The End of the LLP for Fund Managers?

Private Equity ("PE") funds are being impacted by a recent change by the UK's HM Revenue & Customs ("HMRC") in approach and guidance on the Limited Liability Partnerships ("LLPs") tax structure, where the PE fund management vehicle in the UK is an LLP. This change may mean some partners are in fact treated as employees for tax purposes. If there are fewer 'partners', this reopens the debate on the costs and benefits of using an LLP. Indeed, some firms may be liable for backdated charges as a result. Angus Wilson and Lewin Higgins-Green explore these issues and question whether this might signal a move to (or a move back to) a corporate structure.

Privately owned PE businesses in the UK are typically structured as LLPs, rather than as a company. Even if those businesses are ultimately listed in another jurisdiction (e.g., in the US), their UK operations are often structured through an LLP. While there are many reasons for this, one of the key benefits is the tax savings.

Current Landscape

Whilst Employer National Insurance Contributions ("NICs") are payable on employee remuneration, currently at a rate of 13.8%, there is no similar NICs liability for distributions of profits to a member of an LLP.

In a company, a senior employee will pay income tax (at a rate of 45%) and employee NICs (at the rate of 2%) on majority of their remuneration, whilst the company pays employer NICs (at a rate of 13.8%). The company will also pay corporation tax (at the current UK tax rate of 25%) on its taxable profit but is able to take a tax deduction for the employee remuneration costs, which includes the employer NICs it has had to pay.

In contrast when you consider an LLP, a senior member will receive a share of the LLP's profits and will have the obligation to pay income tax and employee NICs at the same rates as an employee. However, there is no obligation for corporation tax or employer NICs. As most profits are usually distributed to the key people in the business (as PE firms are not usually capital-intensive), this can represent a significant tax saving.

The 'Salaried Member' Rule

So, why doesn't everyone set up an LLP structure? There are many commercial and legal reasons for choosing one structure over another, but all things being equal, tax may be a significant factor. However, one cannot just decide to run a business through an LLP and make everyone a partner (member) of the LLP (rather than an employee) simply to reduce the amount of tax paid. There are specific rules, known as the 'Salaried Member' rules which, in certain situations, recategorise members of an LLP as disguised employees for tax purposes. This results

in the LLP being liable for employer NICs. The rules seek to ensure that only genuine owners of the business are treated as partners for tax purposes.

A member of an LLP will be treated, for tax purposes, as a disguised employee if they meet all three of the following conditions (i.e., failing any one of the tests will mean they are not recategorised):

- Condition A: this is met if a member receives only 20% or less of their profit share, in a manner which is variable by reference to the overall profits of the LLP (i.e., not fixed or variable in connection with their individual, team, or business unit performance).
- Condition B: this is met if a member does not have real significant influence over the affairs of the LLP.
- Condition C: this is met if a member has not contributed 'capital', where such capital would give them a real ('at risk') and significant investment in the business.

Although some members in an LLP will not meet Condition A or B (and will therefore not be recategorised as an employee), the catch-all condition which is often relied upon is Condition C. To prevent this condition being met, a member will need to contribute to the capital of the business an amount of cash which is greater than 25% of their 'disguised salary' (i.e., the amount of their profit share that doesn't vary wholly in line with the profits of the overall LLP). Whilst it is typical that LLPs will assist a member to obtain a loan for this amount, the amount does need to be considered to be genuinely 'at risk'. Given this is a specific and numerical test, it's easy to see why it is the focus of planning, and why members typically feel comfortable in ensuring they can take action to prevent meeting this condition.

Whilst Condition C is a formulaic test, there is a targeted anti-avoidance rule (the "TAAR") which in effect states that one needs to disregard any actions that someone takes specifically to avoid being caught by the rules. So, if a member makes a real, at risk, capital contribution, but their main intention was not to fund the business but to ensure they are considered to not be a salaried member, wouldn't the TAAR apply? What about if the amount of that capital contribution was changed each year to ensure that it remained just above 25% of the 'disguised salary'?

The Shift

There are multiple recent reports that several LLPs are now being investigated by HMRC specifically on Condition C. HMRC are relying on their new guidance (which is yet untested, but does appear to be in line with the letter of the law). This creates the threat of backdated tax (i.e., employer NICs) together with penalties and interest equating to millions of pounds.

Until recently, HMRC guidance on Condition C could be (very broadly) paraphrased as saying that so long as the capital was really at risk, HMRC wouldn't apply the TAAR. That HMRC guidance has now been changed — broadly, stating more ways in which HMRC will seek to apply the TAAR. An example is now included which indicates that if the sole reason for increasing capital contributions is to exceed the 25% threshold, the TAAR may be applied. This has happened without consultation or any statement of intent from HMRC. It is evident we're witnessing a shift for PE, with HMRC taking a firmer approach to high earners.

The key risk to LLPs is that if HMRC changes their position and decides to take the point that contributions should be disregarded if they are made with the intention of ensuring Condition C is not met, a number of members are then likely to be treated as employees. The LLP will as a result have underdeclared and underpaid NICs on payments made to those individuals.

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Until the industry sees the outcome of the recent compliance checks by HMRC (and potentially the resulting process through Tribunal and the Courts), it is difficult to predict whether this will result in a significant change to how PE firms are structured.

Suffice it to say, if most LLP members can't rely on capital contributions, it will be difficult for many members to be deemed anything other than disguised employees under the current rules. This is particularly the case in large partnerships where junior members will not have significant influence, and their profit share is not sufficiently dependent on the profitability of the firm.

If that is the case, a PE firm will need to weigh up the pros and cons of continuing to use the LLP model. If the tax advantage was a significant driver, and this benefit is only available to a small number of senior people, this

may prompt some businesses to convert to being a company (for example, those owned by US listed businesses). Of course, choosing to convert an LLP to a company is not a straightforward decision — there will be many factors (including non-tax) to consider, and detailed advice will be needed.

Finally, it is worth noting that these recent challenges are separate from the recent scrutiny that PE firms have been facing in the UK press regarding the treatment of carried interest. The Labour party's manifesto released on 13 June now strongly implies that they will seek to increase the tax rate apply to carried interest — potentially from 28% to 45%. They have promised to consult on the introduction of the provisions, but the introduction now seems to be imminent.

For any firms that are currently operating as an LLP, now is a key time to review their current structure and determine the impact to members through HMRC's new lens and ahead of a potentially new government that may already have PE firms on their radar screens.

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