MACFARLANES

STRUCTURING A BUSINESS AS A LIMITED LIABILITY PARTNERSHIP (LLP)

CORPORATE LAW

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 limited liability partnerships (LLPs) changed this position.

The purpose of this note is to outline the principal characteristics of an 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/her 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 £40). Incorporation can be done on a same day basis, if required, for a registration fee of currently £100. 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 (i.e. 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 (e.g. 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 actions in certain circumstances. There are two principal areas for this: (a) members will owe common law or equitable duties to the LLP in certain circumstances, including if they participate on a management board or committee of the LLP 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.

In relation to the former, LLP members may be personally liable for any loss suffered by the LLP if they fail to properly manage the LLP. However, unlike directors of a company who will have a general oversight duty, members of an LLP can limit their responsibility to certain aspects of the business of the LLP by ensuring the LLP agreement clearly sets out each member's obligations. In practice, this is most likely to be an issue in the event of the LLP's insolvency.

In relation to the latter, 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; that 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. For example, an LLP member may be required to make court ordered contributions to the LLP if the member was knowingly involved in any fraudulent activity carried on by the LLP. 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

Until a recent decision of the Supreme Court, the general position was that members of an LLP would be treated as self-employed rather than as employees, just like partners in a partnership. Now, however, it is clear that LLP members, in almost all cases, will be classified as "workers" for employment law purposes. "Workers" occupy a middle ground between employees and the genuinely self-employed and, importantly, have a number of employment law rights.

A number of employee-only rights (including unfair dismissal and redundancy legislation) will not apply to members of an LLP, but LLP members will be protected from detrimental treatment under the whistleblowing and anti-discrimination legislation. The latter prohibits discrimination on grounds of sex, race, age, religion and belief, sexual orientation, gender reassignment, pregnancy or maternity, or disability. The national minimum wage and laws on working time will also apply to LLP members.

Members of an LLP will typically have their own pension arrangements under the personal pension regime, but depending on each LLP's remuneration structure members may also be entitled to be enrolled in a firm's occupational scheme under the auto-enrolment provisions. This is a very technical area, and specialist advice should be sought in each case.

SALARIED MEMBER RULES

From 6 April 2014, new rules have been introduced which can treat a member of an LLP as an employee in certain circumstances (but only for tax purposes). Broadly, the new rules introduce a test with three conditions, A to C. If all the conditions are met, that member will be treated as employed for tax purposes; employer's NICs will be due in respect of remuneration paid to the member (at 13.8 per cent), the LLP will be required to operate the PAYE regime and the employment related securities and disguised remuneration rules will also apply to that member.

If any one or more of the three conditions is not met, that member will continue to be treated as self-employed for tax purposes.

Broadly, the three conditions are:

Condition A - disguised salary

Condition A is met if it is reasonable to expect that 80 per cent or more of the total remuneration payable by the LLP to the individual will be "disguised salary". Disguised salary is defined as an amount which is: (i) fixed, (ii) if varied, varied without reference to the overall profits or losses of the LLP or (iii) in practice unaffected by the overall profits or losses of the LLP.

Examples of arrangements which may be caught by this condition include remuneration packages based purely on a member's personal performance or based solely on the performance of a division of a business. However, it may be possible for a member to receive some profit share that is dependent to an extent on personal performance as long as the amount still varies by reference to the overall profits or losses of the LLP. HMRC guidance sets out numerous examples, but this a tricky area and some of the boundaries are blurred.

Condition B – significant influence

Condition B is met if the mutual rights and duties of the LLP and its members do not give the member "significant influence" over the affairs of the LLP and its business as a whole. This will largely be a question of fact on a case-by-case basis. For a UK LLP with a large number of members, it is unlikely that all members will have "significant influence".

Condition C - capital contribution

Condition C is met if, at the relevant time of testing, the member's capital contribution to the LLP is less than 25 per cent of the disguised salary amount which it is reasonable to expect will be payable by the LLP in the relevant tax year.

There is a targeted anti-avoidance rule which seeks to ignore the effect of any contrived steps taken to avoid the application of the rules.

Although HMRC has published examples in its guidance clarifying how these new rules will apply in practice, there are still "grey areas" where multiple interpretations are possible and the position is uncertain. Governing documents are only the starting point and whether a particular member is caught by the new rules will depend on all the facts and circumstances, including expectations and understandings between the parties. If there is any doubt as to how the rules will apply, specific advice should be sought.

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 (i.e. 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. Provided 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

Individual members

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. As shown in the example below, the overall tax burden should be lower where an amount is allocated to an individual as a share in the profits of the LLP compared with an amount paid as salary and bonus from a company.

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

The example assumes that the company is a full corporation tax payer (currently at 21 per cent) and the individual is paying tax on earnings at the top rate of 45 per cent (payable in respect of earnings which exceed £150,000). Individual members of an LLP treated as self-employed for UK tax purposes are taxed at an effective tax rate of up to 47 per cent including NICs on their allocated income profits. The total tax burden connected with remunerating individuals who are employees of a company is 53 per cent including employee and employer NICs.

The full corporation tax rate will fall to 20 per cent on 1 April 2015. This example assumes salaries and bonuses (together with employer's NICs) are fully deductible in the corporation tax calculation.

Example

	Company (£)	LLP (£)
Pre-tax profit	100,000	100,000
Employer NICs on salary and bonus	(12,127)	-
Gross salary/bonus	87,873	100,000
Individual tax (and NICs)	41,300	47,000
Net yield	46,573	53,000

Corporate members

Corporate members pay corporation tax (currently at the rate of 21 per cent) on their share of the profits of the LLP. If significant profits were to be retained in the business, it was previously possible to allocate such profits to the corporate member of the LLP (so that they would be subject to the lower corporation tax rates as opposed to the higher income tax rates). However, new rules have been introduced which are designed to prevent this type of planning. These changes affect all partnerships consisting of individual partners and corporate partners (i.e. mixed member partnerships), including LLPs.

Under the new rules, profits allocated to a corporate member are reallocated to an individual member where:

- the individual member has the power to enjoy the corporate member's share or there are deferred profit arrangements in place; and
- it is reasonable to suppose that the whole or part of the corporate member's share is attributable to that power or arrangements.

In general, the rules are very widely drafted and will prevent the use of corporate members to build up working cash in the LLP net of corporation tax (even if the cash is required for genuine working capital or regulatory capital purposes).

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 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.

The introduction of new rules on the tax treatment of LLPs has made the choice of vehicle a much more nuanced decision that will depend on the particular circumstances and aims of the business. If the profits of the business will to a large extent be distributed out to its owners every year, provided that members are treated as self-employed, LLPs will still produce a more tax efficient result.

However, if it is anticipated that a significant amount of the profits will be retained within the business, an LLP may not be the best option from a tax perspective.

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

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