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██████████, Policy & Technical Lead - Partnerships
Business, Assets & International
HM Revenue & Customs

Via email: ██████████

Dear ██████████

Salaried members rules – HMRC’s approach to Condition C and the TAAR

Introduction

The Chartered Institute of Taxation (CIOT) is the leading professional body in the UK for advisers dealing with all aspects of taxation. We are a charity and our primary purpose is to promote education in taxation with a key aim of achieving a more efficient and less complex tax system for all. We draw on the experience of our 20,000 members, and extensive volunteer network, in providing our response.

We refer to the update made in February 2024 to HMRC’s guidance on the salaried members rules (ITTOIA 2005 ss863A-863G) relating to the circumstances in which HMRC believes the targeted anti-avoidance rule (‘the TAAR’) applies to capital contribution arrangements when determining whether Condition C of those rules applies, as well as the approach being taken by HMRC compliance teams in accordance with the amended guidance. We acknowledge that HMRC are currently undertaking an internal review of their position on this matter and expect to conclude this by the end of the summer. Whilst this review is ongoing, we urge HMRC to take on board the concerns that CIOT members have raised about HMRC’s revised practice being technically incorrect and contrary to the original policy intention of the relevant rules, as well as being unfair as it seeks to penalise those that have sought to comply with the rules in a manner which the evidence suggests has previously been considered by HMRC to be perfectly acceptable.

The salaried members rules in brief

The salaried members rules provide for the determination of a Limited Liability Partnership ('LLP') member as either self-employed or employed for tax purposes. The rules were brought in by Finance Act 2014 to remove the presumption of self-employment and to tackle the disguising of employment relationships through LLPs. To address the perceived inconsistency of an individual needing to have the characteristics of a partner to be determined as such in a traditional partnership, but, within an LLP, an individual needing only to be registered as a member, the rules are based around three conditions which focus on certain characteristics of partnership to identify those individuals whose relationship with the LLP is more akin to that of an employee. These three conditions, described below, are intended collectively to encapsulate what it means to be operating in a typical partnership and only if all three conditions are met will an LLP member be treated as an employee for tax purposes. Otherwise, he or she will be taxed as self-employed in the same way as a partner in a traditional partnership.

Condition A: Disguised salary

Condition A will be met if it is reasonable to expect that at least 80% of the total amount payable by the LLP in respect of the member's performance during the relevant period of services for the LLP will be 'disguised salary' (ITTOIA 2005 s863B). An amount payable is 'disguised salary' if it is:

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

Condition B: Significant influence

Condition B will be met if the member does not have significant influence over the affairs of the LLP under the mutual rights and duties of the members of the LLP, and of the LLP and its members (ITTOIA 2005 s863C).

Condition C: Capital contribution

Condition C will be met if the member's capital contribution to the LLP is less than 25% of their disguised salary from the LLP in the relevant tax year (ITTOIA 2005 s863D).

The TAAR

The salaried members rules include a targeted anti-avoidance rule ('TAAR') which disregards arrangements with a main purpose of securing that one or more members are not deemed to be salaried members (ITTOIA 2005 s863G).

Certainty provided by Condition C

As many LLPs have complex profit-sharing arrangements, it is not always clear whether the LLP and HMRC will agree on the analysis of Condition A. CIOT members have raised examples of 'agreeing to disagree' on Condition A in favour of agreeing the employment status based on one of the other conditions. Similarly, the meaning of 'significant influence over the affairs of the LLP' is subjective and it is well-known that HMRC places a high bar for members to be able to fall outside this condition.

To date, therefore, Condition C has been considered by many LLPs and their advisers to provide a 'safe harbour' that, if correctly complied with, prevents members from being caught by the salaried members rules. It was thought that if sufficient capital was genuinely contributed by a member and gave rise to real risk, ie. there were no artificial arrangements used to negate this risk, such as a non-recourse loan, then the TAAR would not apply and the member

would not meet Condition C. As such, many LLPs have required their members to make appropriate levels of capital contribution so that they can rely on Condition C being failed to prevent application of the salaried members rules and provide certainty over the position, often irrespective of whether they may also fail Conditions A and/or B. It should be remembered that for most LLPs, members' capital forms an important source of funds for use in the business.

HMRC's updated guidance and compliance approach

In February 2024, without warning, HMRC published updates to the guidance contained in their Partnership Manual guidance, as set out below.

PM259200 – 'Becoming a member'

A new example has been added, as follows:

'This example looks at an arrangement where members can alter their capital contributions in each period to avoid meeting Condition C.

In 2018, upon joining the ABC LLP, member X contributed capital of £15,000 (this was not part of any arrangement with a main purpose of securing the salaried members rules do not apply and is a genuine contribution).

In 2022 it is expected that X's remuneration for the next period will consist of £100,000 Disguised Salary, meaning that their contributed capital is below the 25% threshold, and they will meet Condition C.

X contributes a further £10,000 as part of a separate arrangement with the LLP, where members increase their capital contribution periodically in response to their expected disguised salary, in order to avoid meeting Condition C.

This arrangement will trigger the TAAR and no regard can be given to the £10,000 when considering whether X meets Condition C. As such X will meet Condition C as their contributed capital remains at only £15,000.'

PM259310 – 'Anti-avoidance: genuine finance'

The guidance previously stated:

'A financing arrangement which results in a genuine contribution made by the individual to the LLP intended to be enduring and giving rise to real risk will not trigger the TAAR.'

This is now qualified by addition of the words:

'... subject to its main purpose (or a main purpose of any arrangement of which it forms part) not being to secure that the salaried members rules do not apply to the individual (or one or more other individuals).'

The updated guidance suggests that HMRC will seek to apply the TAAR to arrangements under which members increase their contributions as their remuneration changes in order to prevent Condition C being met, and we note that CIOT members have observed this approach being taken by HMRC compliance teams in practice. It might also be inferred from the updated guidance that HMRC may attempt to invoke the TAAR in other circumstances under which capital contribution requirements include reference to the amount needed to fail Condition C.

Although HMRC have described the change in guidance as merely a clarification, it is widely considered that HMRC have in fact changed their view. CIOT members are reporting that for many LLPs and their members, particularly those within the professional services and investment management sectors, HMRC's revised practice is causing

significant concern, with a huge amount of uncertainty having been created, potentially substantial amounts of tax being at stake and protracted and costly disputes with HMRC either looming or already underway.

Our view

We recognise that there can be a fine line between arrangements which are structured to comply with the tax rules and those which are designed to avoid them. It should be remembered, however, that the three salaried members conditions are designed to collectively encapsulate what it means to be operating in a typical partnership, with the putting of one's own money at risk in the business being one of the key characteristics. It is therefore surprising that HMRC now believes that the making of a genuine capital contribution to an LLP can be considered an avoidance arrangement.

We remind HMRC of the statement made in HMRC's 'Summary of Responses', published on 10 December 2013 in relation to the consultation titled 'Partnerships: A review of two aspects of the partnership tax rules', as follows.

'The Government considers that a TAAR is needed in the draft legislation in order to counter abusive arrangements structured specifically to avoid the application of the new provisions. This TAAR will not apply if the LLP decides genuinely to engage the member on terms that amount to a partner rather than a salaried member in line with the objectives of this partnerships review. The TAAR will, however, catch those arrangements that are intended to prevent any of the new 'salaried member' conditions from being met, if these arrangements have no other substantive effect.'

We consider this to be a clear articulation of the policy intent behind the TAAR as being 'to counter abusive arrangements' that 'have no other substantive effect'. We find it difficult to see how the making of a genuine capital contribution can be regarded as being abusive or has having no other substantive effect.

As mentioned, members' capital is a source of valuable working and/or regulatory capital for an LLP. Moreover, we believe that HMRC are now overlooking the very real financial commitment that a member takes on when they contribute capital to their LLP. Notwithstanding whether bank loans to fund the contributions are centrally coordinated by the LLP, each member who makes a contribution remains personally liable and may lose their money if the business encounters difficulties, thereby putting their own financial security, and that of their family, at risk.

We firmly believe that policymakers at the time recognised that genuine capital contributions should not be caught by the TAAR when the salaried members rules were introduced.

This position is supported by the inclusion of ITTOIA 2005 s863F, under which existing LLP members were given a 3-month 'transitional easement' when the rules came into force on 6 April 2014, which meant that contributions made by 5 July 2014 would be deemed to have been made on the date that an undertaking to make the contribution was given. This was 'to avoid the position where individuals are treated as employees for tax purposes for a short period whilst they obtain finance in order to invest capital'. This transitional easement was a common-sense approach to allow members, who did not already have sufficient capital in place to fail Condition C on the implementation date, a period of grace to allow time to structure their affairs in order to comply with Condition C. This is a clear indicator that making or increasing a capital contribution for this purpose was not considered at the time to be contrary to the policy intent and would not contravene the TAAR. Given that this was endorsed as an acceptable response to the rules when they were introduced and the legislation remains the same, we see no grounds for HMRC changing their view and deeming this to be unacceptable now.

We also emphasise that HMRC's guidance in respect of the TAAR for c.10 years simply stated that 'HMRC would not consider that genuine and long-term restructuring that causes an individual to fail one or more of the conditions to be contrary to this policy aim' and, further, that 'this includes loan finance arranged for the individual member by the

firm, provided that the loan is full-recourse, so that the risk is that of the individual and the individual bears all the costs of the loan'. Without the qualifying words recently added, our view is that HMRC's own guidance confirmed that no restriction was placed on the ability to make or increase capital contributions to comply with the Condition C requirement and fall outside of the salaried member rules.

Furthermore, CIOT members have been party to discussions with HMRC over the years, either on a general basis or regarding specific capital contribution arrangements of LLPs they advise, and report that, in the past, HMRC have raised no concerns with capital contribution requirements being calculated with reference to Condition C. In fact, it is the experience of CIOT members that HMRC have historically agreed that LLPs and their members can achieve certainty in respect of the salaried members rules by complying with the requirements of Condition C and, in some cases, HMRC have even provided assurance that Condition C is not met so long as the requisite amount of capital has genuinely been contributed.

Conclusion

In summary, we consider that HMRC's revised guidance and practice is technically incorrect as it is contrary to the legislation enacted by Parliament, as well as being unfair as it seeks to penalise LLPs and their members who have, in good faith, complied with the rules to the best of their knowledge, having relied on statements and guidance published by HMRC and, in some cases, direct discussions with HMRC officers. We are aware that HMRC compliance teams are attempting to assess additional liabilities going back up to six years based on the change of view. Such retroactive application feels particularly egregious.

We therefore urge HMRC to take on board the concerns raised and reconsider their position. In our view, HMRC should remove the updates to the guidance made in February 2024, as well as cease its compliance activity based on the revised practice. In the least, we believe that HMRC should not be seeking to apply its revised practice retroactively to LLPs and their members who have complied with the rules in a manner which the evidence suggests has previously been regarded as perfectly acceptable by HMRC, based on the published guidance and actions of HMRC officers for c.10 years since the salaried members rules were introduced. For the avoidance of doubt, we do not consider that the inclusion of additional examples in HMRC's Partnership Manual would provide a satisfactory solution to this issue and would be perceived as HMRC attempting to legislate by guidance. Further, it would not alleviate concerns that HMRC might simply change their minds again in future.

We look forward to hearing from you and would welcome the opportunity to discuss the matter further with you in due course.

Please note that we intend to publish this letter and HMRC's response on our website.

Yours sincerely

Jitendra Patel
Vice Chair, Owner-Managed Business Technical Committee

The Chartered Institute of Taxation

The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

Our stated objectives for the tax system include:

- A legislative process that translates policy intentions into statute accurately and effectively, without unintended consequences.
- Greater simplicity and clarity, so people can understand how much tax they should be paying and why.
- Greater certainty, so businesses and individuals can plan ahead with confidence.
- A fair balance between the powers of tax collectors and the rights of taxpayers (both represented and unrepresented).
- Responsive and competent tax administration, with a minimum of bureaucracy.

The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries.

Our members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.