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The Boston Consulting Group UK LLP v HMRC: taxing the remuneration of members of a limited liability partnership

Introduction

This note comments on the First-tier Tribunal's decision in *The Boston Consulting Group UK LLP v Revenue and Customs Commissioners* (*BCG*)[1] and compares it to other recent decisions on the application of the "mixed member rules" in s.850C of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA), the miscellaneous charge to income tax in s.687 ITTOIA and the sales of occupation income (SOI) rules in Ch.4 of Pt 13 of the Income Tax Act 2007 (ITA 2007).

BCG is the latest reported decision on the application of the above rules to arrangements for the remuneration of members of a limited liability partnership (LLP) and only the third on the mixed member rules. LLPs and their advisers will be aware that these have been areas of focus for HMRC in recent years. Despite being a first-instance decision, *BCG* is an important foil for earlier cases. It is also likely to be appealed and cross-appealed, so an understanding of the decision will help readers anticipate the issues that the Upper Tribunal (UT) could face.

The mixed member rules

The general rule for tax purposes is that the profits of an LLP's business are divided between its members in accordance with their rights to share in those profits.[2] The potential for abuse lies in the fact that an LLP may have individual members (IMs) and corporate members (CMs) who might pay tax on their income at different rates; for many years, the highest rates of income tax have been roughly double the main rate of corporation tax. An IM could shelter "their" share of the LLP's profits from income tax by ceding the right to those profits to a CM from which they could later benefit.[3]

[1] *The Boston Consulting Group UK LLP v Revenue and Customs Commissioners* [2024] UKFTT 84 (TC).
[2] ITTOIA s.850 for income tax and CTA 2009 s.1262 for corporation tax.
[3] ITTOIA s.850A only prevents a profitable LLP from allocating a loss to a member.

The mixed member rules were introduced to counteract such arrangements. However, it is doubtful whether they have ever been an effective means of avoiding income tax. To realise an income tax-free benefit from the CM, the IM would have to escape, among other things, the charge on distributions,[4] the miscellaneous charge, the transactions in securities rules[5] and the SOI rules. The arrangements are not an attractive income tax deferral mechanism due to their corporation tax cost. Their ineffectiveness has been illustrated by three similar cases: *Odey Asset Management LLP v Revenue and Customs Commissioners* (*Odey*),[6] *HFFX LLP v Revenue and Customs Commissioners* (*HFFX*)[7] and *BCM Cayman LP v Revenue and Customs Commissioners* (*BlueCrest*).[8] In each case, the court found that payments of "Special Capital" by a CM to IMs, as the final step in arrangements to defer part of the IMs' remuneration from the LLP's profits, were chargeable to income tax under the miscellaneous charge.[9]

The mixed member rules reallocate LLP profits from a CM to an IM for tax purposes in two situations. The first is that all or part of the CM's share of the profits represents the IM's deferred remuneration for services provided to the LLP and both the IM's profits and the "relevant tax amount"[10] are lower as a result.[11] The rules refer to this as "Condition X". The second situation, referred to as "Condition Y", is that the CM's profits exceeds an arm's length reward for capital contributed and services provided to the LLP, all or part of the CM's profits is attributable to the IM's "power to enjoy"[12] those profits, and the IM's profits and the relevant tax amount are lower than they would have been absent the power to enjoy.[13] The reallocated profit is the amount attributable to the deferred remuneration or power to enjoy as determined on a just and reasonable basis, capped in the latter case at the CM's excess profits.[14]

The decisions of the FTT and UT in *Walewski v Revenue and Customs Commissioners* (*Walewski*)[15] are the first and second reported decisions on the mixed member rules. Mr Walewski (W) and Walewski Ltd (WL) were members of two investment management LLPs. W was the sole director and employee of WL. The shares in WL were held in an offshore trust for the benefit

[4] ITTOIA s.383.
[5] ITA 2007 Pt 13 Ch.1.
[6] *Odey Asset Management LLP v Revenue and Customs Commissioners* [2021] UKFTT 31 (TC); [2021] S.T.I. 1147.
[7] *HFFX LLP v Revenue and Customs Commissioners* [2021] UKFTT 36 (TC) and *HFFX LLP v Revenue and Customs Commissioners* [2023] UKUT 73 (TCC); [2023] S.T.C. 678. The case is currently on appeal to the Court of Appeal; a hearing is scheduled for 9 or 10 July 2024.
[8] *Revenue and Customs Commissioners v BlueCrest Capital Management LP* [2020] UKFTT 298 (TC), *Revenue and Customs Commissioners v BlueCrest Capital Management LP* [2022] UKUT 200 (TCC); [2022] S.T.C. 1696 and *Revenue and Customs Commissioners v BlueCrest Capital Management LP* [2023] EWCA Civ 1481; [2024] S.T.C. 92.
[9] HMRC's primary case was that the IM was the only person with rights to share in the profits in question as the CM was a mere conduit, so any rights it had were illusory and therefore not "rights" for the purposes of ITTOIA s.850. The courts disagreed. In *BlueCrest*, the Court of Appeal said that the CM became legally entitled to the profits as part of a genuine arrangement that had a commercial purpose as well as tax avoidance purpose. However, the Court stopped short of equating "right" with an enforceable legal entitlement: [2023] EWCA Civ 1481 at [75].
[10] The total tax chargeable in respect of the IM and the CM's profits: ITTOIA s.850C(9).
[11] ITTOIA s.850C(2).
[12] This is widely defined: see ITTOIA s.850C(18)–(21).
[13] ITTOIA s.850C(3).
[14] ITTOIA s.850C(4).
[15] *Walewski v Revenue and Customs Commissioners* [2020] UKFTT 58 (TC); [2020] S.F.T.D. 521 and *Walewski v Revenue and Customs Commissioners* [2021] UKUT 133 (TCC); [2021] S.T.C. 1749.

of W's children. HMRC assessed W to income tax on most of WL's share of the LLPs' profits, relying on Condition Y. W accepted that he had the power to enjoy WL's profits.[16] However, he argued that none of the profits were attributable to his power to enjoy and that it would be neither just nor reasonable to reallocate any of the profits to him.[17]

The FTT upheld HMRC's assessment, finding that there was "no commercial, physical or temporal separation of [W's] activities" for WL and the LLPs.[18] In other words, WL was W's corporate alter ego. Absent any rational non-tax justification for WL's existence, the only reasonable inference was that WL's profits would otherwise have been allocated directly to W, thereby increasing the relevant tax amount. It was also just and reasonable in these circumstances to reallocate all of WL's excess profits to W. The UT upheld this decision on appeal.

Walewski involved a clear example of the arrangements that the mixed member rules were intended to counteract.[19] So, while those decisions will have come as some reassurance to HMRC, they reveal little about the limits of the rules. Enter *BCG*.

BCG: the facts in outline

In 2011, The Boston Consulting Group UK LLP acquired the UK trade of the Boston Consulting Group (the Group) from Boston Consulting Group Ltd (BCGL). Membership of the LLP included senior individuals, known as Managing Directors and Partners (MDPs), and BCGL.

Formerly, MDPs were employees of BCGL and were rewarded with salary, bonus, and shares or options to acquire shares in Boston Consulting Group Inc (BCG Inc), the Group's ultimate parent company.

Following the introduction of the LLP, salary and bonus were replaced with a share of the LLP's profits. BCG Inc shares and options were replaced with "Capital Interests", which were rights to payments from BCGL in certain events including departure and the sale or winding up of the LLP. Payments were calculated by reference to the increase, if any, in the value of BCG Inc from the date of award. The LLP allocated the first 18% of its profits to BCGL to fund the payments.[20]

HMRC amended the LLP's returns to reallocate the 18% profit share from BCGL to MDPs under the mixed member rules.[21] HMRC also assessed MDPs to income tax on payments they

[16] The basis for this concession is unclear. The writers consider the definition of "power to enjoy" to be sufficiently wide to cover the situation where a trust beneficiary connected with the IM becomes entitled under the trust to receive a benefit from the CM's profits: see ITTOIA s.850C(18)(c), 20(c)–(d) and (21).
[17] HMRC did not argue that WL's profits represented W's deferred remuneration for services provided to the LLP.
[18] *Walewski* [2020] UKFTT 58 (TC) at [172].
[19] Indeed, it seems that W or his advisers thought that this was the case because soon after the rules came into force, W resigned as a member of one of the LLPs and both were then restructured as companies. The UT upheld the FTT's decision that profits attributable to the period after W's resignation could be reallocated to him: *Walewski* [2021] UKUT 133 (TCC) at [27]–[34].
[20] Strictly speaking, the LLP retained the profits and settled payments on BCGL's behalf.
[21] HMRC also argued that Capital Interests were part of the LLP's profit-sharing arrangements for the purposes of ITTOIA s.850 and that only MDPs had rights to share in the profits in question because BCGL was a mere conduit. The FTT disagreed, stating that Capital Interests were "even further removed from a profit-sharing arrangement than the situation in *BlueCrest* and *HFFX*": *BCG* [2024] UKFTT 84 (TC) at [273].

received for their Capital Interests under the miscellaneous charge and the SOI rules.[22] The taxpayers appealed to the FTT.

BCG: the FTT's decision

Mixed member rules

HMRC relied on both Condition X and Condition Y to reallocate BCGL's profits to MDPs. However, the FTT decided that neither condition was satisfied.

As respects Condition X, the FTT found that although BCGL's profits represented MDPs' deferred remuneration, MDPs' profits were not lower as a result. The Group required each local firm to implement a long-term remuneration plan. While they had some discretion over the mechanics, firms had to contribute the first 18% of their profits to the plan. Realistically, therefore, MDPs would not otherwise have received any of this amount.

As respects Condition Y, the FTT found that BCGL had been allocated profits exceeding an arm's length reward.[23] It also found that BCGL's profits were attributable to Capital Interests, which represented a power for MDPs to enjoy those profits.[24] However, MDPs' profits were not lower than they would have been absent the power to enjoy. Again, this was because MDPs' profits were limited by the Group-wide remuneration policy.

Accordingly, HMRC were not permitted to reallocate BCGL's profits to MDPs. The FTT declined to express a view on what a just and reasonable reallocation would have been had either condition been satisfied.

Miscellaneous charge

The miscellaneous charge applies to income from any source not otherwise charged to income tax.[25]

Jones v Leeming[26] establishes that here "income" means an amount that can be calculated in the year of charge, has the nature of income, and is analogous with an amount chargeable under a different head of income tax.[27] The FTT found that the payments MDPs received for their Capital Interests satisfied these criteria. First, the payments were calculable in the year of receipt. Next, because Capital Interests were awarded to reward and incentivise MDPs for the performance of their services to the LLP, the payments were income-like and "analogous to other amounts

[22] MDPs self-assessed to capital gains tax on the disposal of Capital Interests and claimed entrepreneurs' relief (now business asset disposal relief). HMRC did not dispute the availability of the relief assuming the MDPs had otherwise correctly self-assessed.

[23] In so finding, the FTT agreed with HMRC that BCGL's capital contribution to the LLP for the purposes of Condition Y was the amount credited to its capital account and not the market value of the assets BCGL contributed for its interest in the LLP: *BCG* [2024] UKFTT 84 (TC) at [297]–[307]. HMRC's argument contradicted their guidance in PM221000, which at the time of writing has not been modified.

[24] Specifically, Capital Interests "entitled [MDPs] to receive at any time any benefit provided or to be provided (directly or indirectly) out of [BCGL's] profit share": ITTOIA s.850C(20)(c).

[25] ITTOIA s.687(1).

[26] *Jones v Leeming* [1930] A.C. 415; 15 T.C. 355.

[27] But it excludes amounts treated as income: ITTOIA ss.687(4) and 878(1). Thus, there is no overlap between the miscellaneous charge and the SOI rules since those rules treat as income amounts that would not otherwise be income.

taxable under Schedule D".[28] Schedule D is no longer part of the income tax rules but included profits from a trade, profession or vocation.[29]

The FTT then found that the source of payments was the Capital Interests and not the LLP's trade. Profits of the trade had been taxed in accordance with the LLP's profit-sharing arrangements. Capital Interests were not part of these arrangements and had not been taxed.

Accordingly, the FTT decided that the payments were within the miscellaneous charge.

SOI rules

Although strictly unnecessary, the FTT then considered whether the payments were within the charge to income tax under the SOI rules.

The rules charge a "capital amount"[30] to income tax where an individual (A) obtains the amount in connection with arrangements to put another person in a position to enjoy the income derived from A's activities in a UK occupation,[31] the arrangements are made to exploit A's earning capacity in the occupation[32] and income tax avoidance is a main object of the arrangements.[33]

A capital amount obtained from the disposal of a share in a partnership carrying on a profession is exempt from the charge so far as the value of the share is attributable to the value of the profession as a going concern.[34]

The FTT found that the LLP's profits derived from the performance by MDPs of their duties as members of the LLP, which the taxpayers accepted were activities in a UK occupation. The partnership agreement put BCGL in a position to enjoy a share of these profits. The FTT did not explicitly state that MDPs' earning capacity was thereby exploited, but it rejected the taxpayers' submission that the rules apply only where individuals "sell" their earning potential for capital amounts, noting that the rules are "drafted very widely with a limitation being provided by the tax avoidance purpose rule".[35] As respects that rule, the FTT found that the Group had "the worldwide aim of capital gains tax treatment where possible" for long-term remuneration and that this was the motivation for replacing BCG Inc shares and options with Capital Interests.[36] This was enough to constitute a main object of income tax avoidance.

The FTT considered that the exemption for disposals of partnership shares did not apply. Capital Interests were not shares in the LLP, for four main reasons. First, their value depended not on the value of the LLP, but on the value of BCG Inc.[37] Second, only BCGL was entitled to

[28] *BCG* [2024] UKFTT 84 (TC) at [339].
[29] ICTA 1988 s.18 (Cases I and II). Such profits are now chargeable under ITTOIA s.5. The writers query whether employment income is a more appropriate analogy given the approach of the Court of Appeal in *BlueCrest* [2023] EWCA Civ 1481 at [108]–[109] and [116].
[30] An amount in money or money's worth that would not otherwise be included in an income tax calculation: ITA 2007 s.777(7).
[31] ITA 2007 s.777(2), (3) and (5).
[32] ITA 2007 s.773(2)(a).
[33] ITA 2007 s.773(2)(b).
[34] ITA 2007 s.784.
[35] *BCG* [2024] UKFTT 84 (TC) at [364].
[36] *BCG* [2024] UKFTT 84 (TC) at [369]. There was a perceived risk that the shares and options would become subject to income tax due to proposed changes to the employment-related securities regime.
[37] This also meant that even if Capital Interests were shares in the LLP, their value was not attributable to the value of the LLP's profession as a going concern.

the LLP's capital profits. Third, only BCGL was entitled to the profits from a sale of the LLP itself; for MDPs, such a sale was merely a trigger for payment from BCGL. Fourth, although MDPs would lose the right to payment if the LLP became insolvent, this was just a term of the contract between MDPs and BCGL. It did not signify that MDPs had put capital at risk in the LLP.

Accordingly, the FTT concluded that the payments would have been within the charge under the SOI rules had they not been within the miscellaneous charge.

Outcome

Ultimately, HMRC were largely unable to convert their successful arguments because of procedural flaws in their assessments.[38] Ironically, most of the amendments to the LLP's returns, which were based on HMRC's unsuccessful arguments about the mixed member rules, were procedurally valid. An appeal by HMRC and a cross-appeal by the taxpayers therefore seem likely.

Comment

BCG is an important foil for the earlier decisions on LLP member remuneration, for three reasons.

First, it is the first case where the mixed member rules were held not to apply. The key finding was that MDPs' profits were not lower than they would otherwise have been in the context of the Group's remuneration policy. In *Walewski*, there was no such commercial backdrop to the LLPs' profit-sharing arrangements. The FTT concluded that W would otherwise have allocated WL's profits to himself. In *BCG*, the Group's policy prevented this result. This illustrates the importance of the wider context of the LLP's profit-sharing arrangements.

Second, the case follows *Odey*, *HFFX* and *BlueCrest* in deciding that remuneration paid by the CM was taxable under the miscellaneous charge. There are notable differences between Special Capital in those cases and Capital Interests in *BCG*: the former represented annual remuneration that was typically deferred for three years, whereas the latter was a (potentially) much longer investment in the success of the Group. However, both were awarded to reward and incentivise the IMs for the performance of their services to the LLP. This was critical to the conclusion that the resulting payments were income-like and analogous with amounts chargeable under a different head of income tax.

Third, the case follows *HFFX* and the UT in *BlueCrest* in deciding that the SOI rules would have applied had the remuneration not been within the miscellaneous charge. It is important to note, however, that the Court of Appeal in *BlueCrest* declined to express a view on the application of the SOI rules because "at least some of the issues to which it gives rise are far from straightforward".[39] The writers suspect that one of these issues is whether the CM's profits "derive from" the IM's activities. The FTT in *BCG* had little difficulty concluding that this was the case, but the FTT in *Odey* reached the opposite conclusion, reasoning that the CM derived its profits from its rights under the LLP's profit-sharing arrangements.

[38] Many of the assessments either failed to satisfy the conditions of TMA s.29 or were made outside the applicable time limit in TMA s.34 or s.36.
[39] *BlueCrest* [2023] EWCA Civ 1481 at [127].

If there is an appeal and a cross-appeal in *BCG*, then we can expect the UT to grapple with some complex issues. As instructive as the FTT's decision is, further judicial guidance in this rapidly developing area of tax law would be welcomed.

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