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BlueCrest – the Court of Appeal considers Condition B of the salaried members rules

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The Court of Appeal has remitted the case of *BlueCrest Capital Management (UK) LLP (BlueCrest) v HMRC* back to the First-tier Tribunal (FTT) regarding the application of the UK's salaried members rules (the Rules) to certain members of BlueCrest, an asset manager engaged in the provision of hedge fund management services, following a finding that the FTT and the Upper Tribunal erred in law with regard to the interpretation of Condition B of the Rules.

The Rules recharacterise certain members of a UK limited liability partnership (LLP) as employees ("salaried members") rather than members of the LLP for income tax purposes. Condition B essentially prevents recharacterisation as an employee/salaried member if the LLP member in question has, in broad terms, significant influence over the affairs of the LLP. In this judgment, the Court of Appeal considered the interpretation of Condition B.

In summary, the Court of Appeal found that – contrary to the position of the FTT and the Upper Tribunal and to HMRC's published guidance – significant influence for the purposes of this test needed to derive from the legal and contractual framework of the LLP and it was not enough that an LLP member had *de facto* influence, even if that *de facto* influence was significant. The Court of Appeal has asked the FTT to reconsider the case using this narrower interpretation. However, this decision itself might be appealed to the Supreme Court.

LLPs which rely on Condition B/significant influence for any of their members in relation to the Rules should be aware of this development but should also be aware that the case is likely to still have a long way to run.

Overview of the Rules and prior decisions of the FTT and Upper Tribunal

A high-level summary of the relevant aspects of the Rules under consideration in this decision is set out below, together with a summary of the previous decisions in this case. For more information on the background of the Rules and the FTT decision (June 2022) and the Upper Tribunal decision (September 2023), please refer to our Tax Talks blog posts as linked here: BlueCrest FTT Decision – Salaried Member Rules and Asset Managers – Insights – Proskauer Rose LLP and BlueCrest– the Upper Tribunal considers the salaried member rules – Insights – Proskauer Rose LLP.

For UK tax purposes, the general position is that members of UK LLPs are treated as self-employed partners who each carry on the business of the LLP. However, the Rules were introduced to prevent employment relationships being disguised through the use of LLPs to avoid payment of employment-related taxes. In short, the Rules set out three conditions, one of which must be satisfied (or strictly speaking "failed" because the conditions are drafted in the negative) in order for an LLP member to avoid being recharacterised as an employee/salaried member.

The FTT and Upper Tribunal in the BlueCrest case were both concerned with the application of Condition A and Condition B, two of the three conditions referenced above.

- Condition A requires that at the beginning of the relevant tax year, it is reasonable to expect that more than 20% of the total amount to be paid by the LLP to an individual member in the next tax year would not be "disguised salary". This includes fixed amounts, and amounts which are variable, unless these amounts vary by reference to the overall profits or losses 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.
- Condition B is considered satisfied if the mutual rights and duties of the members and the LLP give the individual significant influence over the affairs of the LLP.

The FTT found that the BlueCrest 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, which was sufficient to disapply Condition B. This ran contrary to the elements of HMRC's published guidance which suggested that Condition B required significant influence over the affairs of the LLP *as a whole*. In relation to Condition A, the FTT determined that all of the members' remuneration was disguised salary, because bonuses were calculated by reference to individuals' performance, not in relation to the profitability of the LLP.

The Upper Tribunal upheld the decision of the FTT, concluding on Condition B that the FTT was entitled to find that (i) the significant influence did not have to extend to all of the affairs of the LLP, as this was an unrealistic approach and would give rise to strange results for larger partnerships, and (ii) that HMRC's argument that influence should be limited to managerial influence was attempting to read words into the statute. The FTT's decision on Condition A was also upheld as bonuses were set initially without reference to the overall profitability of the LLP and so were disguised salary.

The Court of Appeal findings on Condition B and significant influence

HMRC argued that the Upper Tribunal made an error of law in its interpretation of Condition B by relying on the *de facto* position without regard first to what the rights and duties of the LLP members were as a matter of law, and that the decision of the Upper Tribunal should therefore be overturned.

The Court of Appeal agreed and confirmed that, on a proper construction, the test for significant influence was (i) whether the individual had influence over the affairs of the LLP, (ii) whether the source of that influence was the mutual rights and duties of the members of the LLP, in which case it was qualifying influence, and (iii) whether that qualifying influence was significant.

On the first point, influence over the affairs of the LLP, as interpreted by the Court of Appeal, was to be viewed as broader than influence over the business of the LLP and meant the affairs of the LLP generally viewed as a whole and in the wider context of its group. The definition of business in the relevant LLP Agreement should also be taken into consideration. The Court of Appeal considered that the Tribunals had been wrong to confine the test to parts of the affairs of the LLP without a focus on the decision making at a strategic level.

The main focus of the Court of Appeal in their decision related to the second point. The Court of Appeal held that Condition B requires the relevant influence to derive from the "mutual rights and duties" of the members of the LLP and the LLP itself based on the statutory and contractual framework applying to it. In practice, this would mean the influence must derive from the rights and duties of the members as set out in the LLP Agreement and, if not excluded by virtue of that LLP Agreement, the provisions of the LLP Regulations 2001.

Neither HMRC nor BlueCrest had made this argument in the FTT or Upper Tribunal. It had been raised by the Upper Tribunal but in the context of it being "common ground" between the parties that the FTT was entitled to consider the actual position and any *de facto* influence held by members in addition to the terms of the LLP Agreement. Despite this – and despite acknowledging that HMRC's own guidance accepted the possibility that the influence in question could derive from the *de facto* position (an approach which still forms the basis of HMRC's guidance in its Partnership Manual today) – the Court of Appeal held that it was incorrect to ignore the need for the influence to derive from the legal framework, i.e. the LLP Agreement and the LLP Regulations 2001 (if relevant).

Finally, in relation to the third point that any influence must be significant, the Court of Appeal held that BlueCrest and HMRC had been correct to present evidence on any *de facto* influence wielded by members, but this should have been used only to evaluate whether qualifying influence was significant.

In light of these points, the decisions of the FTT and Upper Tribunal were set aside and the case remitted to the FTT for consideration of the evidence in light of the correct statutory interpretation of the test.

The Court of Appeal also rejected BlueCrest's procedural objection that HMRC had been allowed to rely on a new point of law. In doing so, the Court highlighted the public interest in taxpayers paying the correct amount of tax and ensuring justice is balanced with requirements of fairness and case management.

Cross Appeal by BlueCrest – Condition A: variable remuneration

Although the main focus of the case was on Condition B, BlueCrest appealed on whether the portfolio managers and supervisors of portfolio managers could avoid recharacterisation as salaried members by virtue of Condition A. The Court of Appeal upheld the decision of both Tribunals and confirmed they came to substantially the right conclusion.

The question under Condition A related to whether the definition of "disguised salary" was met. Portfolio managers and supervisors of portfolio managers had three elements of remuneration, one of which was a discretionary allocation akin to a bonus. BlueCrest argued that this had a real link to the profits of the LLP, though the bonuses were not computed by reference to the profit and losses of the LLP.

The Court of Appeal agreed with HMRC's argument that, on the facts, the overall amount of profits of the LLP merely functioned as a cap on remuneration which was variable without reference to overall profits. Therefore, the Court upheld the Tribunals' decisions that the individual members of the LLP, including portfolio managers and supervisors of portfolio managers, could not avoid recharacterisation as salaried members/employees by virtue of Condition A.

Conclusion

The Court of Appeal's interpretation of what constitutes significant influence for the purposes of Condition B of the Rules is narrower than (i) the position set out in the prior judgments in this case and (ii) the relevant guidance in HMRC's published manuals. This narrower interpretation ignores *de facto* influence which is not derived from the mutual rights and duties of the LLP member as set out in the LLP Agreement and, if not excluded by virtue of that LLP Agreement, the provisions of the LLP Regulations 2001.

The Court of Appeal have sent the case back to the FTT for the FTT to reconsider the case in light of this narrower interpretation. It is possible, and perhaps likely, that BlueCrest will decide to appeal the decision to the Supreme Court. In that case, if permission to appeal is granted, the next step would be for the Supreme Court to consider the points raised in this Court of Appeal judgment, rather than the FTT reconsidering the case. We will continue to monitor the proceedings until the final position is known.

LLPs which place reliance on Condition B and their members having significant influence may wish to refresh whether that position would still be appropriate if the narrower interpretation of the test applies, particularly if the members' position under the salaried member rules relies solely on Condition B. Please get in touch if you would like to discuss how the Court of Appeal decision may affect you and your structure.

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