Analysis

Partnerships and the *BlueCrest* appeals: doubling down

Speed read

The Upper Tribunal has found that corporation tax rules taxing partners on their share of partnership profits are not subject to the general rule that a company is not taxable on profits that accrue to it as a fiduciary. As a result, the taxpayer was taxable on its share of partnership profits even though it had contributed that share to another partnership. Recent statutory changes can mitigate this outcome but do not cover all eventualities. In addition, these twin appeals confirm that non-resident corporate partners cannot get tax relief for borrowings taken out to acquire a partnership interest; and that the miscellaneous income charge has broad application in the context of deferred remuneration arrangements for individual partners.

Andrew Howard
Ropes & Gray
Andrew Howard is a tax partner at Ropes & Gray. He focuses on UK corporate tax and international tax matters. Andy's practice covers all types of transactions involving investment funds, including private equity, finance, special situations, real estate and fund formation, but also includes UK and international M&A, structured finance, derivatives, stock lending and general advisory work. Email: andrew.howard@ropesgray.com; tel: 020 3201 1538.

In the recent *BlueCrest* cases, the Upper Tribunal has confirmed on appeal all material aspects of the original decision. So, the very short version of this article is: refer to my previous article on the decision at first instance. However, before you stop reading, please bear in mind that this decision (or in fact these decisions as the case has now been split into two) grapples with issues which go to the heart of the UK taxation of partnership income and reaches some surprising conclusions. In addition, the Upper Tribunals remade some aspects of the decision and generally provided clearer reasoning for their findings.

BCM Cayman LP and Bluecrest Capital Management Cayman Ltd v HMRC [2022] UKUT 198 (TCC)

For ease, I set out the facts again. BlueCrest is a hedge fund and the case concerns 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 allocated 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.

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This in effect allowed the individuals who were effectively acquiring the stake to 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.

The Upper Tribunal (UT) found that:

- BCMCL was taxable on the entirety of the profits of the fund manager (not just the share it was entitled to via its interest in BCMCLP); and
- BCMCL was not entitled to any deduction for the finance expense on the bank loan or the loan notes because they were not part of its UK trade.

Indirect partners

In 2015, the Office of Tax Simplification (the OTS) expressed the opinion that UK tax law was 'never designed to cope with' nested or tiered partnerships. The OTS work led to an HMRC consultation on proposals to clarify the tax treatment of partnerships. This proposed a 'look-through' approach in this situation such that the partners in an upper tier partnership would be liable for tax on their allocated share of the lower partnership's profits. This resulted in the introduction of TMA 1970 s 12AA(1C) and related provisions dealing with the position of an indirect partner (and aimed at resolving the administrative difficulty for HMRC of making sure the indirect partners were properly reporting the income). An indirect partner is a person that is a partner in a partnership that is itself a partner in another partnership (and so on).

Under general partnership law, a partnership that doesn't have legal personality (such as BCMCLP) can't itself be

a partner in another partnership and so isn't an indirect partner. This explains why Malcolm Gammie KC on behalf of the taxpayer had to argue that the partners of BCMCLP should be regarded as direct partners of the fund manager. The UT agreed that this is possible but only where, in substance and reality, those partners intended to join the lower tier partnership and the other partners in that partnership consented to their admission. That threshold was not met. The rather bizarre result was that BCMCL, the GP of BCMCLP, being the partner of record in the fund manager, was technically the taxable person.

Fortunately, most tiered partnerships ordinarily encountered in the investment funds world are structured using partnerships with legal personality as the upper tier entities, so it may not be common to run into this tiered partnership trap. On my reading, the UT decision does not cast doubt on the look-through position for indirect partners.

Dealing in partnership interests

The UT could have sidestepped this strange outcome of taxing the GP in its own right if it had accepted the taxpayer's other argument. The taxpayer argued that it is a general principle of corporation tax, now set out in CTA 2009 s 6, that a company is not chargeable on profits which accrue to it in a fiduciary or representative character. This general principle should take priority over the provisions dealing with partnerships in CTA 2009 Part 17. However, the UT disagreed: Part 17 was a free-standing regime. All that is necessary is to identify the partner and then identify the profit-sharing arrangements.

The UT went further. Not only was this the literal reading of the legislation, the UT could not see why Parliament would have intended a different result:

> 'The arrangements which an individual partner may make for dealing with the profits and distributions allocated and then paid should make no difference to the amount of tax which he or she should have to pay.' (para 93(6))

The UT went on to reference both assignments and declarations of trust. In my experience as an English tax lawyer, particularly one working with investment funds, this is a very odd sentiment. In practice in the UK, in nearly all circumstances, income which has been beneficially transferred is taxable on the transferee and not the transferor. There is a host of anti-avoidance statute and case law, such as the rules on transfers of income streams, as a result of this approach. The typical income tax charging provision charges the person who receives or is entitled to the relevant income, but the charge on a recipient who is not also entitled is rarely invoked.

The current position, confirmed by the UT and based on the strict wording of the legislation, but subject to any further appeal of the *Bluecrest* case, is that partnerships are an exception. This is to some extent mitigated by a change made in 2018, alongside the provisions on indirect partnerships mentioned above, the introduction of ITTOIA 2005 s 848A and CTA 2009 s 1258A providing that the beneficiary of a bare trust should be treated as a partner for tax purposes in place of the nominee.

Unfortunately, the legislation does not specifically address assignments. Unless the assignee formally becomes a partner or the assignor is the nominee of the assignee (which may be arguable if the assignment is expressed in those terms), the logic of this decision, confirmed by the obiter statement of the UT, is that the assignor, as the partner, is the person that is subject to tax on the relevant income.

It is not clear if this is simply good news for the assignee or the partners in the partnership whose GP is charged, or if they are somehow also taxable on the amounts which they eventually receive, perhaps as miscellaneous income (see below). In my view, it is an outcome that goes against the grain of usual tax principles, and that makes it difficult to analyse the consequences for other affected parties. If the decision survives the appeal process, changing the law to permit the person that is beneficially entitled to the relevant partnership interest to be treated as the partner for tax purposes seems desirable.

Interest deductibility

It got worse for BCMCL. Not only was it taxable on income it was not entitled to, it was also denied a deduction for interest on the borrowing it incurred to acquire its interest in the BCMCLP partnership. As I mentioned in my previous article, it does seem to me that, while the outcome is harsh, this is the correct reading of the rules for non-resident partners in trading partnerships.

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The issue exposes a tension inherent in partnership tax law. If BCMCL had acquired a part of the fund manager's business directly, rather than through partnerships, it would have been entitled to deduct its interest against the profits of its new business. That is the result you might expect if you apply the simple adage that partnerships are transparent for tax purposes. However, where a partnership is involved, it is not possible to escape the reality that there are two levels: the partner's trade or business in making an investment in a partnership; and the deemed trade of business that the partner is treated as carrying on by virtue of being a partner. It is well established that these do not roll together into one taxable activity.

A non-resident company making a leveraged acquisition of a UK company would usually set up a UK company to make the acquisition to allow interest deductions to be set against UK profits in the target using the group relief rules. It seems advisable from a UK perspective for non-resident companies to invest in UK trading partnerships in the same way. A final thought is whether a loan from a non-resident partner to a UK trading partnership in which it has an interest would result in interest that is deductible in the UK, but not taxable as part of the profits of that partner's UK permanent establishment. However, I wouldn't suggest trying this at home.

HMRC v Bluecrest Capital Management LP, A Dodd and others [2022] UKUT 200 (TCC)

Released on the same day was the UT's judgment in relation to the deferred incentive arrangements in the Bluecrest structure.

A brief recap of the facts is as follows. 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.

In addition to the tax benefits, the structure also fulfilled a commercial purpose. It 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.

The UT found that:

(a) The incentive arrangements were not part of the partnership's profit-sharing arrangement – the corporate member was correctly taxable on its share of the profits;

(b) The awards made to the individuals were nonetheless taxable as miscellaneous income under ITTOIA 2005 s 687; and

(c) If the UT was wrong on (b), the awards would in any case be taxable pursuant to the rules on sales of occupational income in ITA 2007 ss 773–778.

Regular readers will be aware that very similar planning is also being considered by the courts in *Odey Asset Management LLP v HMRC* [2021] UKFTT 31 (TC) and *HFFX LLP v HMRC* [2021] UKFTT 36 (TC) and has been the subject of several articles in these pages. I am therefore assuming some familiarity with the issues and planning to focus only on new or notable points.

Ramsay

The First-tier Tribunal had found that a partnership's profit-sharing arrangements for the purposes of calculating the charge to tax on partnership income was a fixed legal concept and so not susceptible to a *Ramsay* analysis. The UT overturned this conclusion and accepted that it was necessary to consider the profit-sharing arrangements of the partnership realistically and as a whole. One wishes that the other UT had felt able to take a similarly flexible approach. Nonetheless, even taking a realistic view, the corporate partner and not the individuals was entitled to the profit-share.

The UT also reiterated that the decision in *RFC 2012 plc v Advocate General for Scotland* [2017] 1 WLR 2767 (the *Rangers* case) should be limited to employment income.

Ironically, a different finding on these issues would have been better for the taxpayers overall, as this route would have avoided both the corporate partner and the individuals being taxable in respect of the same underlying profits.

Miscellaneous income

The UT confirmed the modern approach that there are alarmingly few conditions for miscellaneous income treatment, making it a very useful stopgap for HMRC to raise in cases where avoidance is perceived. One condition, which has traditionally limited the scope of the charge, is the requirement for the income to have a source. However, this will be satisfied in nearly all cases in light of the affirmation of the finding that the decision to make a payment is itself the source of the income. This is a point of difference from the *Odey* case where the identified source was the work performed for the partnership by the relevant individual. The taxpayer also sought to raise an interesting argument as to whether the source was a UK source for the purposes of the charge for the non-residents that benefited from the incentive plan. Unfortunately, the UT ruled that it was too late to raise this argument.

An argument based on the presumption against double taxation was given short shrift. The presumption established in case law was against taxing the same person on the same income twice. The UT found that in this case the income that was taxable for the individuals was from a different source to the income that was taxable on the corporate partner. Nor was it tax on the same person. The takeaway here, and also evident from the other appeal, is that there is no presumption against economic double taxation.

Sales of occupational income

It is a feature of partnerships that what you get out does not necessarily reflect what you put in. Instead, it is purely up to the partners to agree how to allocate the profits. One of the conditions for the sales of occupational income charge is that one person is put in a position to enjoy income derived from the professional activities of another person. This is the condition that was found not to be satisfied in *Odey*.

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In *Bluecrest*, the taxpayer argued that this condition could not be satisfied in the case of a partnership because the profits were the results of the collective efforts of the partnership and not of any individual. This is similar to the point that prevailed in *Odey*, which was that there was no relevant income from the activities of the individual to divert, given the basic finding that the income was properly allocable to the corporate member (notwithstanding that it had done nothing to earn it). However expressed, this feels to me like a good argument but the UT took a more pragmatic view, noting that this was widely drafted anti-avoidance legislation and intended to catch any arrangements made to exploit an individual's earnings capacity, thereby looking more at the reality of a professional partnership rather than the theory of the nature of partnerships.

Next steps

It would be surprising to me if at least some of these issues don't end up in front of the Court of Appeal. In my next instalment, I hope to have better news than to say that a general partner or an assignor can be taxed on income that someone else is entitled to. However, in the meantime there is binding authority to exactly that effect (albeit obiter in the case of assignments). Any transaction that involves an intended split of legal and beneficial entitlement to partnership interests currently needs careful consideration to avoid the legal partner being caught in a trap where it is taxable on income to which it is not entitled. In my view, that applies equally to investment partnerships as it does to trading partnerships given that the same brief rules govern both. ■

- *BlueCrest* and partnership taxation: presents under the tree (A Howard, 15.9.20)
- Cases: *BCM Cayman LP and another v HMRC* (6.9.22)
- *Odey* and *HFFX*: partnerships with mixed membership (H Coward, G Bud & H Gunson, 16.3.21)
- Cases: *Odey Asset Management* and *HFFX* cases (3.3.21)