Salaried members of LLPs

Overview of measures in draft Finance Bill 2014

Read this if you advise on setting up LLPs with individual members.

From this April some individual LLP members will be treated as employees, subject to PAYE and employer's and employee's NICs.

What are the new rules aimed at?

In short, using LLPs to avoid national insurance contributions (NICs).

The current tax rules allow LLP members to escape being treated as employees even though their relationship with the LLP resembles employment more than being a partner. For example, an LLP member may be treated as a self-employed partner even if they have fixed remuneration, no role in management and limited exposure to risk.

If they are not treated as an employee then the payments they receive from the LLP are not subject to employee's or employer's NICs.

The new rules are scheduled to take effect on 6 April 2014 and will apply to new and existing LLP members. Although the rules are likely to change to some extent before then, LLPs with individual members will need to start planning now.

Salaried members

The new rules will treat an individual LLP member as an employee if 3 conditions are satisfied:

A. 80% or more of the what the member is paid by the LLP for performing services is fixed or does not otherwise depend upon the **overall** profitability of the LLP (such payments are referred to as "disguised salary");

B. the member does not have significant influence over the affairs of the LLP; and

C. the member's capital contribution is less than 25% of the member's disguised salary.

These conditions are discussed in more detail below.

If all three conditions are satisfied then all of the payments that the member receives from the LLP in respect of his or services will be treated as employment income with the result that PAYE will be due as well as NICs.

It will be possible for an individual member to move in and out of these rules during and between accounting periods.

Condition A – disguised salary

This condition will be satisfied if it is reasonable to expect that 80% or more of what the LLP will pay the individual member in respect of his or her services will be "disguised salary".

A payment will be disguised salary if it is:

- fixed;
- variable but varied without reference to the overall profits or losses of the LLP; or
- not, in practice, affected by the overall profits or losses of the LLP.

Period tested

The 80% disguised salary test will be measured over the life of the relevant arrangements. This begins when the arrangements are put in place e.g. the LLP is set up or a new member joins (or 6 April 2014 for existing arrangements) and ends when the arrangements are expected to end or be modified.

The test is forward looking and depends upon what the individual reasonably expects to receive over the relevant period. It is applied at the beginning of that period and is not re-tested unless and until the arrangements are altered.

For example, if an LLP is set up to develop a property over 3 years then the 80% test will be applied over that 3 year period. For open-ended e.g. professional services LLPs the period tested will end when it is reasonable to expect that the terms of the member's profit share will change. If the arrangements are altered earlier than expected then the rest is re-applied (but not retrospectively).

Whilst you cannot avoid these rules by making temporary changes to profit shares, extraneous events (such as a revised profit forecast) should not cause someone to be treated as an employee if they were not when the arrangements were set up.

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Overall profits
It is the overall profits of the LLP that are important. A profit share linked to personal performance or linked to a particular part of the business will be treated as disguised salary.

Contract vs reality
The rules are designed to catch payments which, although contractually dependent upon the LLP's overall profits or losses, are structured so that in practice they will not be affected by the overall performance of the LLP. For example, a payment that will only vary if an unrealistically overall profit target is met will be treated as disguised salary.

Capacity
The rules only look at payments made for services that a LLP member provides in that capacity. Payments made for work genuinely performed in a separate capacity are not caught. Note, however, that attempts to circumvent these rules with artificial structures may be caught by the anti-avoidance rule (see below).

Condition B – management

This condition will be satisfied if the individual member does not have "significant influence" over the affairs of the LLP.

According to HMRC's guidance this will require more than just voting for the management committee or approving the LLP's accounts. Although a hierarchy of membership will not of itself cause this condition to be satisfied, if the management committee effectively run the LLP then this condition will be satisfied for all the members who are not on that committee.

The test looks at whether there is significant influence over the LLP's whole business, not individual parts. For example, an individual in charge of a particular department in a large LLP may satisfy this condition if they are not also on the management committee.

HMRC's guidance is clear that this condition is likely to be satisfied by most members of large LLPs as only a minority of individuals will have significant influence over the affairs of the whole LLP. Members of these partnerships may, therefore, need to focus on the other two conditions when considering how to escape these rules.

This test will be applied on an on-going basis. A member will satisfy this condition at any time that their influence over the affairs of the LLP ceases to be significant. Whether they are caught by the rules will then depend upon whether their arrangements satisfy the other two conditions.

Condition C – capital contribution

This condition will be satisfied if the individual member's contribution to the capital of the LLP is less than 25% of the total amount of disguised salary that it is reasonable to expect will be payable to that member in the relevant **tax year**. Contrast this to condition A, which looks at the amount of disguised salary payable over the expected life of the arrangements.

Also, LLPs will allocate profit based upon accounting periods and often these will not coincide with a tax year. Technically, therefore, these rules will require the proportion of disguised salary payable to be measured over two different periods.

However, in practice many LLPs are likely to apply condition C by reference to their accounting period rather than the tax year and it is hoped HMRC will take a pragmatic view of this.

When to measure contribution
This test will first be applied to all existing individual LLP members on 6 April 2014. Thereafter the test is applied at the beginning of each tax year (6 April).

If an individual becomes a member of an LLP in the middle of a tax year then the test will be applied to them when they join the LLP.

If there is a change in circumstances during a tax year (such as a change in capital contribution) then the test is re-applied.

If an individual joins an LLP or increases their capital contribution part way through a tax year then their capital contribution is pro-rated for the purposes of this test. A relevant proportion of their capital contribution will need to match or exceed 25% of their disguised remuneration. There is a similar pro-rating if it is reasonable to expect that they will cease to be a member before the end of the tax year.

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Anti-avoidance

Anti-avoidance provisions will target arrangements with a main purpose of avoiding these rules. They will catch both arrangements where the individual remains a member and ones where a corporate vehicle becomes a member in place of the individual providing services to the LLP.

Deductions

Subject to the usual rules on tax deductions, payments to individual members treated as employees under these rules will be tax deductible for the other members who are not themselves caught.

Solutions

Given the reality of running many LLPs, and the uncertainty over what constitutes "significant influence", the focus of attempts to escape these rules will probably be on conditions A and C, particularly if there are more than a handful of members in the LLP.

Thus many LLPs are likely to need to change their profit sharing arrangements or ask some members to contribute more capital.

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