MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

August 9, 2013

Via email: partnership.review@hmrc.gsi.gov.uk

Partnerships Review Consultation
c/o Tax Administration Policy Team
HM Revenue & Customs
First Floor
100 Parliament Street
London SW1A 2BQ
United Kingdom

Re: HMRC Consultation Document: *Partnerships: A review of two aspects of the tax rules* (20 May 2013) (the "Consultation Document")

Dear Sir or Madam:

Managed Funds Association ("**MFA**")[1] welcomes the opportunity to provide a response to HM Revenue & Customs's ("**HMRC**") Consultation Document.[2] MFA supports rules designed to prevent abusive tax structures; however, we are concerned that certain of the provisions in the Consultation Document will create uncertainty or otherwise inhibit the use of legitimate business arrangements. Please note that MFA has not responded to specific questions in the Consultation Document and has, instead, focused on providing comment on certain issues and topics in the Consultation Document.

Whilst there are several issues covered in our response, MFA would like to highlight the following key points:

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1 The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and all other regions where MFA members are market participants.

2 Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/200503/130520_Pships_Condoc_FinalVersion.pdf.

- *One single test to determine* "*salaried member*" *status* –MFA urges HMRC to apply only the second condition to determine whether or not an individual member is a "salaried member" and to dispense with the application of the first condition, as we believe this approach is better suited to achieve HMRC's underlying goals while avoiding the uncertainty that would result from applying the first condition.

- *Additional guidance regarding application of the second condition* – MFA urges HMRC to provide guidance as to the circumstances in which an exposure to economic risk and an entitlement to a share of surplus assets on a winding up would be considered to be "significant" for purposes of applying the second condition.

- *Flexibility to implement commercial arrangements within the proposed* "*profit and loss scheme*" *rules* – MFA urges HMRC to provide further guidance to ensure that partnerships are able to make appropriate use of *bona fide* planning, such as implementing deferral arrangements, working capital requirements, and exit/buy-out planning without triggering the anti-avoidance provisions.

- *Avoiding double taxation* – MFA urges HMRC to clarify its position regarding reallocation of profits to avoid effective double taxation.

We would be very happy to discuss our comments or any of the issues raised in the Consultation Document with HMRC. If HMRC has any comments or questions, please do not hesitate to contact Benjamin Allensworth or the undersigned at +1 (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell

Executive Vice President & Managing Director, General Counsel

ANNEX

MFA responses to HMRC Consultation Document

"*Partnerships: A review of two aspects of the tax rules*"

General MFA Comments on "Disguised Employment"

Conditions for an individual to be treated as a "salaried member"

MFA is concerned that the first condition in the Consultation Document[3] and related guidance in the Employee Status Manual, as required by paragraph 2.15, will create unnecessary uncertainty for partnerships. In particular, MFA is concerned that the Employee Status Manual is not well suited for determining the membership status of individuals in professional services partnerships. As such, for the reasons discussed below, we encourage HMRC to delete the first condition.

MFA notes that the Consultation Document provides that whether the first condition will be satisfied will be determined by reference to the "normal tests," as set out in paragraph 0500 of the Employment Status Manual (*i.e.,* those tests which were primarily designed to determine, in the context of a corporate engager, whether an individual is an employee or self-employed). Whilst the Employment Status Manual states that there is no definitive list of factors that should be considered in determining whether an individual should be considered an employee, the following list is given; control, personal service, equipment, financial risk, basis of payment, mutuality of obligation, holiday pay, sick pay, pension rights, part and parcel of the organisation, right to terminate a contract, opportunity from sound management, personal factors, length of engagement and intention of parties.

In relation to a professional services partnership we believe that many *bona fide* members would be unable to pass many of these tests. For example, all but the most senior members of an LLP will continue to work under the control of one or more members (which is consistent with the case *Tiffin v Lester Aldridge LLP (2011)* in which it was held that; "there is no particular reason why a partner cannot be under the direction of other partners"). In addition, as a general rule, members of a professional services partnership will be required to provide personal service, with equipment provided by the LLP, will be entitled to draw regular amounts from the LLP, and will be entitled to holiday and sick pay.

Given the scope of arrangements covered by the second condition,[4] the application of a targeted anti-avoidance rule (the **TAAR**),[5] and the concerns regarding the application of the first condition, MFA encourages HMRC to delete the first condition set out in the Consultation Document.

MFA considers the second condition, applied on its own, is an appropriate test of whether someone should be deemed a "salaried member," as it captures the relevant economic rights

[3] The first condition provides -- A "salaried member" of an LLP is an individual member of the LLP who, on the assumption that the LLP is carried on as a partnership by two or more members of the LLP, would be regarded as employed by that partnership.

[4] The second condition provides -- A "salaried member" of an LLP includes an individual member of the LLP who does not meet the first condition but who: (a) has no economic risk (loss of capital or repayment of drawings) in the event that the LLP makes a loss or is wound up; (b) is not entitled to a share of the profits; and (c) is not entitled to a share of any surplus assets on a winding-up.

[5] We address the scope of the TAAR in greater detail later in this letter.

typically associated with a membership interest. Placing the sole focus on the second condition would further allow businesses to engage in proper and reasonable business planning and would provide a level of certainty as to the expected tax treatment of any given individual's membership status, avoiding the facts and circumstances type of analysis inherent in the application of the first condition and related ambiguity and uncertainty for businesses. In addition, because HMRC is proposing that the second condition would be subject to the TAAR, HMRC will have a robust level of additional protection to avoid abusive structures, which should mitigate against the need for adopting a dual test approach.

Additional guidance on the application of the second condition

MFA notes that, for the purposes of applying the second condition, HMRC is proposing to ignore certain risks and entitlements which are considered to be "insignificant." In paragraph 2.21 of the Consultation Document, HMRC provides guidance as to when a share of profits would be considered to be "insignificant." HMRC has not, however, provided guidance regarding when the other two components of the second condition would be considered "insignificant." In order to allow for greater understanding and certainty as to when the test may otherwise be failed, MFA urges HMRC to provide additional guidance as to the circumstances in which: (i) exposure to economic risk (being either loss of capital or repayment of drawings); and (ii) entitlement to a share of surplus asserts on a winding up would be considered to be "insignificant" for purposes of the second condition.

Further, when considering when the second condition will be applied, MFA urges HMRC to provide guidance which confirms that entitlements that include: (i) amounts which are deferred and/or subject to forfeit; (ii) arrangements whereby profit entitlements are netted out over successive periods; and (iii) amounts subject to clawback, will be recognised as entitlements for purposes of the second condition. We believe that there are legitimate business reasons for partnerships to impose these types of conditions on membership interests, for example, to promote risk-management and long-term risk-adjusted performance, and that the imposition of such conditions should not disqualify an individual's entitlement, for purposes of the second condition.

The scope of the TAAR

MFA encourages HMRC to clarify the circumstances in which it would apply the TAAR. Paragraph 2.22 of the Consultation Document provides that the TAAR will apply where the "main purpose, or one of the main purposes" of "certain arrangements" is to prevent either of the two conditions being satisfied. Given the prescriptive basis on which certain risks or entitlements may be ignored for the purposes of the second condition, and the need for partnerships to consider the application of the second condition when agreeing to the terms on which new members will be admitted to a partnership, it is important for partnerships to have sufficient comfort that HMRC would not invoke the TAAR simply due to the fact that, as a matter of prudent planning, a partnership takes steps to ensure that an individual's terms of membership comply with the requirements of the second condition.

We believe a better approach would be the one noted by HMRC in the opening part of paragraph 2.22, which provides that the TAAR would only apply where membership terms are implemented which have "no practical" effect other than to disapply the legislation (see example 3

on page 12 of the Consultation Document). In light of the uncertainty regarding the intended application of the TAAR, we believe it would be helpful for HMRC to provide further guidance consistent with this approach regarding how the TAAR will be applied in practice.

General MFA Comments to "Profit & Loss Allocation Schemes"

Taking account of existing practices which have a sound commercial basis

MFA considers that it is important for HMRC to address several common business arrangements that are likely to affect the analysis under the provisions set out in the Consultation Document. Those issues are: (i) deferral arrangements, particularly due to regulatory/directive requirements; (ii) working capital arrangements; and (iii) buy-out/exit arrangements for members.

Deferral arrangements

In paragraph 3.18 and Annex D of the Consultation Document HMRC acknowledges that that further consideration may be beneficial in relation to the appropriate treatment of deferred profit arrangements in partnerships. We agree that HMRC should continue to consider this issue, particularly in light of regulatory requirements applicable to hedge fund managers, many of which are structured as partnerships. In particular, we believe that, in circumstances when the deferral arrangement is part of a policy which is required to comply with regulatory/directive requirements, the imposition of such taxes should be deferred to the time when a distribution is made.

Working capital arrangements

HMRC's position in paragraphs 3.19 and 3.20 regarding the allocation of post-tax working capital to a corporate member could, in practice, be restrictive and would not allow for proper, commercial planning required in connection with the running of a business. Moreover, the expansive scope of paragraphs 3.19 and 3.20 seem to be in conflict with paragraph 3.14 (second bullet point) that targets "arrangements [that] are clearly tax-driven because it is evident that the allocation of profits to the company would not occur if it were taxed at the same rate as the individual members."

For example, in relation to a US/UK manager structure, it is common – and entirely proper – to utilise a UK corporate member which, amongst other functions, provides working capital to the UK business. In circumstances where net-profit would otherwise be distributed back to the US, we do not believe that a business should be penalised for using a UK corporate member to provide funding. Accordingly, we urge HMRC to clarify that the use of corporate members for legitimate business planning purposes is permitted.

In addition, we urge HMRC to clarify that the allocation and distribution to a corporate member under arm's-length and commercial principles regardless of the ultimate ownership of the corporate member is permitted. For example, where the corporate member is within a global organization control chain and is the capital contributing partner for the global group, it is within arm's-length principles to expect that profits will be distributed back up the ownership chain in return for such capital funding, risk, and control support of a subsidiary LLP.

Member buy-out/exit arrangements

There are many legitimate business planning reasons to allow one member to acquire the membership interests of another member. If, in connection with such arrangements, it is necessary to accumulate net-profit in a corporate member (with the profit being used to fund the buy-out) then this should not, in itself, necessarily lead to the proposed anti-avoidance provisions applying. Accordingly, we encourage HMRC to revise these provisions to allow for proper, *bona-fide* commercial arrangements to continue without the prospect of the anti-avoidance regime being applied.

Reclamation of taxes paid on amounts never received

In paragraph 3.25, HMRC requests comment on whether retrospective tax relief could be given in the context of profit deferral arrangements, to the extent that a contingent profit award does not vest. To the extent HMRC does not revise the provisions regarding profit deferral, MFA urges HMRC to provide that a member of an LLP will be permitted to reclaim (in whole or in part) any taxes which such member pays up-front on distributions which are subject to deferral and/or forfeit, to the extent such member never actually receives (in whole or in part) the distribution on which the tax was paid. In the absence of such relief, taxpayers could be required to pay taxes on amounts they have not actually received, which we believe is inconsistent with accepted principles of fair taxation.

Introduction of additional measures to provide relief from double taxation

We are concerned that the provisions in the section of the Consultation Document titled "*The profit condition*" that would re-allocate profits between members may, in certain circumstances, lead to double taxation. An example of where such double taxation could arise is where: (i) partnership profit, which was allocated and distributed to a corporate member, is deemed, for the purposes of the new rules, to have been received by certain individual members (so that the members are required to pay income tax, and national insurance contributions, in connection therewith); and (ii) the amount actually allocated to the corporate member is subsequently distributed by the corporate member to its shareholders (with such distribution being subject to UK tax in the hands of individual UK shareholders). In this situation, the amount distributed by the corporate member effectively would have been taxed twice, once when re-allocated to the individual members under the new rules and once when received by the individual shareholders on the actual distribution by the corporate member. This would be an unjust position and MFA urges HMRC to introduce further provisions to avoid such potential double taxation.