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17th July 2013

Partnerships Review Consultation
c/o Tax Administration Policy Team
HM Revenue & Customs
1C/06, First Floor
100 Parliament Street
London SW1A 2BQ

By post and by email (partnership.review@hmrc.gsi.gov.uk)

Dear Sir

Revenue Law Committee response to HMRC Consultation Document on Partnerships: A review of two aspects of the tax rules (dated 20th May 2013)

The City of London Law Society ("CLLS") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees. This response has been prepared by the CLLS Revenue Law Committee.

1. General comments on approach

1.1 As a general matter, we would comment that the review of the tax treatment of partnership taxation as set out in the consultation seems rather at odds with the UK's ambitions to establish itself as the global centre for the investment management industry. As the Government is well aware, the industry is internationally mobile, as well as being extremely sensitive to changes in established tax regimes. Whilst we would not seek to defend the abusive structures that a minority of taxpayers implement (although would note, as an aside, that existing case law should give HMRC sufficient ammunition to stop the abuse in question), we would urge caution in the Government's general approach to the breadth of the rules.

1.2 In particular, it is not credible to be advertising the UK as being "open for business" to investment managers, whilst at the same time amending the tax rules such that businesses (and their advisors) are in a position where the business structure that has been used for such businesses for the last decade may well no longer be workable.

1.3 We also note that the Government asked the Office of Tax Simplification to review the tax treatment of partnership arrangements more fundamentally on 20 March 2013. It would appear to be more sensible to wrap the present consultation into that review, rather than changing the rules once in Finance Bill 2014 and then potentially changing them again shortly thereafter.

2. Timing

2.1 Although we acknowledge that some abusive planning has been undertaken in the areas with which the consultation is concerned, large numbers of businesses, both in the investment management arena (which it is government policy to promote) and also to some extent in professional services firms, have adopted structures where profits are "parked" with a corporate member for working capital or remuneration deferral purposes. Whilst it is obviously open to the government to change policy and tax these arrangements differently, we do not consider them to be abusive under current law and so it would be wholly wrong not to permit businesses proper opportunity to adjust their affairs to deal with a new tax regime.

2.2 The legislative changes being proposed are both complex and detailed. There remain a number of key policy points which the document acknowledges are undecided. Given the nature of the changes, we do not consider that it is fair to expect businesses to incur the very substantial costs associated with responding to them until they have been finalised. Our very strong view is therefore that if the legislative changes are to be included in Finance Bill 2014, they should take effect from April 2015. If the changes are effective from April 2014, there will inevitably be a strong element of the changes which will be retrospective in nature, which cannot be justified in the majority of cases where existing planning cannot fairly be considered to be avoidance.

3. Summary

3.1 Our principal suggestions in relation to the "Disguised Employment" section of the consultation are:

(A) there should be a single test. We would prefer a test based on the first condition, which would tax an LLP member as an employee if, as a matter of employment law, they are an employee. We do not believe that it is necessary or desirable to establish a new test for the employment status for LLP members specifically. The general law test that applies to all partners in other partnerships (embodied in the first condition) should be sufficient to achieve the stated aim of perceived avoidance in this area. There would obviously need to be consequential amendments to the tax legislation which automatically deems a member of an LLP to be a partner for all the activities of the LLP (such as s.863 Income Tax (Trading and Other Income) Act 2005. Having a test which is different for members of LLPs than it is for partners in a general partnership is an unsatisfactory outcome – a test based solely on the first condition would prevent this;

(B) failing that, to remove the employment condition from the salaried member test altogether and simply have an economic test based on the second condition;

(C) if this latter route is followed, to remove the repayment of drawings from the "economic risk" element from the second condition used to determine whether someone is a "salaried member". Risk of repayment of drawings arises as a matter of insolvency law as it applies to LLPs and their members, not simply pursuant to the terms of the LLP agreement, and it is unlikely that the vast majority of members will behave in a way which will result in the condition applying to them; and

(D) to apply the "salaried members" concept only to trading LLPs and not to professional LLPs. This would assist HMRC in having a test which is wide enough in scope but dealing with the consequent difficulties that brings for professional partnerships, as noted by the Government at paragraph 2.13 of the consultation. It is not sufficient to draw such a distinction through guidance alone.

3.2 Our principal suggestions in relation to the "Profit & Loss Allocation Schemes" section of the consultation are:

(A) whilst we note that there are a number of abusive schemes in the market, which the Government understandably wishes to stop, we believe that there are certain types of planning, e.g. in relation to working capital arrangements, which should be unobjectionable from a policy perspective. However, our most significant concern relates to deferral arrangements. Such arrangements are mandated by regulation in a number of different business areas, and the tax legislation currently deals with the tax effect of such arrangements in an entirely unsatisfactory manner. Even where those arrangements are not mandated by law, they are used to encourage responsible behaviour. Using a corporate member to manage such deferral arrangements in an LLP structure has to date been the most efficient and straightforward thing to do. If it is not going to be acceptable to achieve deferral in this way going forwards, the Government must introduce an alternative option which essentially puts taxpayers in a position where they ultimately do not tax pay if they never receive, or have clawed-back, an allocation of profits from a partnership. We cannot accept the proposition that a mixed membership partnership where the corporate member serves a legitimate business purpose such as managing working capital or facilitating remuneration deferral should be at risk of being caught by rules designed to apply to aggressive tax avoidance schemes.

(B) with tax rates as they are now set, it is more tax efficient for a business to incorporate and pay its equity holders dividends than it is for a business to set itself up as a partnership and pay its equity holders profit share. However, in order to achieve the commercially required outcomes, each equity holder in a corporate model is likely to require his own class of share. Partnerships, by contrast, offer the ability to reward equity holders on an individual basis without that structural complexity. The existing proposals may make the playing field more level as between partnerships with mixed membership and partnerships without mixed membership, but it is of course straightforward for any partnership to achieve that levelling today by becoming mixed. The new proposals will create an imbalance which is much harder to correct between smaller and larger businesses.

A business with relatively few equity holders will be able to incorporate and achieve a significantly better tax result than if it was structured as a partnership (doubly so where equity holders are overseas). A larger business will not be able to manage the practicalities of numerous different share classes, and so will be forced into greater tax costs either by disincorporating or by adopting a salary-based model to pay individuals whose stake in the business is really that of equity holders. In our view this is a far more material tilting of the playing field than that created by the current rules, and would be likely to lead to for greater unfairness between taxpayers. Ultimately, LLPs were introduced in order to provide flexible business structures which provided limited liability for their members. Many businesses operate as LLPs because being in partnership reflects their business ethos. The tax rules should not operate so as to undermine this policy aim and de facto force businesses to incorporate.

(C) When drafting the rules, a principles-based approach will be better than a detailed, prescriptive set of rules (we would refer to the disguised remuneration legislation as an example of an approach to be avoided at all costs). As regards mixed member partnerships, the key point should be to ensure that if and when sums representing partnership profits are received by individual partners, such sums are ultimately taxed at individual tax rates (even if such tax is paid in two stages, at the corporate rate on allocation to a corporate member and the excess on later allocation to an individual). We do not consider that the mere deferral of tax which results from those profits being taxed at corporation tax rates on a temporary basis remotely justifies measures of the complexity of those proposed targeted substantially at a business section which the Government is seeking to promote in the UK. We accept that changes are needed to prevent that any deferred profits falling out of any later charge in circumstances where they ultimately benefit an individual partner.

4. Responses to specific questions – "Disguised employment"

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?

4.1 There should be a single test to determine whether or not a member should be taxed as an employee. We do not believe that it is necessary or desirable to establish a new test for the employment status for LLP members specifically.

4.2 Paragraph 2.4 states that tax legislation (such as s.863 Income Tax (Trading and Other Income) Act 2005) goes further than the original tax policy aim envisaged, by deeming an LLP member to be a partner for the purposes of all of the activities of the LLP. If this is the route of the problems that the Government identifies in the "Disguised Employment" section of the consultation, why not simply amend the relevant tax legislation accordingly and leave it at that?

4.3 Paragraph 2.9 states that low paid workers are engaged by LLPs as members, with the effect that they lose the benefits and protections associated with employment status. If the intention is to address the lack of benefits and protections, surely this merits a change in employment law rather than tax law? If the relevant employment law were changed, the tax consequences would follow automatically were the amendments referred to in 4.2 above to be made.

4.4 Overall, the position of members in an LLP should be no different to that of partners in a general partnership. Making the changes described above would ensure this position.

4.5 If it is not felt that amending the rules in this way gives the Government sufficient protection, then we would suggest dropping the first condition altogether and instead having a test based solely on the second condition. In that regard, we believe that the "no economic risk" limb of the current proposal would be deficient as a matter of insolvency law. This is because, even if members have contracted out of the risk of having to repay drawings in the LLP agreement, members can still be required to repay drawings by a liquidator if they should have known that the LLP was insolvent at the time they took their drawings. On this basis, as a practical matter it will be very likely that a (junior) member of an LLP will always to have "economic risk" as regards repayment of drawings. We would therefore suggest limiting the "economic risk" aspect to loss of capital.

4.6 Greater clarity is needed about what the Government regard as "insignificant" (as referred to at paragraph 2.20). It will be common for "genuine" LLP members subscribe £5,000-£10,000 for their LLP interest. Will this be regarded as being not "insignificant"? Such amounts are often not needed by the businesses in question, which will usually generate sufficient cash to meet working capital requirements on an ongoing basis: they are typically only contributed to attempt to ensure partner status for the relevant individuals under current tax law. It is already unsatisfactory that individuals contribute capital to businesses which is not required simply to substantiate a tax status which should be clear anyway: there is a real danger that these proposals might compound that absurdity if they lead to truly substantial amounts of wholly unnecessary capital being subscribed.

4.7 Greater clarity is needed about the consequences of salaried member status. Does this bring into play the employment related securities rules and the disguised remuneration rules? What about pension arrangements, for example will payments to salaried members be able to benefit from salary sacrifice arrangements? Would salaried members remain partners for the purposes of the various connection tests that deem all partners in a partnership to be connected with each other?

4.8 How will this treatment apply in an international context? In particular, will a salaried member now be treated as an employee for double tax treaty purposes? How will this treatment interact with other double tax treaty provisions that would have applied to them as self-employed members of an LLP? Will this impact on the availability of credit for UK tax against foreign tax?

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

4.9 A single test based solely on entitlement to share in profits and in assets on a winding up.

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?

4.10 The Government pays lip service to the fact that large, professional partnerships established as LLPs are not the target of these measures (for example in

paragraph 2.13). However, the wording of the proposed tests provides little comfort that such partnerships would not be within the scope of the rules. It is not satisfactory to have a test which is extremely widely drafted which HMRC then decides whether or not to apply to particular groups through guidance. One way around this problem would be to exclude professional partnerships from the ambit of the rules (see 3.4 above).

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 act inappropriately?

4.11 Principles-based drafting would reduce the need for a TAAR.

4.12 In addition, it is unsatisfactory that, based on paragraph 2.22 of the consultation, no steps can now be taken which might put a member of an LLP in a stronger position than they might currently be in with regard to the application of any future "salaried member" test to their position. If such a member is "upgraded", for example given a greater share of the profits of the business available for discretionary allocation in order to clearly put them on the right side of the line (where it is the desire of both parties to achieve that outcome), why should this be regarded as avoidance? Will consideration of the rules, whatever their final form, in the context of introducing new members into an LLP in the future also be regarded as avoidance?

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

4.13 The need for / scope of guidance will be driven by the approach the Government takes to drafting the rules. We would hold up the disguised remuneration rules as an example of the approach not to take to the drafting of such rules. As a general matter, it is unsatisfactory to have extremely widely-drafted primary legislation with exclusions from the scope of such legislation being given in HMRC guidance (which has no legal force, and is subject to being withdrawn, or to not being applied in a particular case, on the whim of HMRC).

5. Responses to specific questions – "Profit & Loss Allocation Schemes"

Question 6: HMRC would welcome views on this approach to counteraction, particularly what other specific indicators should be taken into account and possible alternative approaches that would counteract the tax advantages (including timing advantages).

5.1 As regards mixed membership partnerships, we would suggest an approach in which all partners are taxed on the profits in the year that they accrue to those members at the prevailing rates. To the extent the profits are subsequently reallocated to or otherwise benefit partners who would have suffered a higher rate of tax had the profits originally been allocated to them, the original partner to whom the profits were allocated would be subject to an additional tax liability, based on the difference between the rate it has already paid and the rate that would have applied to an allocation of profits to the benefiting partner in the year in which the profits were earned.

5.2 We would suggest a formulation similar to that used in the transfer of assets abroad rules ("power to enjoy income") to determine whether or not there is a subsequent benefit to another member.

5.3 As regards partnerships whose members have differing tax attributes, it would be preferable to tighten up the existing rules which are aimed at this type of planning, for example the rules in relation to the transfer of income streams and / or section 960 CTA 2010.

Question 7: Would the legislation approach set out above provide an effective deterrent and counter the schemes described?

5.4 Yes, albeit that the way that it is proposed to apply would also catch a genuine commercial arrangement such as the following:

For example, in the context of a US-headed asset management group, a UK individual may participate as a member of a UK LLP (which is effectively a subsidiary of the US parent, which will own a stake in that LLP through a corporate member), but also as partner / member in US parent partnership / LLC (because the individual in question is sufficiently senior to have an ownership interest in the US parent). Profits will be allocated to the corporate member of the LLP for genuine commercial reasons. These profits will form part of the overall profits of the US business, paid out to the owners of that business. If the UK individual is non-domiciled, he would only be subject to UK tax on the profits from the US business if remitted to the UK (and such profits made be regarded as dividend income or capital gains from a UK perspective in any event). This is an entirely commercial arrangement, and yet "P" (the individual in question) may benefit from the profits allocated to "C" (the corporate member owned by the US parent entity).

The allocation of profits to the corporate member of the LLP would not have a "tax avoidance purpose". However, the Government's interpretation of the test it proposes at paragraph 3.34 would catch such an arrangement.

Question 8: Would the proposed changes impact on situations that are not in line with the stated policy objectives? If so, HMRC would welcome detailed explanation of why you believe these situations fall outside the intended target areas.

5.5 See 5.4 above.

Question 9: Do you consider that there are circumstances in which this rule would give rise to outcomes inconsistent with the policy objectives and, if so, in what circumstances and how might these situations be addressed?

No comments.

Question 10: As described above, it is proposed that the profit deferral arrangements will be tackled in the same way as the other mixed membership arrangements. HMRC would welcome views on whether relief could be given retrospectively in the event that a contingent profit award does not ultimately vest. To prevent the risk of abuse, such relief would need to be confined to clearly defined circumstances and would also need to provide for additional tax charge

[sic] to be imposed on other members in the event that those profits were allocated to non-members.

5.6 Deferral is not, and should not be confused with, tax avoidance. Structuring payments in a way to ensure that tax is only paid on profits which have been economically received by the partners in a partnership is not tax avoidance, its simply entirely sensible commercial behaviour.

5.7 It is absolutely key that the rules provide a fair and workable way of taxing partnership profits which are subject to deferral arrangements. Any tax liability should also be deferred until deferred amounts are paid out to the partners in question. Providing tax relief to the extent those profits are either forfeited or, if already paid out, subsequently clawed back, is a far less satisfactory way to proceed.

5.8 The most straightforward way of doing this would be as set out in paragraph 5.1.

5.9 Partnerships cannot allocate profits to non-members as a matter of partnership law.

Question 11: A possible alternative to the approach suggested in question 10 would be to allow a member subject to a profit deferral arrangement to elect to be taxed as a salaried member, with the consequences then being as set out in paragraphs 2.24 and 2.25 above. Views on this proposal would be welcome.

5.10 This would not be an attractive alternative.

Question 12: Should there be any other exceptions to the proposed treatment? If so, please provide information why these cases should be excluded and suggestions on how these exclusions can be effected.

No comments.

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?

No comments.

Question 14: Do you agree that the legislation can help the Government to meet with the wider objectives of fairness without adversely affecting the flexibility of the partnership structure?

5.11 The proposed legislation does (and is obviously intended to) adversely affect the flexibility of the partnership structure as it applies to the allocation of profits and losses between different partners (which has always been one of the advantages of the flexibility of the partnership structure).

5.12 The effect of these changes may well be to push businesses back towards a corporate model, particularly given that such a model now potentially carries the

lowest tax rate of any business model (given the decreasing rates of corporation tax and the tax treatment of dividend income) even though we are talking about businesses whose equity sharing arrangements more naturally fit the partnership model. As we have already discussed, we think that the proposals will create a different, but greater, unfairness within the system: businesses which require flexibility in equity allocation (and which have historically been structured as partnerships for that reason as much as any other) will achieve a much better tax result if they incorporate, as overall rates will be lower and undistributed profits will only be taxed at 20%. However, that option will only be open to businesses with relatively few equity holders as the necessary flexibility cannot otherwise be achieved with a corporate. A very significant unfairness will therefore be introduced between smaller businesses and larger ones, with the additional quirk that there may almost be a penalty on growth as if such a business reaches a size where the corporate structure is unwieldy, it will suffer material tax and other costs in reorganising itself.

5.13 In our view it is a false premise to say that deferral and working capital planning is an attempt being made to cherry pick the benefits of corporate and partnership structures which amounts to avoidance. It is the exercise of legitimate choice by taxpayers to eliminate unjustified tax costs. From a pure tax perspective a corporate structure, paying dividends out of taxed profits to equity holders, is now by far the most efficient, and so a partnership structure will not be chosen for tax reasons per se. A partnership structure will be chosen where the necessary flexibility of equity returns cannot be delivered using a corporate. This will lead to material tax disadvantages without a measure of planning, which is commonly undertaken. Thus the unfairness between the positions of smaller and larger businesses which unavoidably exists if only corporate structures are used can be addressed, although some additional tax results as against the pure corporate structure even where mixed member planning is utilised.

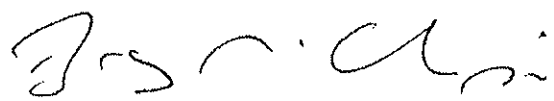
Question 15: Can interested parties offer views on any other likely costs that partnerships and their partners may incur in order to implement the changes?

No comments.

Question 16: Will the proposals described about provide a comprehensive response to all schemes involving manipulation of partnership profit and loss allocations (including but not limited to the arrangements described in Annex C)? If not, what other types of scheme should be tackled?

No comments.

Yours faithfully,



Bradley Phillips
Chair
The City of London Law Society Revenue Law Committee

THE CITY OF LONDON LAW SOCIETY
REVENUE LAW COMMITTEE

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