

MACFARLANES

CORPORATE LAW

STRUCTURING A BUSINESS AS A LIMITED LIABILITY PARTNERSHIP (“LLP”)

INTRODUCTION

Partnerships have been used for many years as flexible business vehicles for enterprises, especially where they involve a number of highly skilled entrepreneurial individuals, as they allow individuals to be brought into, leave or change their interests in the partnership without significant tax issues (in contrast to the position where directors or employees need to acquire or dispose of shares in a company).

Generally, partnership profits are also taxed at a lower effective rate than equivalent amounts received as employment bonuses or dividends from a company, because there is only one level of taxation of profits and no employer's national insurance contributions (“NICs”) on profit shares.

In the past, the price for the flexibility and tax efficiency of partnerships has been unlimited liability for the individuals involved. However the introduction of LLPs changed this position.

The purpose of this note is to outline the principal characteristics of a limited liability partnership (LLP) and to consider the advantages and disadvantages of structuring a business as an LLP rather than as a company or a general partnership.

WHAT IS AN LLP?

Despite the name, a limited liability partnership is not a type of partnership and partnership law does not generally apply to LLPs. An LLP is a type of body corporate, introduced in 2001 by the Limited Liability Partnerships Act 2000.

An LLP is not a company, it is a different type of body corporate. However, like a company it is a separate legal entity from its stakeholders; the stakeholders in an LLP being called the “members” of the LLP.

A “limited liability partnership” should not be confused with a “limited partnership”, which is very different. Limited partnerships are a special type of partnership, which have existed in the UK since 1907. They have been used successfully in investment fund structures but have not been widely used as a business vehicle as they do not allow their limited partners to enjoy limited liability while also participating in the management of the business.

Key features of an LLP, which are explored in more detail later, are as follows:

- ◆ An LLP must be incorporated by being registered with the Registrar of Companies. The formalities for establishing an LLP are relatively straightforward.
- ◆ Unlike a company, an LLP does not have shares or shareholders, nor does it have directors – it simply has members.
- ◆ Unlike a company, an LLP does not have articles of association which must be publicly filed with the Registrar of Companies. Members will often enter into a members' agreement (setting out the rights and obligations of the members of the LLP) but that is a purely private document which does not need to be filed on any public register.
- ◆ LLPs afford broadly similar protection from liability as is available to directors and shareholders of companies. In principle, a member of an LLP is not liable for losses caused to third parties by other members/employees or for the financial consequences of general business failure, but may be liable to third parties for losses caused by his own defaults.
- ◆ The insolvency regime applicable to LLPs is largely the same as for companies, although LLPs are subject to special “clawback” provisions which mean that members of an LLP are slightly more exposed than directors/ shareholders of a company.
- ◆ Like a company, an LLP is required to prepare and publish audited accounts, which must comply with UK GAAP or International Accounting Standards.
- ◆ In broad terms, an LLP is tax transparent like an ordinary partnership. The individual members of the LLP are treated as self-employed for tax purposes and are taxed on the profits of the LLP in accordance with their profit share entitlements (whether or not those profits are actually distributed to the members).
- ◆ There should be no tax charge on introducing a new member or on changing the profit shares between members. This compares favourably to the significant tax issues around giving shares in a company to directors or employees.

ESTABLISHMENT OF AN LLP

An LLP must have at least two members on incorporation. There is no maximum number of members.

An LLP is incorporated by delivering the appropriate form to the Registrar of Companies (which principally just contains the name and registered office of the LLP and the name, address and date of birth of each of the initial members and must be signed by each of the initial members) together with a cheque for the registration fee (currently £20). Incorporation can be done on a same day basis, if required, for a registration fee of currently £50. The Registrar of Companies issues a certificate of incorporation, just like for a new company, giving the LLP its own registration number.

Similar restrictions on choice of names apply for LLPs as for companies. So, for example, a name cannot be used if it is already being used by another LLP or by a company, or is sufficiently similar to a name which is already being used, and certain sensitive names require prior approval.

MEMBERS' AGREEMENT

Members of an LLP are not required to have a "members' agreement" or "limited liability partnership agreement" in place between them. However, if they do not, certain 'default provisions' set out in the Limited Liability Partnerships Regulations 2001 will apply to the LLP. These default provisions include all of the members having equal profit shares, there being no power to expel a member from the LLP without his or her consent, the introduction of new members requiring unanimous consent and each of the members having equal rights to manage the business of the LLP.

Most LLPs will therefore want to put in place a members' agreement, which will override those parts of the default regime which the members do not want to apply to their LLP and will also provide for any other relevant matters (for example garden leave and restrictive covenants). A members' agreement is a private document. It is not required to be filed with the Registrar of Companies or otherwise made publicly available.

ONGOING ADMINISTRATION OF AN LLP

An LLP must have at least two "designated members". If no members are identified to the Registrar of Companies as the designated members, or if the members so choose, all of the members will be designated members. Designated members have particular responsibilities, over and above the other members, similar to those of a company secretary.

Designated members must notify the Registrar of Companies of such things as changes in the members (ie new or leaving members) and any change of registered office or accounting reference date.

PERSONAL LIABILITY OF MEMBERS OF AN LLP

An LLP is a separate legal entity from its members. As such, members of an LLP will not be liable for the debts and obligations of the LLP itself, subject to certain statutory qualifications in the event of the LLP becoming insolvent. A member is also not generally liable, simply by virtue of being a member of the LLP, for the acts or defaults of other members or employees.

An individual's own assets are, therefore, protected against the financial consequences of general business failure or the acts of other members or employees. This protection may have to be given up (eg where a bank or landlord requires individual members to guarantee certain liabilities of the LLP) and is also subject to certain exceptions if the LLP goes into an insolvent liquidation.

A member may still be personally liable for his own defaults. There are two principal areas for this: (a) a member is treated as an agent of the LLP and therefore owes the general duties of good faith etc to the LLP which an agent owes to his principal under the general laws of agency and (b) a member may assume, or be deemed to assume, personal liability to a customer/client of the LLP in relation to his own actions.

However, it is unlikely that a member will be personally liable to a customer or client of the LLP for his own actions unless he assumed personal responsibility for his actions and the customer or client relied on this assumption of responsibility and such reliance was reasonable. Steps can be taken to limit this risk by, for example, making it clear in the LLP's terms of business that the customer/client is engaging only with the LLP and that no members or employees of the LLP are assuming personal responsibility.

In the event that the number of members falls below two for more than six months, the remaining member will become jointly and severally liable with the LLP for all liabilities incurred by the LLP following the expiry of that six month period.

INSOLVENCY OF THE LLP

The insolvency regime for LLPs is largely the same as for companies. So LLPs can propose a voluntary arrangement, apply to the court to go into administration, resolve to go into a voluntary liquidation or be wound up by the court at the instigation of either the LLP's members or creditors.

The concepts of wrongful trading and fraudulent trading apply equally to members of an LLP on an insolvent liquidation of an LLP as they do to directors of a company on an insolvent liquidation of that company. Preferential transactions and transactions at an undervalue also apply to LLPs as well as to companies.

However, for LLPs there are also additional “clawback” provisions. These apply solely to LLPs and there is no equivalent for shareholders or directors of a company. Any amounts withdrawn by a member (or former member) of an LLP in the two years before the commencement of a winding-up of the LLP can be clawed back by the liquidator if the member making the withdrawal knew or ought to have concluded that, after that withdrawal and any other withdrawals in contemplation at the time, the LLP was unable to pay its debts and there was no reasonable prospect of the LLP being able to avoid an insolvent liquidation. (For these purposes “withdrawals” has a very wide meaning and would include normal monthly drawings, any distributions of surplus profits, any repayments of loans or capital to members and any transfers of property to members).

ACCOUNTS

All LLPs must prepare audited accounts in respect of each financial year. These must be prepared either under UK GAAP or International Accounting Standards. If an LLP has any subsidiaries then it must also prepare consolidated accounts.

The audited accounts must be delivered to the Registrar of Companies within nine months of the end of the relevant financial year and will be publicly available.

Just as for companies, abbreviated accounts may be prepared for dormant, “small” and “medium” sized LLPs and certain dormant and “small” LLPs may be exempt from the requirement to audit their accounts.

There is a special Statement of Recommended Practice (“SORP”) concerning accounting by LLPs. The SORP gives guidance as to how to apply UK GAAP in the preparation of LLP accounts.

EMPLOYMENT STATUS OF MEMBERS AND PENSIONS

The general position is that members of an LLP will be treated as self-employed rather than employees, just like partners in a partnership.

As such, most mainstream employment protection legislation (including unfair dismissal and redundancy legislation) will not apply to members of an LLP. There is a limited number of exceptions to this general rule, including:

- ◆ the laws against discrimination on grounds of sex, race or disability;
- ◆ rights under the Working Time Regulations; and
- ◆ rights under the Age Discrimination Regulations.

Only individuals who are in employment can be admitted to, or retained as active members in, a Revenue approved occupational pension scheme (including a SSAS). So members of an LLP must make their own pension arrangements under the personal pension regime.

TAX TREATMENT OF AN LLP

In broad terms, an LLP is tax transparent (like an ordinary UK partnership). The key points here are:

- ◆ Profits (whether retained or distributed) are taxed on individual members of the LLP in accordance with their entitlement to share profits. Tax is on an arising basis (ie whether profits are distributed to members or not). Subject to cases where substantial profits are retained, the overall tax burden on profits should be lower than if a corporate vehicle is used.
- ◆ There should be no tax charge on introducing a new member (effectively, promoting an employee to “member” status). This compares with the often substantial tax charges which could arise if shares are given to an employee/director of a company. The same applies to changes in members’ interests in an LLP and members leaving.
- ◆ Substantially reduced NICs arise on remuneration (profit shares) of individual members compared to salaries of employees. Because they have self-employed status, no employer’s NIC liabilities arise on their remuneration.

UK TAXATION

Changes in the LLP

The appointment of individuals as members of the LLP and changes in profit shares should not, of themselves, give rise to a tax charge on the individuals. The introduction of a new member is tax neutral as far as the new and continuing members are concerned.

Taxation of members' profits

The aim is that members of an LLP should receive by way of a share in the profits of the LLP an amount equivalent to what (in a corporate structure) would have been their salary, bonus and any dividend entitlement. There is no tax liability at the level of the LLP itself. Instead, profits are taxed on individual members of an LLP in accordance with their profit share entitlements. Subject to cases where substantial profits are to be retained in an LLP, the overall tax burden should be lower than if a corporate vehicle is used.

Example A below compares the net after tax yield on a payment of £100,000 to individuals who are (i) members of an LLP and (ii) shareholders receiving this payment (on top of a modest salary) by way of dividend from a company (assuming that the company is a full (28 per cent) corporation tax payer and the individual is paying tax on all his earnings at the higher rate of 50 per cent which became effective from 6 April 2010 on earnings over £150,000).

Example A

	Company (£)	LLP (£)
Pre-tax profit	100,000	100,000
Corporation tax	(28,000)	-
Gross distribution	72,000	100,000
Individual tax (and NICs)	(26,000)	(51,000)
Net yield	46,000	49,000

Example B below compares the net after tax yield on a payment of £100,000 to individuals who are (i) members of an LLP and (ii) shareholders but who receive the payment in the form of additional salary and/or a bonus.

Example B

	Company (£)	LLP (£)
Pre-tax profit	100,000	100,000
Employer NICs on salary and bonus	(11,348)	-
Gross salary/distribution	88,652	100,000
Individual tax (and NICs)	45,213	51,000
Net yield	43,439	49,000

(This example assumes bonuses are fully deductible in the corporation tax calculation - which would need to be justified by reference to employment factors - in which case NICs would be fully deductible too.)

However, if profits are to be retained, the initial tax burden may be higher if an LLP is used. This is because retained profits will still be taxed (again at 51% including NICs) on members of an LLP. But no further tax will be paid in future years if those profits are subsequently distributed.

If significant profits are to be retained in the business, it may be possible to have the best of both worlds by using an LLP with a corporate member to which retained profits are allocated and reinvested in the LLP.

VAT

The LLP itself, rather than its members, will be the registerable entity for VAT purposes. An LLP is capable of forming a VAT group with subsidiaries which it controls.

Conclusion

LLPs are increasingly being used as a business vehicle, particularly for businesses which involve a number of manager/owners. Their main attraction is that they combine much of the limited liability protection afforded by companies with the flexibility and tax transparency afforded by partnerships. They can also be a lot more tax efficient for implementing succession planning arrangements.

LLPs are relatively easy to establish and to operate on an ongoing basis, although some of the formalities associated with companies such as the preparation and filing of audited annual accounts also apply to LLPs.

LLPs are a distinct type of legal entity, with their own specific legislation, rules and regulations, so specific tax, legal and regulatory advice should always be taken to determine whether they are the right vehicle to use in any particular case.

CONTACT DETAILS

If you would like any further information or specific advice please contact your usual Macfarlanes contact, or

JOHN DODSWORTH
DD +44 (0)20 7849 2203
john.dodsworth@macfarlanes.com

MACFARLANES LLP
20 CURSITOR STREET LONDON EC4A 1LT

T: +44 (0)20 7831 9222 F: +44 (0)20 7831 9607 DX 138 Chancery Lane www.macfarlanes.com

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