Salaried members guidance: changes to the rules-based test

Employment Tax OMB



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HMRC’s updated guidance on Condition C of the targeted anti-avoidance rule has been met with consternation among some professional services partnerships.

Key Points

What is the issue?

The salaried member rules introduced by HMRC in 2014 treat certain LLP members as employees for tax purposes if they meet three rules-based conditions related to their remuneration, influence and capital contribution. Condition C requires a member’s capital contribution to be at least 25% of their ‘disguised salary’.

What does it mean for me?

A recent update to HMRC’s guidance suggests that periodically increasing capital contributions in response to their expected disguised salary to avoid meeting Condition C could be considered avoidance. This change has caused concern among firms and practitioners, as it appears to contradict previous understandings with HMRC.

What can I take away?

We consider the potential reasons behind HMRC’s change in interpretation and the need for firms to be more thoughtful in their approach to Condition C, document their policies, and present a comprehensive picture to HMRC if asked about their practices.

Since its introduction just over 10 years ago, the salaried member legislation has been an important compliance area for many professional services limited liability partnerships (LLPs), especially those that operate a two-tier equity model for junior and senior partners. In short, these rules have the potential to treat individuals, who are legally engaged as members of the LLP, as employees for tax purposes.

As a result of the extensive engagement that the professional services industry had with HMRC in the gestation of the legislation, HMRC developed comprehensive guidance which has largely enabled firms and their advisers to be comfortable that they understand how to apply the rules in practice. At least, that was the case until February 2024, when HMRC made a small, but highly significant, change to that guidance.

The updated guidance suggests that HMRC may apply the targeted anti-avoidance provisions in the salaried member legislation in a way that may affect the approach that some firms have taken towards their initial and ongoing compliance with the rules – and which, for good reason, they have always understood HMRC to be at ease with.

In this article, we give a recap of the basic rules as they apply to professional services firms and the impact of the revised guidance to these firms. However, we think it is essential to consider the background (and history) of what a typical professional services LLP equity model looks like, as the context is key to interpreting HMRC’s guidance (including the recent revision). It is also important to

flag that the salaried member rules only apply to LLPs established under the Limited Liability Partnerships Act 2000, and not toother types of partnership.

The limited liability partnership model

Before LLPs became available in 2000, professional partnerships were typically established as general partnerships (under the Partnership Act 1890). Limited partnerships (established under the Limited Partnerships Act 1907) have never been a suitable vehicle for such businesses.

Corporate structures have been adopted to some extent, but in certain professional services areas (especially law and accountancy) the partnership model was borne out of historic regulatory rules and is deeply entrenched in terms of culture, convention, coherence with other jurisdictions in which the firm might operate, and the customary stakeholder relationship that exists between partners, firms and their clients.

The availability of the LLP transformed the landscape for professional services firm structures. Its balance of limitation of liability, with the preservation of many of the traditional features of partnership, has proven to be an extremely constructive legal framework to enable firms to thrive in an increasingly complex environment. It has also increased the attractiveness and accessibility of becoming a member in such a firm.

Most professional services firms still operate a traditional career progression model, involving a pathway through training or qualifications, followed by promotion through the hierarchy to develop professional skills and experience. The top level of seniority – partnership – is generally associated with individuals who stand apart in their mastery of their professional discipline, who are ready to take personal responsibility for the quality of their work, and who are involved in the broader growth and success of the firm.

Some firms have a separate class of ‘junior’ equity partners, often as a stepping stone to progression to the more remunerative ranks of senior partnership. Junior partners usually have the same or similar professional standing and responsibility as more senior partners, and operate at a clearly differential level of responsibility to the employees.

The promotion to equity partner normally results in a step up in remuneration. In return, the partner is expected to give up their employment rights, accept various legal risks that come with partnership, possibly live with a longer deferral of at least some of their remuneration, and accept the income volatility that is a consequence of sharing in profits.

At the lower rungs of the profit-sharing ladder, this volatility (combined with the other factors) can be problematic. These partners often have less of a personal financial cushion and are often at a point in life where they have high fixed outgoings. Hence, some firms award these partners a base level of priority ‘fixed’ profit share, with a variable sum on top depending on firm and personal performance. This gives the partners more, but not complete (as it can never be guaranteed) security over their base remuneration level.

The tax status of partners

Turning to the question of the tax status of partners, for general (i.e. traditional) partnerships there has always been a need (for tax and legal reasons) to consider whether the relationship an individual has with their firm is, as a matter of fact and substance, one of partnership or employment.

This requires an analysis of various legal and contextual factors, rather than the application of a ‘bright line’ test.

Following the introduction of LLPs, HMRC’s view was that Income Tax (Trading and Other Income) Act (ITTOIA) 2005 s 863 required that every member of an LLP must automatically be regarded for tax purposes as self-employed.

However, in the ensuing years HMRC became concerned that the automatic treatment of members as self-employed for tax purposes was leading to abuse. For example, a business could achieve a lower overall national insurance cost compared to employment simply by admitting an individual as a member of an LLP, rather than engaging with them under an employment contract.

There were also wider concerns about the potential to circumvent minimum wage legislation and other protections normally reserved for employees. From a tax perspective, this was the genesis of the salaried member rules.

The salaried member rules

Rather than use the contextual approach that would be used for general partnerships, a new rules-based test was developed that was considered to provide amore certain outcome. However, the policy intent has always been clear (and is stated in the current version of the guidance) that the provisions are intended to apply to members of LLPs who are more like employees than partners in a traditional partnership.

It is important to hold this thought in mind. The rules retain the basic s 863 provision; however, from 6 April 2014 three specific conditions were introduced.

If all three conditions are satisfied, then an individual will be treated for income tax and national insurance purposes as employed – with a corresponding deduction available in the computation of the LLP's taxable profits inline with the deemed employment treatment subject to the normal rules on deductibility. In other words, failing one of the tests means that a member will be taxed as self-employed.

The three conditions are summarised as:

a) The member provides services to the LLP and is remunerated for those services to the extent of 80% or more by way of 'disguised salary', the quantum of which does not vary by reference to the overall profitability of the LLP.

b) The member does not have significant influence over the affairs of the LLP.

c) The member's capital contribution to the LLP is less than 25% of their 'disguised salary'.

Condition A

Condition A deals with the expectation that a true partner is someone who shares in the ups and downs of the profits of the firm, but it applies a specific threshold. There are a few traps for the unwary, especially concerning the fact that the variable element has to be affected by the profits of the whole LLP.

The HMRC guidance is relatively comprehensive, with plenty of examples to draw from. Many professional services firms operate a remuneration structure for junior partners that allows them to reliably fall out of the rules on this basis.

Condition B

Condition B attempts to encode another of the traditional features of a true partner – the expectation that they are involved in the business as an owner/director, as well as a practitioner.

Because the test refers to ‘significant’ influence, in practice it is mostly relevant to partnerships with few members – the HMRC guidance uses an example of a ten partner firm. Larger partnerships inevitably mean a dilution of the influence of any individual partner and such firms are also more likely to have governance arrangements that delegate certain authorities to executive teams.

Of the three conditions, this is the most subjective and usually the least relevant for professional services firms (even ones with few partners, and even post- the UTT findings in *BlueCrest* in 2023) as the junior partners to whom the salaried member rules are most likely to be relevant are also the least likely to hold highly influential roles. In our view, this test was always outdated, harking back to a time when traditional partnerships were much smaller (often by necessity).

Condition C

Condition C (the main topic of this article) deals with another traditional feature of a true partner – that they have a stake and financial exposure in the firm in the form of partner capital.

The legislation sets the minimum capital expectation at 25% of the amount of the disguised salary (determined on the same basis as Condition A). For example, a partner with an entirely fixed profit share of £100,000 must have at least £25,000capital in order to fail Condition C. There is no science behind the 25% – it was alighted on as representing a sufficiently material amount. In the real world, there is no set proportion of capital to profit share that firms require their partners to invest (whether they are senior or junior) as it depends on factors specific to each firm.

Partner capital is one of a number of sources of funding for firms, so there is usually a desire to balance the various sources, and this in turn depends on the capital requirements of the firm in context of its cash flows, capital projects and so on. It is also customary for firms to require that partners have some capital at risk as ‘skin in

the game’, and in the case of LLPs this is a substantive component of the liability exposure of members.

Anti-avoidance provisions

From the outset, HMRC bolstered the salaried member rules with targeted anti-avoidance provisions (ITTOIA 2005 s863G), in particular that no regard is to be had to any arrangements the main purpose (or one of the main purposes) of which is to secure that the salaried member rules do not apply.

This provision caused significant concern when the draft legislation was originally published, because it called into question whether partners entitled to a fixed share could increase their capital contribution in order to secure continued recognition as a self-employed partner.

The new rules were an inexact reflection of the long-established contextual rules, the 25% threshold was arbitrary, and so denying this pragmatic opportunity was considered to be at odds with the policy aim. It was therefore understood that individuals and firms should be at liberty to reorganise their affairs to fit within the parameters defined by HMRC, as a matter of policy, to secure tax treatment as a partner if and so long as the reorganisation is genuine, commercially effective and enduring.

Through discussions, HMRC reassured stakeholders that this was not a situation where the targeted anti-avoidance rule would be invoked, and the same principle seems to have been applied ever since when capital has been set or adjusted to ensure that the firm would be compliant in relation to newly admitted partners and those whose fixed profit share has changed. In practice, the 25% test operated much like a ‘safe harbour’.

Updated guidance

With this backdrop, it came as a surprise when HMRC updated its guidance on the targeted anti-avoidance rule to catch a situation ‘where members increase their capital contribution periodically in response to their expected disguised salary, in order to avoid meeting Condition C’.

In our view, this does appear to represent a change in interpretation rather than a clarification, based on understandings established at the inception of the legislation and the way HMRC seemed to apply the rules in the years that followed. It is therefore understandable that the change has been met with consternation among firms and tax practitioners (the CIOT has made a compelling submission to HMRC in this regard).

How might this situation have arisen? Well, it is possible that the context that had originally enabled HMRC to be comfortable has become obscured over time. This context included the expectation that the capital was genuine (i.e. a part of the funding structure of the firm, and genuinely at risk).

This context also recognised the vagaries of how firms are commercially structured in practice. In applying a percentage threshold, junior partners, who in other respects carry the hallmarks of partnership, might fall either side ofthe25% test purely by virtue of the proportionate blend of sources of finance that their firm has at that time. Such an arbitrary outcome would not be in line with the policy objectives of the rules. For example, it might penalise a firm that is particularly efficient at collecting cash, as such a firm might reasonably have overall lower funding requirements from partners than a firm that is equally profitable but collects cash more slowly.

We also wonder whether HMRC's prior practice had become so embedded that, in the course of communicating with HMRC, some firms' internal tax teams and their agents had aligned themselves with the premise that HMRC was applying the test as a safe harbour, and presented the approach they were taking to Condition C in line with that philosophy.

On a narrow interpretation, this may have given HMRC officers pause for thought in the context of the targeted anti-avoidance rule. For example, a firm might tell HMRC that they increase capital to manage the salaried member exposure, believing HMRC to be comfortable with this, and calculations may indeed be performed on this basis. However, that narrow lens on the question might not reflect the firm's broader objectives or policies. For example, most firms operate a written or unwritten principle of equitable treatment of partners, and this tends to mean that partners who earn more should have more capital at risk in the firm. Proactively managing the salaried member threshold with this backdrop seems entirely consistent with the policy objectives.

It is, of course, possible that HMRC’s new guidance is not intended to contradict situations like this, and further clarity may emerge. However, it is undoubtedly a prompt for firms and their advisers to be more thoughtful about their approach to Condition C, how they might do a better job of presenting the whole picture to HMRC if asked, and to pay attention to their approach to documenting their policies in this area.

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