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The FSBC
The House of Lords Economic Affairs Committee

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Dear Sirs

**Response to proposed changes to partnership taxation**

1. The City of London Law Society ("CLLS") represents approximately 15,000 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. As such our members have a very direct interest in the proposals for changes to partnership taxation, as well as being concerned on behalf of their clients.

2. We have extremely grave concerns about there being tax provisions which treat one form of partnership very differently to other forms of partnership (as is the result of the LLP salaried member proposals) and over the way in which these measures are being implemented, which we think are contrary to the principle of legal certainty by which the UK sets so much store in measuring its international competitiveness. We think that as currently drawn the measures go too far, and would apply in circumstances which are not offensive when tested against the professed policy behind the changes. Of particular major concern is that we would dispute key aspects of HMRC's proposed interpretation of the new legislation as set out in the "HMRC Technical Note and Guidance" published alongside the draft legislation.

3. We also note that the measures will cause serious difficulties for the asset management industry, potentially leading to a materially higher tax burden for businesses operating in that sector. Indeed, the documentation published by HMRC in December explicitly stated that they had been surprised at the extent to which it would affect alternative investment managers and had accordingly increased the estimated tax take. This is of course an entirely legitimate policy choice of government. However, these measures were announced last summer almost simultaneously with the launch of the Government's investment management strategy by Treasury ministers, at which the Economic Secretary to the Treasury stated that: "In short, our mission is to make the UK the most competitive location for funds. We want funds domiciled here. And we want funds managed here." There is an evident serious inconsistency in policy here which is extremely regrettable. We also very much hope that it remains Government policy to support the UK as a base for professions.

4. This submission focuses on the "salaried member" proposals as these raise particular difficult policy issues and are the most relevant to the membership of the CLLS. However our concerns about process and timing apply equally to the "mixed membership" part of the proposals as well (where there will be situations where

genuine commercial arrangements are going to be caught by the new taxing provisions, unfairly in our view).

***The policy background***

5. Historically in the UK businesses providing professional advice almost invariably constituted themselves as partnerships for a variety of commercial, regulatory, tax and cultural reasons. However, following the great expansion of the City of London in the 1980s, concerns began to arise that the unlimited liability borne by partners was not appropriate in the context of the size of those businesses and the risks to which they were unavoidably exposed.

6. The largest accountancy firms in particular undertook quite a lot of work to investigate whether it would be possible to move their legal seats, although not places of business, to Jersey, whose government obligingly legislated to bring into existence a partnership with limited liability that could be utilised by such a firm.

7. The UK government of the day responded by opening a consultation on the possibility of creating an entity which would have most or all of the liability-limited features of the limited company, but would offer tax consequences similar to that of a partnership. This was clearly considered important to ensure that the UK (and the City of London) remained a leading centre for financial and professional services. This led to the creation of the UK LLP under the Limited Liability Partnerships Act 2000.

8. The tax policy intention behind the 2000 Act (and consequential amendments to the various taxes acts) was explicit: "Members of an LLP will be treated for income and capital gains tax as if they were in a conventional partnership". (*House of Commons Research Paper 00/54, 22 May 2000, note on Clause 10 of the LLP Act.)*

9. At the time, there was substantial agreement as to the merits of the proposals. They were first put forward by John Major's Conservative government in its latter days, and were carried through to fruition by Tony Blair's Labour administration. They received cross-party support when put before Parliament. Whilst some individual members of Parliament objected that the privilege of limited liability should only be extended to shareholders in companies, it would be fair to say that the measures, and the policy behind them, were not controversial. Indeed the proposition that a member of an LLP should not be able to be an employee was an explicit part of the policy, having been originally advanced by Baroness Buscombe in the House of Lords debate on the Bill which became the 2000 Act: "we believe that the Bill should make clear that a member of an LLP will not be an employee of the LLP unless there is express agreement to that effect between the member and the LLP." (*HL Deb 09 December 1999 vol 607 c1424.*)

10. Over time, of course, LLPs became the preferred (though not universal) choice of the professional firm facing a decision as to how it should be constituted. LLPs also came to be utilised for a much wider variety of purposes than were originally anticipated.

11. The remuneration arrangements of members of LLPs also evolved over time, reflecting the fact that if an individual became a member of an LLP, they could be remunerated without suffering the burden of employer's National Insurance contributions. With the last Labour government choosing to increase employer's National Insurance substantially during its tenure, the financial incentive to do this grew over time. However, of course, any individual accepting LLP membership would not be an employee as a matter of law and so would forgo those statutory rights which would accrue to him as an employee. The LLP would also lose the right

to claim statutory sick pay or statutory maternity pay in respect of the individual should they become relevant.

12. It is fair to say that for a period after 2000 there were differences of opinions among advisers as to how far it was possible to push an individual LLP member's arrangements towards having the characteristics of employment and remain confident that an employment would not actually arise. However, HMRC's attitude became clear over time – it would not argue that an individual was an employee of an LLP if they were a member of that LLP. This stance was confirmed orally by representatives of HMRC to various of our member firms, and also in writing by HMRC to the Association of Partnership Practitioners.

13. In our view this background is very important in understanding the scale of the impact of the existing proposals, and our criticisms of them. We must emphasise: since 1997 it has been clear government policy, endorsed by governments of different parties, that there should be neutrality for income tax purposes as between LLPs and general partnerships. This policy has been confirmed by HMRC. No change was suggested until the announcement of the current measures.

14. It follows from this that making individuals members of LLPs on terms as to remuneration which may resemble those of an employee of equivalent seniority in a company is not of itself tax avoidance. It is misleading to talk pejoratively, as HMRC did in the 20 May 2013 policy document putting forward these proposals, of LLPs being used to "disguise" employment and so "avoid" employment taxes. Where our member firms adopted such structures they acted entirely in accordance with Government policy, openly promoted and endorsed by HMRC. There was no disguise; there was no avoidance.

15. It is also worth repeating that this is not a case where a tax benefit can be delivered without any commercial consequence. In becoming an LLP member rather than an employee, an individual may give rise to a tax benefit but also suffers a very real detriment in losing their statutory employment rights – indeed the leading case of *Tiffin v Lester Aldridge LLP* concerned an LLP member who tried to claim employment status in order to found an unfair dismissal claim. This is not a clever piece of tax structuring which delivers a tax benefit for no cost – it is a changing of the parties' legal relationship with very real non-tax consequences. The fact that the proposals would result in the tax cost of employment status arising without the attendant benefits is in our view an unfair result of the underlying policy.

16. It is of course open to any government to change policy and subject any given category of taxpayers to a less favourable tax regime. Indeed, the 20 May document contains a more honest statement of the position where it states that "The Government considers that the continuation of this favourable treatment for an individual who, but for the legislation, would otherwise be employed by the LLP is unfair to other taxpayers and can create avoidance opportunities." This is a change of policy: it is not a closing of loopholes.

17. We would accept that the 2000 legislation and subsequent HMRC practice could perhaps be criticised as failing to deliver the desired neutrality of income tax treatment between LLPs and partnerships, on the ground that it made it so hard to be an employee of an LLP that it actually put LLPs in an advantaged position. However, the current proposals demonstrably go further than treating as an employee for tax purposes an LLP member who would otherwise be an employee as a matter of general law and change the policy fundamentally in that they clearly and explicitly place the LLP at a positive disadvantage. We have genuine difficulties with a policy that treats as an employee a member of an LLP who in another form of partnership, would (as a matter of general law) be a partner and thus treats one form of

partnership (ie the LLP) differently from other forms of partnership, particularly in view of the policy rationale behind the creation of LLPs.

18. Many of the businesses affected are world-class professional services firms, whose value to the economy is incalculable. This value is direct, in that these successful businesses are highly profitable and wealth generative. They have international client bases, and so make a real contribution to the balance of payments. The benefit is also indirect, in that the presence of these businesses, in a diverse and thriving competitive market, provides the essential infrastructure to support the UK's world leading financial services industry.

***Our recommendations***

*Our first recommendation is that the implementation of the proposals should be delayed until 2015.*

19. These proposals are detailed. They remain the subject of consultation and extensive lobbying. They are also still relatively undeveloped in a number of areas: while draft legislation and guidance exists on the major points, a number of consequential impacts remain unclear and, as stated above, there are real concerns over HMRC's views on how the legislation should be applied. It would also in our view make sense to await the Office of Tax Simplification report on the taxation of partnerships in order that any reforms arising from that report can be implemented as part of a package with these changes.

20. As things stand the new rules will come into force on 6 April. However, the legislation giving effect to them will not receive Royal Assent until mid- to late-July, and will be subject to change throughout that period. Indeed we would hope it would change in some respects before enactment.

21. Businesses need to be given the opportunity to consider properly the application of this legislation to themselves and evaluate their response. A variety of legitimate responses are possible – some minimal, some very fundamental. A firm whose remuneration structure includes some salaried members may decide the best course of action is to do nothing and pay the National Insurance imposed by the new law. It may decide it is best to change its remuneration structures such that the current salaried members are remunerated on a different basis – however, that process will, in a large firm, be time consuming as it will likely require amendments to the firm's constitution. It may decide to change its policy on making up partners such that individuals are not given the title partner until they have satisfied the firm that they are ready to become full equity partners.

22. We would note that whilst it is unlikely to be an option for law firms, one possibility that many investment managers to whom this legislation will apply will be considering is moving to a corporate structure instead of an LLP. Due to the slow process of regulatory approvals, it would be impossible for an investment manager wishing to respond in this way to do so before 6 April.

23. These are all decisions of great importance to these businesses, and will involve (indeed are already involving) the commitment of large amounts of senior management time to the detriment of their core businesses. It is of course not improper for businesses to go through this thought process. It is not indicative of tax avoidance in any way. It is a perfectly legitimate examination of the changed choices offered by the tax legislation and a resulting consideration of the business' response to those choices.

24. The consultation process has also been managed in a regrettable manner. It is extremely unusual, as was the case here, for the second iteration of proposals to be more aggressive to taxpayers than the first. Additionally, during the early part of the consultation process, many of our member firms were told by representatives of HMRC that they should not worry about the proposals as HMRC was not looking to target professional firms. This message has now been reversed, and in similar discussions HMRC are now saying the opposite. This does not promote trust and confidence in the consultation process. It also emphasises the point on timing: law firms could not have reasonably anticipated that they would be targeted by these measures until the publication of the second iteration on 10 December 2013.

25. Requests for a deferral of the proposals to HMRC have been met by the response that the tax take from the measure has now been baked in to the government's 2014/15 fiscal projections, and so a delay is impossible. This further undermines the validity of the consultation process, since it also implies that a significant reduction in the scope of the measures could not be contemplated.

26. In promoting its international competitiveness the UK sets great store by its commitment to the rule of law and legal certainty. The manner of introduction of these measures undermines both to the detriment of some of the country's most successful businesses. Put simply, it is not fair to require businesses to consider their response to a fundamental policy change – and that is what these proposals are – without being able to see the law and all relevant supporting material in its final form. Doubly so where legitimate responses to the change will in many cases be substantial and time-consuming. Yet that is what is currently happening.

*Our second recommendation is that the detail of the proposals be reviewed as their current scope exceeds that of the published policy and so does not give proper effect to it.*

27. We will be making detailed technical recommendations to HMRC on these points. However, in our view the key points to be addressed are around the remuneration-based test of true partnership ("Condition A" in the draft legislation):

    - If individuals come together to try and maximise their collective profit in order to divide that profit amongst themselves, they have the economic character of partners rather than employees. It should not matter how that profit is divided up. A business is no less a partnership if it divides up its profits based on the recommendations of a remuneration committee considering individual performance than if it does so by reference to a pre-set formula based on set partnership shares. As drawn the legislation (certainly as interpreted by HMRC based on their Technical Note and Guidance) does not deliver this result.

    - Similarly HMRC contend that an individual may be a salaried member if he is remunerated by reference to the performance of part of a business rather than all of it (for example, in a multi-office firm, if they get a share of their office's profits rather than the profits of the entire firm). This cannot be right: if such an individual is not "really" a partner in the entire firm, then surely their position is far more akin to that of a partner in a smaller firm than that of an employee? On the flipside, especially in the context of overseas firms with UK offices, members of UK LLPs are often remunerated by reference to the profits of both the UK LLP and an overseas LLP. HMRC are contending that such an arrangement should be caught, whereas again the analogy should not be to an employment but to partnership in a different (in this case bigger) firm.

- Our view is that the legislation should not apply to any individual whose arrangements are such that what they get is a slice of the firm's total profits. It should not matter whether that slice is fixed or variable or, if variable, the basis of any variation. It also should not matter if some members' call on profits is senior to that of others. The defining feature of salaried member status should be whether an individual gets paid anyway even if profits are insufficient. An employee of a business has a contractual right to be paid. If the business has insufficient cash to do this it must raise that cash somehow or declare itself insolvent. An equity holder of a business knows that they only get paid if profits are sufficient, and has no right to claim payment if they are not. This is the economic distinction between an employee and a partner. Put in those terms it is easily drawn. The much more extensive terms of Condition A, as interpreted by HMRC, will catch many individuals who are in fact clearly equity holders in economic terms and not employees. The draft legislation does not deliver the policy objective.

- It follows from our reasoning above that we would accept that where a member of an LLP is entitled to a minimum (or fixed) guaranteed payment, such that other members will fund the payment in the event profits are insufficient, then that minimum or fixed amount should be treated as disguised salary within the current draft legislation.

- The targeted anti-avoidance rule is also drafted far too widely. In seeking to ignore for tax purposes all arrangements whose main purpose is to ensure that the new provisions do not apply, it calls into question whether HMRC would seek to disregard a genuine restructuring of arrangements in response to the new rules with the real commercial effect of turning members into what HMRC would accept were "true" partners. It cannot be correct for this to be the effect of the provision.

28. If these points were to be adequately addressed the importance of postponing the measures would of course diminish to some degree since it would follow that the number of businesses affected would be greatly reduced.

29. The City of London Law Society Revenue Law Committee[1] will also be making these policy points to HMRC directly in due course as part of the consultation process in addition to making detailed technical submissions on the draft legislation and Technical Note and Guidance.

Yours faithfully,

**David Hobart**
Chief Executive, City of London Law Society



[1] A list of the members of the CLLS Revenue Law Committee can be found here: http://www.citysolicitors.org.uk/index.php?option=com_content&view=category&id=156&Itemid=469