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# BlueCrest– the Upper Tribunal considers the salaried member rules

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The Upper Tribunal (UT) has upheld the decision of the First-tier Tribunal (FTT) regarding the application of the UK's salaried member rules (the Rules) to certain members of BlueCrest Capital Management (UK) LLP (BlueCrest), an asset manager engaged in the provision of hedge fund management services. We previously reported on the FTT decision in June 2022.

A high-level summary of the relevant aspects of the Rules, which can treat certain limited liability partnership (LLP) members as employees, and the FTT's decision is set out below. For more information on this decision and for further background on the Rules, please refer to our Tax Talks blog post from last year.

The case heard by the UT had two strands: an appeal by HMRC that the FTT was wrong to determine that certain of the members in question were not salaried members because they had significant influence over the affairs of BlueCrest; and an appeal by BlueCrest that none of the members in question were salaried members because they all received sufficient "variable remuneration." The discussion and decision on the significant influence point is of the most interest. The decision on variable remuneration is not surprising given the very limited circumstances in which BlueCrest's overall profits might affect the bonuses awarded to the members.

*Overview of the Rules and FTT decision*

For UK tax purposes, the general position is that LLPs are treated as partnerships and their members as self-employed partners, each carrying on the business of the LLP. The Rules were introduced to treat LLP members as employees for UK tax purposes unless one or more of three conditions are satisfied by the member. The conditions are, in a very broad sense, intended to be proxies for characteristics of partners in traditional partnerships. The most notable consequence of the Rules applying to a member (so that the member is categorised as a "salaried member" and an employee) is that the LLP is then required to operate PAYE (including accounting for employee and employer national insurance contributions and, if relevant, apprenticeship levy) on the member's remuneration. The Rules are actually drafted in the negative, so that a member is a salaried member unless he or she "fails" one of the three conditions. We discuss the Rules below as if the member had to "satisfy" one of the conditions to avoid being a salaried member for ease of reading.

In the BlueCrest case, HMRC claimed that the members of the LLP were all salaried members because they did not satisfy any of the conditions, only two of which were in dispute. BlueCrest claimed that all of the members in question satisfied at least one of the conditions so that they were not salaried members. The two conditions that were in dispute were:

- Condition A: requiring that it is reasonable to expect at the beginning of the relevant tax year that more than 20% of the total amount to be paid by the LLP to the member in the following tax year would not be "disguised salary." Disguised salary includes both fixed amounts and also amounts which are variable unless such amounts vary by reference to the overall profitability of the LLP. So to satisfy this condition, it must be reasonable to expect at the beginning of the tax year that at least 20% of the member's pay will vary by reference to the overall profitability of the LLP; and
- Condition B: requiring that the LLP member has "significant influence" over the affairs of the LLP.

The case involved three classes of members. The first were senior investment managers who had control of significant amount of BlueCrest's funds (generally $100 million or more) and/or who supervised members with control over significant amounts of BlueCrest's funds but who were not, in either case, necessarily involved with the overall strategy or management of BlueCrest's business (senior investment managers). The second were members providing investment management services with no overall control over funds (investment managers). The third were members with responsibility for BlueCrest's back office activities (back office managers). In summary, the FTT found that the senior investment managers had "significant influence" over the affairs of the LLP based on their financial influence over a material part of BlueCrest's overall business, notwithstanding not having managerial influence over the whole of the LLP's affairs. This was in disagreement with HMRC's published view that significant influence requires influence over the affairs of the LLP as a whole and not just over part of its business. The FTT also found that the investment managers and the back office managers did not, on the facts, have significant influence. Those members indirectly contributed and assisted with portfolio management, but this was not sufficient to amount to significant influence.

On Condition A, regarding variable remuneration, the FTT found that all of the remuneration of all of the members in question was disguised salary as their bonuses were calculated by reference to their personal performance rather than by reference to the performance of the LLP as a whole and the mechanism that had been introduced into the LLP's remuneration process, which would reduce members' allocated bonuses/profit shares to the extent that the overall profits of the LLP were insufficient to pay them all (and which had never been used), was not sufficient to meet the test that the members' remuneration was, in practice, variable by reference to the overall profitability of the LLP.

*HMRC's Grounds of Appeal and UT findings – Significant influence*

HMRC put forward nine grounds of appeal to the UT. As noted by the UT, in essence, they all went to the same points that the FTT had incorrectly addressed what was meant by significant influence and the affairs of the LLP and had incorrectly applied the facts to the Rules as a result. HMRC's grounds of appeal and the UT's findings are summarised below.

- Ground 1 - The FTT failed to adequately consider the legal distinction between traditional partners and employees in a partnership and failed to apply this test in the assessment of whether members had significant influence. The UT rejected this

contention noting that the FTT was required to apply the words of Condition B to the facts of this case rather than apply any strict or rigid test seeking to distinguish traditional partners from employees.

- Ground 2 - The FTT erred in its construction of "affairs of the partnership." HMRC argued that the business as a whole needed to be examined rather than just particular aspects of it. The UT rejected this, stating that to do so would be to write additional words into Condition B and that this approach is unrealistic for larger, more sophisticated partnerships in respect of which HMRC's approach would result in very few members satisfying Condition B.
- Ground 3 - The FTT was wrong to approach the test of "influence" as being what an individual might do or the impact that an individual might have. Rather, the requirement was to focus on influence over the management of the LLP's business and not, for instance, financial influence or impact. Otherwise, the distinction between partner and employee would be difficult to discern. The UT rejected this submission stating that the effect would be to add extra words to the statute. Responsibility and/or activities in respect of operations, financial performance or management could all give rise to significant influence, but this would depend on the facts of each case.
- Ground 4 - The word "significant" should have been a qualifier to the word "influence" and, as such, appreciably add to the concept of having "influence." Again, the UT rejected this noting that there is no one size fits all approach to Condition B. While noting that the word "significant" is important and the requirement is for more than simple influence, whether there is significant influence in any case of an individual member will depend on the specific facts and circumstances.
- Ground 5 **-** Any significant influence must ultimately derive from the LLP agreement as the document governing the LLP and the FTT failed to properly take into the account the terms of the BlueCrest LLP agreement, noting that the senior investment managers' influence did not stem from that agreement. This ground was also dismissed, the UT noting that the FTT had undertaken a thorough analysis of the constitutional documents of the LLP as well as the practical realities of the business and that significant influence could derive from the way that the business actually operated outside the terms of the governing documents.
- Ground 6 - The FTT was wrong to apply the analogy with a traditional professional services firm in the way that it did, in particular referring to the role of a partner as being to "find, mind and grind." Even if this approach was right, the senior investment managers were limited to doing work, not seeking it out (the only client being the fund in question), nor in most cases did they supervise others. However, the UT held that the FTT's analysis did not actually turn on the senior investment

managers having such a role. Rather, the analogy had been applied in discussion about HMRC's assertion that significant influence required managerial influence. The UT stated that the FTT had then considered all of the evidence and had not decided that the senior investment managers had significant influence applying a simple "find, mind and grind" or any similar test.

- Ground 7 - The FTT was wrong to conclude that the relevant portfolio managers had "managerial clout," that it conflated managerial and operational issues and that its conclusions were inconsistent with the evidence of the witnesses. For similar reasons to those for Ground 3, the UT rejected this submission. Nothing in the wording of Condition B restricts the types of activity or sources of influence within an LLP which can be considered for the purposes of deciding whether an individual has the required significant influence. In addition, the UT emphasised that the FTT had the benefit of two-and-a-half days of evidence, that it had reached its conclusions based on the entirety of that evidence, and that the UT did not have to accept that the extracts from the FTT's judgement presented by HMRC were definitive of the basis on which the FTT had reached its conclusions.
- Ground 8 - The FTT's findings in relation to "involvement" in operational decisions (recruitment, development of juniors, identifying new business opportunities and managing counterparty relationships) were not sufficient to demonstrate significant influence of the type required by Condition B. The UT held that this assertion was nothing more than an attempt to reargue the evidential case that was before the FTT and did not consider that there was a basis for interfering with the FTT's conclusions on these matters.
- Ground 9 - The FTT was wrong to conclude that a capital allocation of $100 million was sufficient evidence to demonstrate significant financial influence. The UT observed that the FTT did not rely on financial impact alone and that the senior investment managers exercised influence for a number of different reasons and that the FTT had not relied on $100 million as providing a clear line between members with and without significant influence. Equally, the FTT found, in the case of senior investment managers with supervisory roles over other senior investment managers, that they exercised significant influence without making express reference to a specific level of capital allocation.

Accordingly, the UT held that the FTT had not misapplied itself on the meaning of Condition B and had been perfectly entitled to reach the conclusion that the senior investment managers did have the required significant influence over the affairs of the LLP based on the copious evidence heard by it. While not providing any bright line test as to what does qualify as significant influence, the decision will provide some level of comfort to taxpayers that it is not limited to top level managerial involvement as asserted by HMRC.

*Cross Appeal by BlueCrest – Variable remuneration*

In general terms, BlueCrest's remuneration process operated by the relevant committee setting the members' individual bonuses principally by reference to their individual performance or the performance of the particular portfolio that they worked on or were responsible for and had added a term in response to the introduction of the Rules that provided for those bonuses to be scaled back if the LLP did not generate enough profit to pay all of the allocated bonuses. BlueCrest argued that the FTT was wrong in its construction and approach to whether all members received "disguised salary" or variable remuneration for the purposes of Condition A, given the possible scaling back of bonuses and that the FTT had set the bar too high in terms of the link required between the bonus paid to each member and the profits and losses of the LLP.

The UT noted that the variable remuneration question is concerned with what it is reasonable to expect at the relevant time (that is, at the beginning of each tax year) each member will receive. Applying that approach, the UT agreed with the FTT that, because bonuses were set initially without reference to the overall profits of the LLP and the question of whether there would be sufficient funds to pay such amounts come the end of the year was a separate question, all of the bonus payments were "disguised salary," none were variable by reference to the overall profits of the LLP and the members all failed Condition A.

Accordingly, those members who failed the significant influence test were salaried members.

*Conclusion*

The UT’s decision on the significant influence question will be welcomed by LLPs which have members in senior positions who are important to the business but not necessarily involved directly in top level managerial decisions. Given the rejection of HMRC’s published position on the requirement for significant influence, it will be interesting to see whether HMRC seeks to appeal the decision, although the clear view of the UT that the FTT was entitled to reach the conclusions that it reached based on the detailed evidence that it heard might deter any appeal. Should HMRC not appeal, they may seek to limit the conclusions in this case to these particular facts.

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