The Special Tax Rules That Apply To Partnerships

BUSINESS TAX GUIDE

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OVERVIEW

Changes to partnership taxation in 2014 have had a significant impact on both LLPs and traditional partnerships. Three perceived tax abuses that were behind the Government's decision to bring in anti-avoidance rules in these areas:

1 LLPs that have disguised the employment status of certain members who have been treated automatically for tax purposes as self-employed but who have shared little, if any, of the risks and rewards of being in partnership and were therefore, in reality, employees of the business;

2 So-called 'mixed' partnerships that allocate an 'excessive' share of profits to a corporate partner that is controlled by an individual partner or partners of the same partnership/LLP, and that is generally taxed at a lower tax rate than an individual; and

3 The use of partnerships to transfer an asset or income stream between partners for a tax avoidance motive.

These three areas are examined in greater detail below.

1. Disguised Employment in LLPs

The disguised employment rules apply to LLPs, but not to non-LLP partnerships. They put in place hurdles for individual members of LLPs to achieve self-employment status. Failing the hurdles means that the individual's remuneration is subject to PAYE and NIC, payable monthly, including employer's NIC at 13.8%. Such an individual is known under these rules as a 'salaried member'.

In order to be self-employed and avoid 'salaried member' status, at least one of the three following conditions below must be met by a member:

- Significant Influence: The member must be able to demonstrate that they have significant influence over the direction and management of the LLP.

- Variable Profit Share: It must be reasonably expected that a member's entitlement to a 'fixed profit share' or to guaranteed drawings (i.e. their 'disguised salary') will not exceed 80% of his or her total profit share. In effect, at least 20% of their profit share must be truly variable and dependent on the financial performance of the LLP.

- Capital Contribution: The member must make a firm commitment at the beginning of each tax year to have invested at least 25% of his or her expected 'disguised salary' of that tax year in the LLP's capital. For members joining an LLP, the commitment must be made on becoming a member and capital contributed must be within two months.

These are clearly very significant changes which have impacted many existing LLPs. Some of the key points are considered here:

- A salaried member is now treated as an employee for income tax and NIC purposes, suffering 12% and 2% NIC as an employee rather than 9% and 2%;
- LLPs are now required to operate PAYE each month on a salaried member's drawings, rather than making twice yearly tax payments on their profit allocations;
- LLPs are now subject to employers' NIC at 13.8% on all salaried members' drawings;
- The inherent uncertainty acts as a deterrent to retaining or admitting certain members, or even to remaining incorporated as an LLP; and
- Members may no longer want the downside of being taxed as an employee without the upside of employment rights.

We recommend that LLPs with members who are potentially caught by these rules should, prior to the start of each financial year:

- Prepare a realistic business plan to estimate each member's variable profit share; and
- Consider calling on additional capital contributions from members to ensure the 25% test will be met.

2. The Profits Of Mixed Partnerships

The rules for mixed partnerships (i.e. those with both corporate and individual members) apply to all partnerships including LLPs. These rules seek to reallocate, for tax purposes, that part of the profits allocated to a corporate partner (or member) which represents profits diverted to it from an individual partner where that individual partner of the same partnership (or LLP) has the 'power to enjoy' those profits.

The 'power to enjoy' is widely defined but, broadly, if would be a fair summary to say that if an individual can benefit economically from the profits allocated to the company, then he has the power to enjoy them. In particular, an individual partner who has control of the corporate partner is regarded as having the power to enjoy the company's profits.

The rules however permit the corporate member to retain an 'appropriate notional profit share'. This equates to notional interest at a commercial rate on capital contributed by the corporate member to the partnership, plus arm's length remuneration for any services provided by the corporate member but, unhelpfully, not if the services involve the individual partner himself.

As a result of these rules, individual partners will have to pay income tax on those profits reallocated from a corporate member. Equally, corporate members will recognise a corresponding reduction in their taxable profits, and any dividends paid to individuals (with the 'power to enjoy') are ignored for tax purposes. The overall result is that the rate of tax on a corporate member's profits that are reallocated to an individual member will more than double from as little as 20% to as high as 47%. The rules do not just apply to profit making partnerships. HMRC will also actively seek to reallocate losses which have been diverted for tax avoidance to the individual partner rather than the corporate partner to prevent the individual reducing their income tax arising on other sources of income.

Alternative structures may therefore be appropriate if individual partners of mixed partnerships wish to avoid personal taxation on any intended allocation of profits to corporate members. Possible options to consider include:

- Transferring the business of the partnership to its corporate partner and establishing an appropriate remuneration strategy for individual members who are now solely shareholders / directors in the corporate partner; or
- Establishing a subsidiary of the partnership to operate the business.

Changing the structure may have other tax implications, and the commercial ramifications of the change in operating entity will also have to be weighed up against any tax consequences.

3. The Tax-Motivated Transfer of Assets and Income Streams Between Partners

These rules apply to all partnerships, and seek to counter arrangements where one partner (or member) disposes of, actually or in substance, all or part of an asset or an income stream to another partner (or member) through their partnership (or LLP), when securing a tax advantage is the main purpose, or one of the main purposes, of the disposal.

The effect of the legislation is to treat the partner disposing of the asset or income stream as in receipt of taxable income equal to the consideration received for the transfer, or market value if higher.

How can Rawlinson & Hunter help?

LLPs and other partnerships impacted by these anti-avoidance rules should implement appropriate steps to mitigate the potential additional burden of tax. At Rawlinson & Hunter we can advise on the specific steps required by your partnership.

If you are interested in further information in this regard, please contact the Rawlinson & Hunter partner who normally acts for you. Where you are not one of our regular clients, please contact Craig Davies or Andrew Shilling, who would be delighted to discuss this with you in more detail.

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