When is a partner an employee?

Employment Tax



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Michael Beart and *Francis Fitzpatrick QC* ask when a partner is deemed to be an employee in a trading LLP under the salaried member rules

Key Points

What is the issue?

Following the introduction of the salaried member legislation in April 2014, individual partners in trading LLPs run the risk of being recharacterised as employees. HMRC are actively seeking additional taxes, penalties and interest from non-compliant LLPs.

What can I take away?

Taxpayers need to reassess their position regularly and be mindful of potential trigger points.

What does it mean to me?

LLPs should take proactive measures to review and document their compliance with the new rules, particularly where businesses have grown quickly or operating models have changed.

Since its introduction in 2000, the limited liability partnership (LLP) has been a success. The number of LLPs has grown year on year until recently when the trend reversed – a reversal coinciding with the development of the salaried member rules.

Introduced following heavy lobbying by the UK's leading accountancy firms, the rate of growth of LLP structures had until recently far outstripped both traditional limited partnership (LP) and limited company structures. Favoured for its combination of flexibility and limited liability status, the LLP structure was increasingly adopted by owner-managed professional services firms, such as accountants and lawyers, and other industries such as asset management.

However, following the introduction of salaried member and mixed member tax reforms in 2014, the growth of LLPs stagnated until in 2018 and 2019 numbers began to fall. According to data from Companies House, there are now approximately 52,500 LLPs in the UK, compared to a peak of around 60,000 a few years ago. This fall is at a time when the number of companies is still growing, despite the increase in dividend taxation by 7.5% from 6 April 2016.

One of the key features of trading LLPs is that they are transparent for tax purposes and individual partners are classified as self-employed. There is no delineation between what a partner may receive in relation to services rendered and an equity return; instead, they simply receive an allocation of profits.

Compared to traditional employee relationships, the partnership structure saves 13.8% employer national insurance contributions (NICs). At the additional rate of income tax, this means that trading profits are subject to 47% income tax and NICs, whilst the equivalent for an employee is a little over 53%.

As corporation tax rates have fallen, the company was, for a short while, a better vehicle through which to extract profits; however, this ended with the rise in dividend taxation in 2016, albeit the next corporation tax drop in 2020 will more closely align the two structures.

Introduction of the salaried member rules

The salaried member legislation, brought in with effect from 6 April 2014, was an attempt by government to eliminate the NICs saving where individuals are providing services on terms similar to employment.

The disparity between employment and self-employment has been a running battle between HMRC and taxpayers for some time, and continues to be a topical area with the proposed extension of off-payroll working legislation from April 2020. Furthermore, the salaried member rules were introduced alongside the mixed membership rules (which covered partnerships of individuals and companies) that operate to reallocate excess profit allocation back to the individual partners for tax purposes – an interesting topic in itself but outside the scope of this article – but a clear sign that HMRC felt the existing LLP flexibility allowed taxpayers to have their cake and eat it.

Prior to the 2014 tax reforms, the default position was that an individual, M, who is a member of a LLP, carrying on a trade, profession or business, should not as a matter of law be treated as an employee of the LLP. (See *Reinhard v Ondra LLP and Others* [2015] EWHC 26 and also *Clyde & Co LLP and another v Bates van Winkelhof* [2014] UKSC 32.) This caused HMRC particular concern as someone who, in substance, was more akin to an employee would as a matter of law be treated as a partner and self-employed.

Although there was no statutory basis, a practice of contributing capital to the LLP became commonplace to evidence a partner’s financial commitment in the business, and allay fears that partners were ‘disguised employees’. This was to demonstrate that profit allocations were at least in part a return on equity and not merely for services provided. Figures in excess of £1,000 were often seen as a minimum benchmark, but contributions grew as attention from HMRC came more prevalent.

The concern that partners were disguised employees led to the introduction of statutory provisions, introduced as ITTOIA 2005 ss 863A to 863G by FA 2014, to

provide that if three conditions, A to C, are satisfied (see below), M will be treated as an employee for tax and NICs purposes. All three conditions must be satisfied for M to be treated as an employee. Partners wishing to retain self-employed status should seek to breach two, if not all three, of the conditions to provide them with a safety net. These rules only apply to LLPs; they do not apply to LPs, presumably on the basis that limited partners may not be involved in the management of the LP.

If M is treated as an employee, then the normal tax consequences flow both for M and for the LLP. M's remuneration is treated as employment income. The LLP is an employer, must operate PAYE and will be liable for employer's NICs; and will be entitled to a deduction in respect of the deemed employment income paid to M. Of particular concern is the knock-on effect of associated legislation like the employment related securities rules and employee benefits regime (albeit the latter now has an equivalent embedded in the disguised remuneration rules for self-employed individuals).

The three conditions that render an individual partner an employee

These are aimed at distinguishing between:

- the traditional concept of a person who is a partner in a partnership; and
- a person who, although in name a partner, is more akin to a salaried employee.

The three conditions focus on: whether M is remunerated by reference to the profits of the partnership; M's influence over the affairs of the partnership; and M's capital contribution to the partnership.

Condition A: disguised salary

Condition A is met if it is reasonable to expect that at least 80% of the total amount payable by the LLP, in respect of M's performance of services for the partnership in M's capacity as a member of the partnership, will be 'disguised salary'. It is worth noting that M must be performing services for the partnership.

A 'disguised salary' is an amount which is:

- fixed;

- variable, but not by reference to the overall amount of the profits or losses of the LLP; or
- not, in practice, affected by the overall amount of those profits or losses.

The test is forward looking and not retrospective, and is to be applied on the basis of the parties' reasonable expectations, which one would expect to be reflected in the LLP agreement or in the LLP's policies on profit sharing arrangements. If, applying the test prospectively on the basis of reasonable expectations, M does not satisfy Condition A, but it turns out as a result of unexpected events that the test was satisfied, there is no requirement to retrospectively change the tax treatment. From a practical perspective, this is important, as moving a partner onto payroll retrospectively would be a very painful process for a number of reasons.

The application of this test is far from straightforward in practice, as many LLPs allocate profit based on the performance of a partner rather than by a fixed profit share. HMRC guidance suggests that the mere fact of the remuneration of a partner being based on performance will not satisfy Condition A, provided the amount available to be allocated turns on the firm's profits; however, given the complexity of many remuneration arrangements, there is considerable uncertainty as to how the test operates in practice.

For larger LLPs with numerous internal teams or departments, linking an individual's remuneration to the overall profits and losses may prove challenging, posing the question of whether multiple LLPs would better suit the business? However, more collaborative remuneration structures, where all partners share in the success or failure of the partnership, find it far easier to breach the condition.

Condition B: significant influence

Condition B is that the mutual rights and duties of the LLP, and of the partnership and its members, do not give M significant influence over the affairs of the partnership. The term 'significant influence' is not defined, which means it falls to be determined as a matter of purposive statutory construction in the light of the facts viewed realistically.

Its purpose is to exclude from the ambit of the test those who, as HMRC put it, 'are the business', those who truly run and operate the business. The concept is easy enough to grasp, but the application of the test is intensely fact specific with all

material circumstances being taken into account.

It is an easier test to apply in the case of an LLP with a small number of members as, barring particular members exercising the lion's share of influence, each member should be regarded as having significant influence over the business. In the case of an LLP with a large number of members, it becomes more difficult to say that simply by reason of being a member, a member has a significant influence, and it will be necessary to review the constitutional documents of the LLP and the manner in which the LLP is operated on a day to day basis.

Whilst HMRC say they will not draw a line in the sand, their guidance suggests that in an LLP of ten members, all things being equal, each partner will be regarded as having significant influence. The guidance notes that where junior members of the LLP are entitled to attend meetings but not to vote, they will not have significant influence. Some LLPs allocate powers to a management committee.

In the case, the guidance states that: 'If the members of the management committee effectively run the LLP, then Condition B will not be satisfied in respect of those members. Condition B will be satisfied for the remaining members, who are potentially salaried members.' Whether in practice those members are salaried members will, of course, depend on the other two conditions.

HMRC's guidance on the meaning of 'significant influence' at ESM 62000 is useful but far from definitive and is qualified by statements that ultimately the question will be one of fact to be resolved in the light of all material circumstances.

In practice, particular care needs to be taken when assessing the factual position and the context is important. For example, LLPs regulated by the UK's Financial Conduct Authority (FCA) already have their own 'significant influence test', which is currently being revised under the Senior Managers and Certification Regime (SMCR).

Whilst there is no direct read-across for tax and regulatory purposes, as acknowledged by HMRC's guidance, arguing competing factual positions across the two regimes will clearly not be helpful. Likewise, which partners appear on the 'Persons with Significant Control' register with Companies House may require some thought.

Condition C: capital contribution

Condition C is that M’s capital contribution to the LLP is less than 25% of M’s disguised salary for the year in question.

If a disguised salary can be reliably identified, then this is a more straightforward test compared to the others and turns on the figures. It is applied in respect of each tax year, as well as when there is a change of circumstances which might affect the result. LLPs in which the partners have no disguised salary – for example, where they all have a fixed profit share – should comfortably breach Condition C with a nominal level of capital, as well as Condition A.

Practical steps to ensure compliance

As is common with any new legislation, there is always a lag between introduction and HMRC’s attempts to enforce the new rules. Five years post implementation, enquiries have now been in operation for a number of compliance cycles.

What has become apparent is that not enough LLPs have taken proactive measures to review and document their compliance with the new rules, particularly where businesses have grown quickly or operating models have changed, thereby further opening them up to challenge. As a matter of best practice, LLPs should reassess compliance regularly, but there are a number of trigger points to watch out for.

Year end

As an accounting period draws to a close and a new one begins, LLPs should be reviewing the salaried member position for the year ahead. This is particularly important for Condition A as it is a forward-looking test.

It would be prudent to document the expectations at the beginning of the year should the LLP ever be challenged on the position taken. Importantly, it may help to demonstrate to HMRC that due care and attention has been taken in arriving at the classification, thus placing the LLP in a better position should there be a future dispute. With drawings typically being made monthly, the LLP will need to know quickly if they have to move a partner onto payroll and start making PAYE deductions. The additional financial burden of the employer’s NICs will also need to be determined along with who will pick up that cost.

Recruitment, promotion and retirement

Whenever a new partner joins, an employee is promoted to partner or an individual retires from the LLP, their individual position will need to be assessed, along with the impact on the wider LLP. This should in theory be a relatively straightforward exercise for isolated incidents, but it becomes more complicated in a merger scenario or where there is a wider succession planning arrangement.

Determining who has significant influence as the LLP grows is often critical, as founders are often not inclined to share power with relative newcomers and corporate investors may seek to ringfence control.

New teams, products and business lines

Material changes in the way an LLP generates profits could lead to a change in remuneration sharing arrangements that will require reassessment under the salaried member rules. Competing profit centres in the same partnership make sharing partnership profits as a whole difficult. Tax considerations need to be factored into the equation while the commercials are still being negotiated to ensure that there are no unwanted surprises.

Where change is gradual over a number of years, it is important to fact check the reality against the past position and historic assumptions. A fairly well balanced business can quickly become skewed where the performance of one part of a business outstrips the rest.