Salaried partner, hidden tax charge

Employment Tax | Personal tax

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Keith Gordon considers the Upper Tribunal’s decision in a case looking at the employment status of a member of an LLP

Key Points

What is the issue?

The widely held view was that (at least until the introduction of a limited exception with effect from 6 April 2014) all LLP members are taxed as self-employed, even if (had the LLP been a traditional partnership) some of them would have been treated as employees for tax purposes.

What does it mean for me?

The Limited Partnerships Act 2000s 4(4) provides that an individual member of an LLP will not be regarded as employed by the LLP unless (assuming that the members of the LLP were in fact partners in a partnership) that individual would be an employee of the hypothetical partnership.

What can I take away?

This case should focus the minds of those who advise partnerships and LLPs so as to ensure that, where there are different levels of partner within the organisation, the status of individuals at each level is as clear as it possibly can be.

It is probably a sign of my advancing years, but I still consider the advent of limited liability partnerships (LLPs) to be a relatively recent development in the world of work and the taxation of earnings. In fact, LLPs are just a few months short of their 21st birthday (April 2022), meaning that they will have been around for some 70% of my tax career so far. Despite the fact that LLPs are therefore an established and widely used form of business structure, some fundamental issues remain. This article concerns the question about the employment status of LLP members.

In what I tend to call ‘traditional partnerships’ (i.e. those governed by the Partnership Act 1890), there are broadly two classes of partner: the equity partner; and the salaried partner. Even though salaried partners are rarely entitled to a share of partnership surpluses, that does not necessarily preclude them from being sued by a creditor of the partnership. However, for tax purposes, it is generally accepted that only equity partners are taxed as self-employed. The mismatch might not always be too great, as an individual’s true status will ultimately turn on the precise nature of the relationships. However, there remains the risk in practice that salaried partners are employees who might get sued for partnership debts.

It might be thought that the taxation of LLP members would operate on a similar basis. However, the widely held view was that (at least until the introduction of a limited exception with effect from 6 April 2014) all LLP members are taxed as self-employed, even if (had the LLP been a traditional partnership) some of them would have been treated as employees for tax purposes.
It is the correctness of this widely held view that lurks in the background of the case of Wilson v HMRC [2021] UKUT 239 (TCC).

The facts of the case

Mr Wilson qualified as a chartered accountant in Australia in 1975. In 2008, he was one of a number of individuals who set up a limited company which intended to acquire and operate London-based accountancy firms. In 2011, Mr Wilson and his fellow shareholders entered into discussions concerning the possible sale of the company to Haines Watts London LLP.
As a part of the sale negotiations, it was proposed to Mr Wilson that he continue to be employed via his limited company. However, Mr Wilson preferred a simpler arrangement going forward. Eventually, it was agreed that Mr Wilson should become a member of Haines Watts. Within Haines Watts, there were already two different classes of members, each with their own set of rights, responsibilities and rewards.

Mr Wilson initially became a member of the class who were ‘required to devote the whole of their time and attention to client matters and the day-to-day management of the LLP business as requested by the [other class of] members’. Immediately afterwards (via a deed of variation of the LLP agreement), he then became what was known as a Fixed Income Member. By doing so, Mr Wilson lost a number of the voting rights otherwise available to his class of LLP members and also lost access to certain financial information relating to the LLP. He also became entitled to a basic income of £180,000 (subject to some potential adjustments), albeit not in any year in which Haines Watts made an overall accounting loss.

Initially, Mr Wilson completed his tax returns on the basis that he was liable to income tax on his share of partnership profits; however, in later years, he declared his income as employment income. HMRC determined that Mr Wilson was self-employed in respect of his work with Haines Watts. Mr Wilson appealed against the determination to the First-tier Tribunal and, when he lost that appeal, to the Upper Tribunal.

Before the Upper Tribunal, Mr Wilson advanced three grounds of appeal.

Ground 1 was an objection to the First-tier Tribunal's conclusion that the provision in the Income Tax (Trading and Other Income) Act 2005 s 863(1) acts as a deeming provision, so that all members of LLPs are taxed as if they were self-employed. In particular, Mr Wilson complained that the point had not even been aired before the First-tier Tribunal.

Ground 2 also concerned a point that Mr Wilson did not consider had been aired before the First-tier Tribunal. This was an objection to the First-tier Tribunal's conclusion that the Limited Liability Partnerships Act 2000 s 4(4) provides that a member of an LLP cannot also be an employee of the same LLP.

Ground 3 argued that the First-tier Tribunal had not given proper effect to the deed of variation which 'hollowed out' Mr Wilson's membership of the LLP, so that his relationship was in substance one of an employee.

The Upper Tribunal's decision

The case came before Mr Justice Adam Johnson and Judge Jonathan Cannan.

In relation to Ground 1, the Upper Tribunal noted that there were conflicting pointers as to what the First-tier Tribunal actually thought about the effect of s 863(1). The decision under appeal certainly reads as if the First-tier Tribunal had considered that s 863(1) trumped everything else. However, when the First-tier Tribunal responded to Mr Wilson's application for permission to appeal (a necessary first stage before a case can progress to the Upper Tribunal), the First-tier Tribunal seemed to withdraw somewhat from that position and considered that s 863 applies only when there is 'substance' to an individual's membership of an LLP.

Despite the fact that LLPs are an established and widely used form of business structure, some fundamental issues remain.

However, ultimately, the Upper Tribunal considered Ground 1 to be academic. HMRC was seemingly not supporting the First-tier Tribunal's apparent view that s 863(1) trumps everything else and therefore the case turned on the substance of Mr Wilson's relationship with Haines Watts, which was the subject of Ground 3.

For similar reasons, the Upper Tribunal declined to resolve the dispute at the heart of Ground 2.

In relation to Ground 3, the First-tier Tribunal had recognised that Mr Wilson was not required to contribute to Haines Watts's capital and had no right to any surplus on a winding up of the LLP. However, the First-tier Tribunal also noted that Mr Wilson was not entirely disinterested in the LLP's profits (as his £180,000 fixed share was dependent on profits being made and he also had an underlying interest in the LLP's international tax practice which he was working in). For these reasons, the First-tier Tribunal had considered that Mr Wilson's membership of the LLP was not completely hollowed out.

Mr Wilson argued that the First-tier Tribunal had been swayed by the use of labels describing his position in Haines Watts, even though it had expressly acknowledged that the use of such labels is not determinative. However, the Upper Tribunal could see no evidence in the decision to suggest that the First-tier Tribunal had been influenced by the labels used when it proceeded to consider the substance of the relationship.

Furthermore, the Upper Tribunal refused to accept Mr Wilson's arguments that his status should be determined by reference to the usual Ready-Mixed test for employment (as discussed at length in my October 2021 article 'Our Mutual Friend'). Instead, the Upper Tribunal considered that, when addressing this point, the first question should be focused on the Limited Partnerships Act 2000 s 4(4).

Section 4(4) provides that an individual member of an LLP will not be regarded as employed by the LLP unless (now assuming that the members of the LLP were in fact partners in a partnership) that individual would be an employee of the hypothetical partnership.

The Upper Tribunal considered that there was sufficient basis for the First-tier Tribunal to have reached the conclusion that Mr Wilson was a 'partner' within that hypothetical partnership, carrying on a business in common with the other members of the LLP. In other words, despite the cut-down rights, Mr Wilson was more than a mere employee.

For these reasons, the Upper Tribunal dismissed the appeal.

Commentary

Given the dispute underlying Ground 1, the case illustrates how court and tribunal decisions can sometimes give a misleading impression of how facts and legal

submissions were argued by the parties. Whilst judges invariably try to capture the flavour of the proceedings, it is inevitable that there is a slight mismatch between what actually happened and the picture that will be drawn from the decision. In my view, this will often occur when a judge is writing up his or her decision and starts to evaluate the legal position from a fresh perspective.

This might also explain the apparently different approaches taken to s 863(1) by the First-tier Tribunal. Indeed, I am not even sure that the differences are quite as stark as portrayed by the Upper Tribunal. Interestingly, the Upper Tribunal records HMRC as not arguing that s 863(1) determines the tax status of members of LLPs, even though I always understood that to be its position.

Reading between the lines, I think that the various positions can be reconciled. In cases where an individual's membership of an LLP is a sham (i.e. the LLP documentation is nothing short of fraud), s 863(1) will not bite. However, in all other cases (irrespective of the level of management participation by any particular individual member), s 863(1) will be determinative of the issue (at least until the 2014 changes came into force), meaning that the distinction between equity and salaried partners has no application in the case of LLPs.

However, because Ground 1 was not fully explored by the Upper Tribunal, we will probably have to await another case for a fuller analysis of the scope of s 863(1) (or at least hope that HMRC will issue a statement as to how it considers that s 863 operates).

Ground 2 concerned two conflicting decisions of the Court of Appeal and Supreme Court as to the meaning of the Limited Partnerships Act 2000 s 4(4).

In Tiffin v Lester Aldridge LLP [2012] EWCA Civ 35, the Court of Appeal considered that the literal wording of s 4(4) led to an absurdity because partners cannot also be employees of their own partnership. However, in Clyde & Co LLP v Bates van Winkelhof [2014] UKSC 32, the Supreme Court resolved the apparent absurdity highlighted in Tiffin by noting that s 4(4) might have been worded as it is in order to deal with doubts as to the employment status of partners in a Scottish partnership.

However, once again, the point was not fully explored by the Upper Tribunal.

In Ground 3, the Upper Tribunal made useful reference to earlier cases that consider a partner's status, but making the necessary observation that each case turns on its

own facts. Indeed, the Upper Tribunal's role is generally limited to ensuring that the First-tier Tribunal had correctly undertaken the evaluative exercise required to determine an individual's status; it is not necessary that the Upper Tribunal should reach the same conclusion had it carried out the exercise itself. Nevertheless, for good measure, the Upper Tribunal ended its decision by noting: 'Looking at the facts as a whole, we would have reached the same conclusion.'

What to do next

It is unlikely that this case will now progress to the Court of Appeal and, given the legal questions that remain unanswered, this is a shame.

However, the uncertainties that this case has highlighted should focus the minds of those who advise partnerships (and LLPs) so as to ensure that, where there are different levels of partner within the organisation, the status of individuals at each level is as clear as it possibly can be. Particularly in the case of a traditional partnership, such an exercise will be relevant not only for tax purposes.