Capital interests: mixed member partnerships

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Boston Consulting Group considered how to tax proceeds relating to a 'capital interest' when there is no link between the capital interests and the value or balance sheet of a mixed member partnership.

Key Points

What is the issue?

The case of *Boston Consulting Group UK LLP and others vs HMRC* considers the tax status of payments for the sale of 'capital interests' of individual members of a UK LLP. It is one of the first cases to consider the mixed member partnership rules.

What does it mean for me?

Calling something a capital interest in a partnership does not make it a capital interest.

What can I take away?

In a mixed member partnership, even if there is a deferral of profit or an excess allocation to a corporate member, there still needs to be overall less tax paid by the individual member for the mixed member rules to apply.

In January, the First-tier Tribunal handed down its decision in *Boston Consulting Group UK LLP and others v HMRC* [2024] UKFTT 84. The case is particularly interesting because it is one of the first considering the mixed member partnership rules. The decision also delves into the nature of partnership interests and (as is a popular sport these days) concludes that the miscellaneous income rules apply.

Various procedural points are considered by the tribunal but they are not explored in this article. It is, though, interesting that the First-tier Tribunal allowed written appeals to be submitted by the parties as late as seven months after the oral hearing in light of decisions handed down by the Upper Tribunal.

A brief overview

A brief overview of the facts are as follows:

- Boston Consulting Group is a global management consulting business headquartered in the United States.
- BCG Ltd, a wholly owned subsidiary of the global parent company The Boston Consulting Group Inc, carried out the UK business.
- In 2010-11, the UK business was restructured. BCG Ltd contributed the business to a limited liability partnership in exchange for a partnership interest, which entitled it to a fixed margin and any residual profits. Senior individuals at BCG Ltd, known as managing directors and partners, became members of the limited liability partnership and were granted 'capital interests'.

Managing directors and partners were entitled to sell their capital interests to BCG Ltd in certain conditions and, unsuccessfully, claimed gains tax treatment on the proceeds.

Capital interests

Managing directors and partners worldwide were compensated using the same ‘framework’. In addition, the framework provides for an ‘equity’ element – known as the lifetime custom value (LTCV). This element was designed, according to Boston Consulting Group, to allow managing directors and partners to participate in the growth of the global business.

Before the 2011 restructuring, the UK LTCV programme was implemented using a specific share class in The Boston Consulting Group Inc. After the formation of the limited liability partnership, the UK LTCV programme was converted to capital interests in the limited liability partnership.

Boston Consulting Group’s intention was for the capital interests to replicate the structure of the old UK LTCV programme; and, accordingly, the capital interests were accounted for as share-based payments by the limited liability partnership and BCG Ltd.

Unlike in the case of The Boston Consulting Group Inc shares, however, the UK managing directors and partners did not buy the capital interests, nor did any new joiners to the LTCV pay a price upfront for the capital interests.

The curious and crucial factor underpinning the operation of the capital interests is that their ‘cash out’ value was designed to track the global value of the business; in other words, the value of The Boston Consulting Group Inc (as it had done using the old programme). This meant that the value of the UK business could fall but, provided the value of The Boston Consulting Group Inc had grown, a UK managing director or partner could ‘sell’ their capital interest profitably.

There was no link between the capital interests and the value or balance sheet of the limited liability partnership. Despite this disconnect, Boston Consulting Group claimed that the capital interests were a means for UK managing directors and partners to participate in the goodwill of the UK limited liability partnership.

Faced with these facts, the First-tier Tribunal held that capital interests did not reflect interests in the underlying assets and that the managing directors and partners ‘consequently did not have any interest in any profits arising from the disposal of capital items’.

This conclusion was supported by the accounting treatment adopted by the limited liability company; by the internal communications made regarding the capital interests; and by the descriptions of the arrangements used by external advisers. The decision is a useful reminder that calling something a spade does not always make it a spade.

Income tax treatment

Following the decision that the capital interests were not taxable under the capital gains regime, the next question was on what basis the proceeds should be taxed.

HMRC put forward three suggestions:

1. Tax as the value accrues
The capital interests formed part of the limited liability partnership’s profit sharing arrangements and were

therefore taxable as trading income. Profits allocated to BCG Ltd, as corporate member, possibly needed to be re ?allocated to the managing directors and partners under the mixed member partnership rules (Income Tax (Trading and Other Income) Act (ITTOIA) 2005 ss 850 and 850C). **This suggestion was not successful.**

2. Tax on disposal of the capital interests (Option 1)

The disposal of capital interests gave rise to taxable miscellaneous income (ITTOIA 2005 s 687). **This suggestion was successful.**

3. Tax on disposal of the capital interests (Option 2)

The disposal of capital interests should be chargeable to income tax under the sale of occupational income provisions (Income Tax Act 2007 Part 13 Chapter 4). **This suggestion was successful** (except trumped by the miscellaneous income option above).

Taxation on disposal

Taking first HMRC's winning argument, the First-tier Tribunal determined that disposal proceeds in relation to the capital interests fell to be taxed as income under the miscellaneous income provisions. Although this is the winning argument, it is the least interesting part of the decision. This is partly because it is not a surprising result once it had been determined that the capital interests were not interests in capital. Also, there has been a recent swathe of decisions on the miscellaneous income rules and this really only serves to bolster those decisions.

The initial reaction to this case may be one of concern for other equity incentive arrangements existing in both a corporate and a partnership context. However, the facts of this case are fairly unusual in the way that the capital interests do not provide any rights to underlying assets and don't even have a value that is tied to the business that they purport to provide an interest in.

The case does, though, serve as a reminder when setting up structures to consider how they are presented internally (and externally) and to ensure that the substance of arrangements and their form are aligned and coherent.

The First-tier Tribunal also determined that if the miscellaneous income rules had not applied, the payments would be taxable as income under the sale of occupational income provisions. The tribunal determined that there was evidence that obtaining capital rather than income tax treatment was one of the reasons for moving from a share based scheme to a capital interests scheme. Therefore, the First-tier Tribunal found fairly quickly (especially in the context of a 71 page judgment) that the arrangements were tax motivated and that the sale of occupational income rules would therefore apply.

Taxation on an accrual basis

HMRC's unsuccessful argument was that the capital interests formed part of the limited liability partnership's profit sharing arrangements and therefore that the managing directors and partners should have to be taxed as profits arose to the business. However, the First-tier Tribunal disagreed because of the absolute disconnect between the limited liability partnership's profits and the capital interests (discussed above).

The First-tier Tribunal further noted that BCG Ltd was not a mere conduit for transferring profits to the managing directors and partners. Prior to the reorganisation, BCG Ltd had carried on the UK business and the profits that it received were used to support Boston Consulting Group's group treasury function.

In considering whether the mixed member rules altered this conclusion, the First-tier Tribunal again found in favour of the taxpayer. The mixed member rules aim to prevent partnerships allocating profits to corporate members instead of individual members, where the arrangements are set up to give such individual members the benefit of lower corporate income tax rates.

There are two circumstances where the rules can apply:

- where profits to an individual partner are deferred and instead allocated to a corporate member and overall less tax is paid by the individual **(Condition X)**; and
- where the corporate member is allocated more than their 'appropriate notional profit' and an individual has the power to enjoy such excess amount and consequently less tax is paid by the individual **(Condition Y)**.

Condition X

The First-tier Tribunal concluded that amounts allocated to BCG Ltd were deferred profits because the profits allocated to BCG Ltd were used to purchase capital interests. This is interesting because the tribunal applied a broad interpretation of the meaning of deferred profit, holding that deferral needs to be determined applying a simple dictionary definition: 'put off to a later time; postpone'. In other words, even though the payment made for a capital interest would not be known until the actual sale, 'there is no requirement that there is an entitlement which is crystallised'.

Despite this unhelpfully wide decision, overall the First-tier Tribunal decided that Condition X was not satisfied because even though there was a deferral, there was not a corresponding reduction in any managing director and partner's profit allocation; the profit allocations were determined based on Boston Consulting Group's global compensation framework.

To have allocated BCG Ltd's profits to the managing directors and partners would mean that they would receive compensation in excess of their entitlement and out of step with their Boston Consulting Group peers globally.

This is a helpful conclusion for many mixed member partnerships sitting within global groups where global compensation frameworks are common.

Condition Y

Condition Y follows a similar analysis. There was an excess allocation made to BCG Ltd. The managing directors and partners did have the power to enjoy those excess profits but there was not a reduction in either the allocation to them or their tax bill. Therefore, Condition Y was not satisfied.

In considering whether an excess allocation had been made to BCG Ltd, it was necessary for the First-tier Tribunal to determine what the appropriate notional profit allocation to BCG Ltd should be based on its capital contribution.

The value of this capital contribution was subject to debate. The taxpayers argued that it was the market value of the business contributed to the limited liability partnership during the reorganisation, with annual increases.

HMRC stated that it was the (much lower) book value of the business at the time of the contribution.

Interestingly HMRC's position contradicts its view expressed in the Partnership Manual. In disregarding this contradiction and finding in favour of HMRC's argument, the First-tier Tribunal delivers our favourite statement in the judgment, which feels like a good place to end this article: 'HMRC's manuals are not law. They set out HMRC's opinion and therefore must be viewed as no more than that.'