms of membership for all professional partners to ensure the conditions are met. LLPs may consider, for example, requiring partners to increase their capital investment in the LLP to ensure that all members take on an appropriate degree of financial risk;

ii) seeking indemnities from partners who are at risk of being re-categorised as "salaried members" in respect of the risk of liability for national insurance contributions;

iii) establishing an emergency fund to deal with any unexpected NIC liability (it is expected setting up such a fund would have an impact on the funding position of LLPs and may mean LLP members drawings are affected with resulting contractual difficulties – see below).

15.6 Taking these steps would require LLPs to re-negotiate the LLP agreement with existing members. It may not always be possible to agree changes. There is a risk that disputes will arise in relation to any changes proposed. The changes are therefore likely to give rise to considerable legal and financial uncertainty for LLPs and may give rise to litigation/disputes between LLP members.

15.7 The level of cost and expense will depend on the steps taken by LLPs in each case. ELA cannot quantify the likely costs other than to say it is expected that these will be significant and will include both operational and advisory costs.

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