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Analysis – Tyrwhitt: when employees become partners

Insight and analysis

Dominic Stuttaford

Norton Rose Fulbright

is a partner at Norton Rose Fulbright LLP. He specialises in the tax aspects of corporate finance with a particular interest in the insurance and technology sectors. Dominic's experience includes mergers and acquisitions of public and private companies and group restructurings. Email: dominic.stuttaford@nortonrosefulbright.com; tel: 020 7444 3379.

Sofia Casselbrant-Multala

Norton Rose Fulbright

is an associate in the tax team at Norton Rose Fulbright LLP. She advises on a range of corporate tax matters, including public and private M&A, IPOs, joint ventures and financing as well as indirect tax. Email: sofia.casselbrant-multala@nortonrosefulbright.com; tel: 020 7444 3938.

Speed read: In Charles Tyrwhitt LLP v HMRC, the FTT ruled that bonuses paid to members of Charles Tyrwhitt LLP, under a plan to which they enrolled as employees, should be taxed as earnings from employment. In the absence of a statutory basis for disregarding the temporal aspect of the source of the income, the judge nevertheless found that case law supported this approach and that the payments were earnings 'from' employment. The potential overlap between employment and LLP membership status remains an open question.

How members of a LLP should be taxed on their income has been a vexed issue ever since LLPs became popular following their introduction in 2000. Some of the issues were dealt with when the 'salaried members' rules were introduced in 2014. However, difficulties remain; in *Charles Tyrwhitt LLP v HMRC* [2020] UKFTT 272 (TC), the First-tier Tribunal (FTT) was asked to consider how the rules should apply to members whose drawings in part reflected an incentive plan to which the individuals had belonged before they joined the LLP as members.

The facts in this case are straightforward. Five individuals had been employees of Charles Tyrwhitt, and at that point they had become participants of a long-term incentive plan (LTIP). However, by the time the bonus payments were made, each of the individuals had joined the partnership as members. The FTT considered how the payments should be treated for national insurance purposes.

LTIPs commonly reward performance over the course of a period, but will typically only pay out if the participant remains affiliated with the company at the end of that period (or even later). This was the case with the Charles Tyrwhitt LTIP: it offered the opportunity to receive a bonus calculated by reference to the difference between Charles Tyrwhitt's earnings before tax in the 'base year' and its average earnings before tax in the remainder of the three-year calculation period. The scheme was open to employees and directors of the Charles Tyrwhitt group.

In order for a participant in the LTIP to be eligible to receive a bonus, the employee had to remain employed by that group on a date that fell some four months after the end of the calculation period. Prior to their appointment as members, the five individuals had received letters from Charles Tyrwhitt to the effect that the terms of the LTIP were varied so that entitlement to receive a bonus instead depended on, *inter alia*, being 'appointed' on 31 January 2014, which included being a member of Charles Tyrwhitt. The payments were in fact made to the individuals during the course of 2013, at a point when each of the individuals had already become members. Charles Tyrwhitt argued that the bonus payments should have been subject to NICs as self-employed earnings rather than as earnings of an employed earner.

The statutory framework

For the purposes of national insurance, a distinction is made between 'employed earners' and 'self-employed earners'. The earnings of an employed earner are subject to primary and secondary class 1 NICs, whereas the profits of a self-employed earner are subject to class 2 and class 4 contributions (Social Security Contributions and Benefits Act (SSCBA) 1992 ss 6, 11 and 15).

The parties were agreed on the general proposition that liability for employed earner's or self-employed earner's NICs is intended to follow liability for income tax on earnings, as provided for in either ITEPA 2003 or ITTOIA 2005.

ITEPA 2003 charges 'employment income': this includes 'general earnings'. The amount of employment income charged to tax for a particular tax year is the net taxable earnings from an employment in that tax year (ITEPA 2003 s 11). General earnings that are earned 'in, or otherwise in respect of ' a particular period are general earnings for that period (ITEPA 2003 s 16). Specific provision is made for general earnings from an employment that would otherwise fall to be regarded as general earnings for a tax year in which the employee does not hold employment: such earnings will be treated as general earnings for the last tax year in which employment was held (ITEPA 2003 s 17).

ITTOIA 2005 imposes a charge to income tax on the profits of a trade, profession or vocation (such as a member's share of partnership profits). Tax is charged on the profits of a 'basis period', which is generally the period of 12 months ending on the accounting date in a particular tax year (ITTOIA 2005 ss 7 and 198).

For both ITEPA 2003 and ITTOIA 2005, the qualitative as well as the temporal aspect of the source of income is key.

Employees versus members

It is provided by statute that a member of a limited liability partnership shall not be regarded for any purposes as employed by the partnership unless, in effect, the member would be regarded as an employee of a traditional partnership (Limited Liability Partnerships Act 2000 s 4). While it has often been said that a person cannot simultaneously be an employee of and a partner in a partnership in England and Wales, recent case law has cast doubt on whether this dichotomy is truly an absolute

(see *Clyde & Co v Bates van Winkelhof* [2014] UKSC 32).

In *Charles Tyrwhitt*, the judge held that he did not need to decide whether it is possible to be simultaneously a member and an employee of a partnership or an LLP. He did however reject the suggestion that status as a member is an absolute

bar to classification as an employee, indicating perhaps that, in his view, the answer to that question was not so obvious as to be unworthy of consideration. Instead, the judge found as a fact that, at the time when the LTIP bonuses were paid to the individuals, they were each members of the LLP and not its employees. This finding of fact could turn out to be significant on appeal.

The judgment did not include any discussion around the implications of the so-called salaried member rules which took effect from 6 April 2014, at which point the bonuses in question had already been paid. These rules provide that members will be treated as employees of the LLP for tax purposes where, *inter alia*, a significant part of a member's profit share constitutes disguised remuneration (ITTOIA 2005 ss 863A–863D). What is clear from the comments of the judge is that, whilst the salaried member rules put the treatment of LLP members as employees on a statutory basis in certain circumstances, even if the salaried member rules do not apply, there is still a residual risk that members of an LLP may be treated as employees.

The 'source' principle

The 'source' principle provides that income is only taxable if it emanates from a taxable source; if this is the case, it should be taxed in accordance with the rules that apply to the source in question. The history of the UK tax system highlights its importance: the present-day tax code has evolved out of a schedular system whereby different types of income were taxed separately under distinct schedules. Case law has confirmed that the schedules were generally distinguished from each other by distinctions as to the nature of the source from which the chargeable profit arose; this source should be properly identified before a profit can be assessed to tax. Once the source has been identified according to the correct schedule, it is obligatory that the profit should be charged under that schedule only: the sources of profit in the different schedules are therefore mutually exclusive (*Mitchell and Edon (Inspectors of Taxes) v Ross* [1962] AC 81).

In addition to the qualitative aspect of the source, its temporal characteristic is also relevant. Crucially, income tax is charged by reference to an annual period. In *Bray (Inspector of Taxes) v Best* [1989] STC 159, the House of Lords held that 'a receipt of entitlement arising in a year of assessment is not chargeable to tax unless there exists during that year a source from which it arises'.

Bray was subsequently reversed by statute (now in ITEPA 2003 s 17). At other times, Parliament has legislated to provide that certain income should be taxable even where a source has ceased to exist. An example was previously to be found at ICTA 1988 s 313 (now rewritten as ITEPA 2003 ss 225 and 226), which provided that certain payments made to a person after such person had ceased to be an employee would nonetheless be charged to tax as income. If the temporal aspect of the source of income was not central to the taxing right itself, such rules would not be required; their existence indicates that the recipient's status as at the time when the income is received is key in establishing the nexus by which the income is charged to tax as employment earnings.

In *RCI Europe v Woods (Inspector of Taxes)* [2003] EWHC 3129 (Ch), the judge held that ICTA 1988 s 313 brought into charge payments made before, during or after employment. As a result of SSCBA 1992 s 4(4) — which, at the relevant time, provided that all sums paid to or for the benefit of an employed earner which were taxable under ICTA 1988 s 313 should be treated as remuneration from an employed earner's employment — all such payments should be treated as earnings. This indicates that the judge in *RCI* arrived at his conclusion in reliance on statutory provisions which made specific provision for periods during which the employment had ceased.

In *Charles Tyrwhitt*, the judge said he did not consider that the *RCI* construction of the distinction between 'employed earners' and 'self-employed earners' set out in SSCBA 1992 s 2 was confined to the operation of that Act in conjunction with a specific provision such as ITEPA 2003 s 313. The reason for this analysis was not further explained by the judge.

Findings

Ultimately, the judge was persuaded that the LTIP bonus payments satisfied the criteria of being both earnings from employment under ITEPA 2003 and earnings in respect of employed earner's employment under SSCBA 1992. Notably, he agreed with HMRC that this proposition could be tested by considering what the outcome would have been if the individuals had received their bonuses by virtue of being so-called 'good leavers' under the LTIP rather that members of the LLP. The judge did not explain why such analogy would be useful even though it would have been

based on the individuals' entitlement to the bonuses having vested as a result of fundamentally different factual circumstances.

He held that, for the reasons given in *RCI*, the fact that the five individuals had ceased to be employed earners by the time the bonuses were paid is not an obstacle to such bonuses being treated as earnings of an employed earner for NICs purposes. Arguably, this reasoning constitutes a significant leap from how the source principle was applied in *RCI* where the judge had based his analysis on specific statutory provisions. By contrast, in *Charles Tyrwhitt*, there was no suggestion that statute explicitly provide for the relevant income to be chargeable to tax by reference to the members' previous employment.

The judge found that the bonus payments should not be characterised as a share of profits: they are merely the most common (though not the only) example of payments by an LLP to its members. In this case, the bonus payments were made by virtue of the individuals being members who had complied with all the conditions of a bonus scheme that was open only to employees. The payments *could* have been received otherwise than by virtue of the individuals being members of the LLP.

While the FTT found for HMRC in this case, the case law that was referred to in the judgment could have yielded a more favourable outcome for the taxpayer. The judge recognised the importance of the source principle. Even if it is accepted that bonuses were *prima facie* paid in respect of employed earner's employment, it does not necessarily follow that they should be subject to NICs as earnings of an employed earner where the employment had ceased at the time of payment in circumstances where the payments *were* received by virtue of the individuals being members of the LLP.