Analysis

BlueCrest and partnership taxation: presents under the tree

Speed read

The recent decision of the First-tier Tribunal in *BlueCrest Capital Management Cayman Ltd* covers some fundamental questions of UK tax including the treatment of tiered partnerships, the deductibility of loans to non-resident partners and the taxation of partnership distributions. The answers reached by the tribunal, if upheld, are likely to have implications for other taxpayers, particularly non-resident companies that are members of UK trading partnerships and individual partners that may have entered into remuneration planning arrangements. The decision is also notable for finding that a thinly capitalised SPV will not necessarily have its profits adjusted under transfer pricing rules.

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The judgment of the First-tier Tribunal in *BlueCrest Capital Management Cayman Ltd and others v HMRC* [2020] UKFTT 298 (TC) is a difficult read. However, it is worth persevering because at its heart lie some surprising and potentially far reaching conclusions on some fundamental questions on the UK taxation of partnerships.

BlueCrest is a hedge fund and the case involves how the profits earned by the fund manager should be taxed. The structure varied over time but essentially the fund manager (the 'fund manager') was a partnership (either a limited partnership or an LLP). The identity of the partners also varied, primarily consisting of the senior individuals involved in managing the fund and at least one third party UK corporate with a stake in the business.

Sale of a 19% stake in the fund manager

In 2007, it was proposed that two senior individuals and the corporate would reduce their stake in the business. Management resolved to acquire the stake. In order to finance the acquisition a bank loan was taken out and the remainder of the consideration was left outstanding in the form of loan notes – essentially the price would be paid out of the future profits of the business.

The chosen structure was that a new Cayman Islands company (BCMCL), would take out the bank loan, which it would use to pay the partners which were reducing their interests, and become the debtor under the loan notes, thereby acquiring the stake. BCMCL would then contribute its interest to a newly established Cayman limited partnership, BCMCLP, of which it was the general partner. Very broadly, the partnership sharing ratios of this partnership were such that BCMCL would receive a share of the profits sufficient to meet its obligations under the debt. It appears that the remainder would go to individuals involved with the business except that profits above a certain level ('super-profits') would go to a company connected to the lending bank, which would pay them back to BCMCL's parent pursuant to the terms of a total return swap (for which the bank received a fee).

It appears that the intended tax treatment was that BCMCL would be taxable on its share of the profits of the fund manager (representing its UK permanent establishment) but with shelter from the finance expense under the debt. Any profits that arrived via the total return swap would not be attributable to a UK permanent establishment and so would not be subject to UK tax. The remaining profits would be subject to UK tax on the other partners in the usual way.

This in effect allowed the individuals who were effectively acquiring the stake to effectively get a deduction for the finance cost of the loans (not necessarily easy to achieve for a partnership of individuals), and for the superprofits used to repay the loan to fall out of UK tax altogether. In the event, it appears that the superprofits were only earnt in one year during the relevant period (one wonders if this is the element that HMRC found really objectionable). The structure also seems to have been influenced by the desire for the debt arrangements not to influence the business's regulatory capital requirements adversely.

In any event, HMRC found the arrangements offensive and challenged them. It aimed its challenge at BCMCL's position, arguing:

(a) that BCMCL should be taxed on the entirety of the profits of the fund manager thought to be attributable to the partners in BCMCLP;
(b) alternatively, that BCMCL should be taxable on the superprofits as the total return swap arrangements should be disregarded on *Ramsay* grounds ([1982] AC 300); and
(c) that no deduction was available for the finance expense on the bank loan or the loan notes, either: (i) because there was no statutory basis for such a deduction; or (ii) if there was, because the arrangements would not have been entered into at arm's length.

HMRC succeeded at first instance on points (a) and (c)(i). Although it failed on points (b) and (c)(ii), this amounted to a total victory for HMRC, though an appeal seems inevitable.

Tiered partnerships

Before going into the technicalities on point (a), it is worth observing that it leaves a very messy outcome. If BCMCL, as GP, is taxable on these profits, presumably the other partners in BCMCLP are not also taxable on them. Does that mean they fall out of tax altogether, or is it necessary to reinterpret the partnership arrangements as involving a separate payment by BCMCL out of the profits it is deemed to receive? If so, can it claim a deduction for their on-payment and what is the nature of the receipt for the other partners? What happens if the profits are retained in the partnership and not distributed to the other partners?

These questions are not addressed in the judgment, but it is implicit in the position HMRC argued for in the adjusted returns that no deduction is available. It therefore appears that the profits are taxed twice in economic terms. HMRC would no doubt argue that that is the price of engaging in tax planning; however, it must also be noted that the judgment on this point is not in any way limited to planning arrangements and so, if the decision stands, there is a trap for the unwary here. There may also be planning opportunities: what if the underlying partnership is not trading and the GP is non-UK, is there at least a deferral opportunity for UK LPs?

The basis for the finding is that a partnership without legal personality can't be a partner in another partnership. This is a point often made by funds lawyers, although what they are usually concerned about is the outcome contended for by the taxpayer in this case, that the partners in the upper tier partnership should be treated as partners in the underlying partnership. (Tiered partnerships are common in fund arrangements; for this reason Scottish limited partnerships, which do have legal personality, are usually used for the upper tier partnerships.) However, the conclusion drawn by the tribunal is that the partners in the upper tier partnership have no rights (and presumably no obligations) as regards the lower partnership: instead, these all reside with the GP and the other partners are treated as strangers.

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It seems implicit in this that it is not possible to deal with the beneficial ownership in a partnership interest in a way which will be respected for UK tax purposes. I expect this conclusion will be looked at very carefully on appeal.

Loans to non-resident partners

The deductibility of the finance expense is a good example of a situation, not unusual in the partnership context where the legislation typically does little more than lay down general principles, where it appears appropriate to take a common sense approach to fill in an apparent gap in the legislation.

If a UK company takes out a loan to invest in a partnership, there is no issue with deductibility. The company has a loan relationship and, subject to the usual anti-avoidance provisions, it can expect to be taxed in accordance with its accounts. Technically, the loan is unlikely to be treated as part of the partnership trade and so may not be a direct off-set against profits earned by the partnership, but in principle relief should be available. You might expect the same outcome for a non-resident company such as BCMCL. However, as there is nothing that deems the loan to be part of the partner's UK trade as carried out through the partnership, there is technically no UK nexus and the loan falls outside the scope of UK corporation tax.

Counsel for the taxpayer appealed to history and a fairly creative attempt to argue that the loan is in substance part of the partnership's trade, but he was in a very difficult position once HMRC had decided to take the point.

One wonders if the same result would arise if the taxpayer had been in the EU or a territory with a double tax treaty with the UK including a non-discrimination clause. Otherwise, if this decision stands, one imagines that there must be more than one non-UK company participating in a trading partnership that may find that it has been incorrectly claiming deductions. There seems to be a good case for a change in law here.

Transfer pricing

Decisions of the UK courts on transfer pricing matters are fairly few and far between and so usually noteworthy. HMRC's case was broadly that given the inter-relationship of the various arrangements, even though they were independent third parties, the banks and the holders of the loan notes were within the scope of the transfer pricing rules on the basis that they were acting together in relation to financing arrangements, and that had they been truly independent the loans would not have been advanced at all, particularly given that BCMCL (or more strictly its UK permanent establishment which was 'all of BCMCL') had only $1 of equity and was therefore thinly capitalised.

The tribunal found as a fact that the parties were acting independently in their own interests, and that that was sufficient for the transactions that actually took place to be regarded as on arms' length terms. The tribunal concluded from this that the parties were not related for the purposes of the transfer pricing rules, as opposed to being related but not required to make any adjustment under the rules, which seems slightly surprising. However, the conclusion that a company which has very little equity and broadly matching assets and liabilities will not necessarily be subject to a transfer pricing adjustment is welcome, as this is relatively common in back to back financing arrangements. Sadly, there is no discussion about whether a taxable margin is required and, if so, what level it should be set at.

Incentive arrangements

The manager had also put in place some incentive arrangements which were challenged by HMRC. This involved UK corporate SPVs becoming partners in the fund manager. These companies were allocated profits on which they paid UK corporation tax, but they then contributed their post-tax share of the profits back to the fund manager, which subsequently paid it back out to individual partners as an allocation of 'special capital'. The partners took the view that, as the income had already been taxed in the hands of the company, there was no further tax to pay; they relied on the old adage that a distribution from a partnership is a tax nothing (it being the allocation of the profits of the partnership that is important, resulting in tax being paid regardless of whether the profits were ever actually distributed to the relevant partner).

This type of planning, and less aggressive deferral variants where the profits were warehoused in the company and subsequently distributed, are generally no longer effective following the introduction of the mixed member rules. In advising on the structure at the time, EY noted that this planning was used by a number of hedge funds, and that it had previously been reviewed and not challenged by HMRC. As a result, the judgment in this case may cause a number of individuals to double check limitation periods.

In addition to the tax benefits, the structure also fulfilled a commercial purpose in that it effectively allowed management to defer the decision as to how part of the partnership profits should be allocated into future periods to check that they were not rewarding excessive risk taking or transactions delivering short term profits that would likely be matched by a loss in a subsequent period, when the individual may have moved on.

Miscellaneous income

Pleading *Ramsay* and *Rangers* [2017] UKSC 45, HMRC argued in the first place that, on a realistic view, the profits were allocated to the individuals that ultimately received them, rather than the company. This was a step too far for the tribunal, which disagreed. However, HMRC had a back-up argument, based on the charge to miscellaneous income; this is traditionally a very limited sweeper category, but it is one that seems to be gaining increased prominence. The basic requirements are that an amount is income (as opposed to capital) and that it arises from a source that is not otherwise charged. The question of source is rather arcane and prominent in decisions of the distant past, but the tribunal, following an earlier decision of the Upper Tribunal in *Spritebeam* [2015] STC 1222, had 'no difficulty' in deciding that the decision to make payment to the individuals created a new source, meaning the income could be taxed in the hands of the individuals.

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Double taxation

As the profits had already been taxed in the hands of the company, there was still a question to resolve as to whether this offended the principle of the presumption against double taxation. This was an important factor in the recent *Investec* case ([2020] EWCA Civ 579), which illustrates another area of difficulty with UK partnership tax: namely, how to make sense of the rules in a situation where a financial trader acquires an interest in a trading partnership and thus has two overlapping taxable trades. This didn't cause the tribunal any problems either. As there was a new source, this was not the same income being taxed. The analogy of a distribution paid by a company out of taxed profits was used (though ignoring the lower rates that apply to dividends as a result). Ultimately, getting festive, the tribunal found that the receipt was analogous to a 'bankers' bonus' rather than a 'present under the tree'.

There is no escaping that the outcome does involve economic double taxation and as a result is materially worse overall than if HMRC had succeeded on its *Rangers* argument – at least unless the company can claim a deduction for the incentive payment it is treated as making. If it stands, it also seems to debunk the principle that a distribution from a partnership is a tax nothing, and it will raise questions as to in what, if any, circumstances a partnership is able to allocate in one way and distribute in another.

Stepping back, it is rather received wisdom that the UK tax legislation is over-complicated and ought to be simplified. However, in the context of partnerships you can see what happens where legislation is designed around basic principles with taxpayers and tax authorities left to fill in the gaps. Perhaps unsurprisingly, it turns out they may have different ideas on what constitutes the right result. ■

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▶ Cases: *BCM Cayman LP and others v HMRC* (30.7.20)