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Taking an interest in partnerships: examining the UK FTT's decision in *BCG v HMRC*

While there have been a number of recent cases concerning the tax treatment of partnership incentivisation arrangements, the recent decision in *The Boston Consulting Group UK LLP & Others v HMRC* may be viewed as an extension of the principles derived from those cases (in particular, on the scope of the charge to 'miscellaneous income'), in the context of arrangements intended to give partners a long-term, 'equity' interest in the business in which they operate. The case also provides much-needed further guidance on how future tribunals might apply the so-called 'mixed member rules' in s 850C ITTOIA.

One attraction of conducting business through a partnership (or LLP) is the flexibility which partnership law affords businesses to adopt bespoke arrangements which meet their commercial needs. However, that flexibility can give rise to complex questions regarding the taxation of those participating in those arrangements.

The recent First-tier Tribunal (the ***Tribunal***) decision in *The Boston Consulting Group UK LLP & Others v HMRC* [2024] UKFTT 84 (***BCG***), in which the authors' firm acted for the appellants, illustrates some of those complexities. That case concerned the tax treatment of certain 'capital interests' held by the individual members of a large LLP, conducting the UK business of a global management consultancy firm. Broadly, individual members acquired those interests on becoming members, and sold them, on their retirement, to the LLP's corporate member. An important (and unusual) feature of those interests was that, to align the interests of the firm's UK partners with the global firm, while the interests were intended to represent interests in the LLP itself, their value would increase (or decrease) by reference to the value of the *global* business, rather than the UK business alone.

It was intended that the proceeds realised on disposals of those interests would be subject to capital gains tax. However, HMRC argued that those proceeds were taxable as income, either:

(i) on an *accruals basis*, either because increases in value of members' capital interests should properly be viewed as allocations of additional LLP profit to those individuals, or under the so-called 'mixed member rules' (***MMRs***) in section 850C of the Income Tax (Trading and Other Income) Act 2005 (***ITTOIA***); or

(ii) alternatively, on a *realisation basis*, either as miscellaneous income falling within section 687 ITTOIA, or under the 'sales of occupation income' rules in Chapter 4, Part 13 of the Income Tax Act 2007.

Ultimately, HMRC were successful on both of the 'realisation' issues (but not on the 'accruals' issues), although most of the assessments under appeal were found to be invalid for procedural reasons.

Many of the issues in *BCG* were similar to those arising in a series of recent cases concerning the taxation of members of partnerships – *BlueCrest* [2023] EWCA Civ 1481, *HFFX* [2023] UKUT 73 and *Odey* [2021] UKFTT 31. However, it was accepted by HMRC during the hearing, and by the Tribunal in its decision, that the arrangements in *BCG* were materially different from those other cases. In particular, while *BlueCrest*, *HFFX* and *Odey* concerned, in effect, arrangements for delivering deferred bonuses to individual LLP members, the arrangements in *BCG* were intended to provide members with long-term 'equity' interests in the value of the global business, giving them economic exposure to any increase (or decrease) in the value of that business.

At the time of writing, the deadline for either or both parties to apply for permission to appeal the Tribunal's decision has not yet expired. However, subject to any further appeal, the fact that the Tribunal has reached a conclusion which is broadly similar to those reached in *BlueCrest*, *HFFX* and *Odey*, despite the factual differences as compared to those cases, demonstrates the potential breadth of some of these rules relied upon by HMRC in those cases, and their potential to lead to unexpected tax consequences for a variety of commercial partnership equity and incentivisation arrangements. We focus below on two key aspects of the Tribunal's decision – the charge to miscellaneous income and the MMRs – which may be of relevance to those participating in (and advising on) such arrangements.

The charge to miscellaneous income

A key basis for the Tribunal's conclusion that proceeds realised on disposals of members' capital interests were taxable as miscellaneous income was its finding that those interests should be regarded as part of an individual member's '*remuneration or compensation for services*', even though the value of those interests reflected the value of BCG's global business, and not the value or quality of the services carried out by the individual member in question.

While the Tribunal's conclusion on miscellaneous income is consistent with the conclusions reached in *BlueCrest*, *HFFX* and *Odey*, given that (unlike in *BCG*) the arrangements in those cases were intended as a means of delivering deferred bonuses to members, the *BCG* decision could be viewed as a substantial extension of what many practitioners may have previously considered to be the scope of the charge to miscellaneous income. In particular, there will be many other firms in which partners receive equity or equity-like instruments as part of arrangements to attract, retain and incentivise key personnel. It may come as a surprise to those advising on, or participating in, those arrangements that the fact that they are, in a broad sense, intended to 'reward' or 'incentivise' partners might *in itself* cause them to fall within scope of the charge to miscellaneous income.

The Tribunal's conclusions on this issue should, however, be viewed in the context of its finding that the capital interests were not interests in the capital of the LLP or a share of its assets, but simply a right to receive a cash sum determined by reference to any increase in value of the global business. While it is not clear that that (legal) conclusion should affect the (factual) question whether the relevant interests represented 'remuneration' or 'compensation', this does appear to have influenced the Tribunal's conclusion on the miscellaneous income issue. As a result, it remains an open question whether the charge to miscellaneous income could apply to partners acquiring or disposing of more conventional equity interests, as part of a firm's management incentivisation arrangements, where the 'reward' can properly be analysed as resulting from having a stake in the business (with potential downside as well as upside), and not from services provided by the relevant individual.

The 'mixed member rules'

Despite a large number of ongoing MMR enquiries, very few cases concerning the application of those rules have reached the tribunals. In fact, as we approach the ten-year anniversary of the rules taking effect, *BCG* is just the second published case on the application of those rules (after *Walewski v HMRC* [2020] UKFTT 58 and [2021] UKUT 133) – and the first to consider both of the two substantive, alternative gateways to the application of the rules: 'Condition X' and 'Condition Y'.

Stepping back, the primary purpose of the MMRs, when introduced, was to counteract arrangements involving diversion of LLP profits from individual members to non-individual members (or, as articulated by the Upper Tribunal in *Walewski*, and cited by the Tribunal in *BCG*, 'to prevent individual partners making arrangements which seek to accumulate profits in a corporate partner at a lower tax rate') – that is, arrangements more akin to those in *BlueCrest*, *HFFX* and *Odey* (although the decisions in those cases concerned periods prior to the introduction of the MMRs, the Court of Appeal in *BlueCrest* appears (at para. [9]) to have confirmed that the arrangements in that case remained in place post-MMRs, and were treated as falling within scope of those rules).

Against that background, the Tribunal's conclusion that the MMRs did not apply in *BCG* is perhaps unsurprising – those arrangements did not involve the introduction of a corporate member into a partnership in order to facilitate a diversion of profits, and it was accepted by the Tribunal and by HMRC that the arrangements did not involve profits which would otherwise have been enjoyed by the individual members instead being received by the corporate member. However, the Tribunal's reasoning in reaching that conclusion indicates that the MMRs may apply in a broad range of other cases, with different facts to those in *BCG*.

Some of the key aspects of the Tribunal's decision on the MMRs, which may be of interest to those currently advising on mixed member partnership structures, include:

- On Condition X (the 'deferred profit' condition), the Tribunal concluded that the value realised by individuals on disposal of their capital interests represented 'deferred profit' of those individuals, as defined in section 850C(8) ITTOIA (that is '*remuneration, benefits or returns, the provision of which to [the individual] has been deferred*'). In doing so, the Tribunal rejected the appellants' submissions that, for amounts to be '*deferred*', there must have been some pre-existing entitlement to (or expectation of receiving) those amounts which is then postponed – instead taking the view that, adopting what the Tribunal saw as an ordinary definition, the '*deferral*' condition simply required there to be some benefit provided *in the future* to an individual member. While the Tribunal took the view that the wording of the legislation '*shows a clear purpose of casting the net widely*', this interpretation extends the concept of 'deferred profit' significantly beyond the sorts of deferred bonus arrangements which the MMRs were originally introduced to counteract.

- On Condition Y (the 'power to enjoy' condition), the Tribunal rejected the appellants' submissions that the 'safe harbour' under section 850C(3)(a) ITTOIA – which applies where, broadly, the corporate member's profit share does not exceed an arm's length return on the services which it provides, and/or the contribution it has made, to the LLP – applied. Central to the Tribunal's conclusion on this issue was its view that the corporate member's 'contribution to' the LLP was limited to the amount recognised in the LLP's accounts as capital contributed to the LLP, and not the *market value* of that contribution (either as at the date of the contribution, or in the relevant year in question). While the Tribunal's conclusion here is understandable, given the restrictive way in which a member's 'contribution' is defined for these purposes, there are reasonable purposive arguments that, in assessing whether the corporate member's profit share is 'excessive', it is appropriate to look at the *actual* value (rather than book value) of what has been contributed. And, while the Tribunal accepted HMRC's submissions on this question, it acknowledged that the view advanced by HMRC differed from the view in their published guidance (in the *Partnership Manual* at PM221000), that non-cash contributions can be fair valued at the date of contribution, for the purposes of these rules.
- Also on Condition Y, having determined that the individual members exercised a 'power to enjoy' the corporate member's LLP profit share – on the basis that payment by the corporate member for an individual member's capital interests was a '*benefit provided…out of [the corporate member's] profit share*' – the Tribunal concluded that it was 'reasonable to suppose' that part of the corporate member's profit share was attributable to that power to enjoy. While the Tribunal's reasoning behind that conclusion is briefly-stated, importantly, it does not appear to have engaged in the sort of 'but for' analysis – in which the corporate member's actual profit share is compared to the share of profits which it would have received, in a counterfactual in which no 'power to enjoy' existed – which is contemplated in HMRC's *Partnership Manual* at PM228000.

Despite these views, the Tribunal ultimately concluded that neither Condition X nor Condition Y was met, and therefore that the MMRs did not apply, as (broadly) it was not 'reasonable to suppose' that the individual members' profit shares were lower, as a result of the arrangements. In particular, the Tribunal relied on the fact that the arrangements formed part of BCG's global working capital and incentivisation arrangements, which were compulsory for partners around the world, and that there was no possibility of the UK partners (collectively or individually) foregoing participation in those arrangements in order to receive a greater LLP profit share.

While this achieves an outcome which is consistent with the purpose of the MMRs, the basis on which those rules were held not to apply was therefore a narrow one, based on specific features which are unlikely to be present in many other cases. The fact that the Tribunal's analysis differs in some respects from the position set out in HMRC's published guidance may also be a source of further uncertainty for taxpayers and advisors considering these rules. For those reasons, despite its conclusion that the MMRs did not apply on the specific facts of the case, the decision may provide limited comfort, regarding the likely scope of those rules, to those currently involved in MMR enquiries with their own unique fact patterns.

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