Mixed partnerships

Overview of measures in draft Finance Bill 2014

Read this if you advise on partnership structures with a mixture of individual and non-individual partners.

From April 2014 new tax rules may reallocate partnership profits or losses in these partnerships to produce a higher tax charge for the individuals.

What are the new rules aimed at?

A variety of partnership structures take advantage of companies being taxed at a lower rate than individuals.

Individuals are taxed at a top rate of 45%. The corporation tax rate has been falling over the past few years and will reach 20% next year. There is, therefore, a clear tax advantage to be gained from streaming more profits to a company partner (or more losses to an individual partner). The structures will usually allow the individuals to eventually access or benefit from that profit.

Some profit shifting arrangements are driven by regulatory requirements to defer profit distributions. The deferred profit is "warehoused" tax efficiently in a company partner until it vests.

New rules designed to prevent such planning will apply from 6 April 2014, both to new and existing partnerships.

Excess profit allocation

The new rules will apply to partnerships (including LLPs) with a mixture of individual and non-individual partners where the profits allocated to non-individuals either represent deferred profit or are excessive. For simplicity this note refers to non-individual partners as company partners.

Deferred profit

The rules will apply where it is reasonable to suppose that what would have been an individual partner's deferred profit (conditional or not) is instead included in a company partner's profit share and this produces a lower overall tax bill.

Excess profit allocation

The second situation in which the rules will apply is more complex. The rules compare a company partner's profit share with a benchmark measure to determine whether it is excessive. They then test whether any excess is attributable to the relationship between that company and an individual partner.

The rules will apply if:

- a company partner's profit share exceeds the sum of (i) a commercial rate of interest on its partnership capital and (ii) an arm's length payment for any services the company provides to the partnership;
- that company partner is connected with an individual partner OR an individual partner otherwise has "power to enjoy" any of the company partner's profit share;
- it is reasonable to suppose that any of the company partner's profit share is attributable to that connection or power; and
- it is reasonable to suppose that the individual's profit share and the overall tax bill are lower because of that connection or power.

Power to enjoy?

This is widely defined and will catch, for example:

- the individual partner holding any shares in the company partner;
- the company partner using its profit share for the benefit of the individual partner; and
- the individual partner being able to direct how the company partner uses its profit share.

What happens when the rules apply?

For tax purposes a "just and reasonable" amount of the company partner's profit is re-allocated to the relevant individual(s).

Anti-avoidance

An individual can still be caught by these rules even where they are not a direct partner in a mixed partnership.

Anti-avoidance rules will treat an individual as having been a partner if:

- that individual "personally performs" services for the partnership but is not a partner; and
- the individual has invested via another partnership (and so is a partner in an associated partnership) OR it is reasonable to

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suppose that the individual has not become a partner so as to avoid these rules.

The deferred profit and excess profit allocation tests described above are then applied as if the individual had been a direct partner in the main partnership.

The Alternative Investment Fund Managers Directive (AIFMD)
The AIFMD remuneration guidelines require firms managing certain alternative investment funds to defer remuneration of some individual managers. Such deferred remuneration has often been temporarily allocated to a company partner to spare the individuals an unfunded tax charge.

Such warehousing of deferred profit shares would be caught by these rules. However, instead of an individual paying the tax on their deferred profit share the firm can choose to pay it.

The firm will need to elect for these special rules to apply. Once it has elected each individual partner will be free to shift the tax liability for their deferred remuneration onto the partnership. Firms may want to contractually limit who is entitled to do this.

Once the remuneration vests the individual can be paid without a further income tax liability (although there will be NICs). However, if the individual never becomes entitled to be paid the deferred remuneration the partnership cannot reclaim the tax already paid.

This special treatment will only be available for remuneration that is deferred in line with the AIFMD guidelines. It will be available for deferred remuneration paid in units or shares as well as in cash.

Excess loss allocation

A number of structures have sought to allocate partnership losses to higher tax paying individuals whilst streaming profits to lower tax paying company partners.

New rules will counteract arrangements where the main purpose, or one of the main purposes, is to secure that losses are allocated to an individual rather than a non-individual with a view to the individual obtaining tax relief.

Where the rules apply the individual is denied tax relief for the whole of their loss.

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4 February 2014

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