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Limited Liability Partnerships

Recently, companies have become increasingly interested in looking at an alternative business form which has been more commonly associated with professional firms such as accountants and lawyers, namely a Limited Liability Partnership (LLP).

In this article we look at the pros and cons of the LLP medium and consider some of the issues that should be taken into account if a firm is contemplating such a move.

So what has prompted this change?

The attractions of partnership status may include simplicity of start-up and management, pooling of resources and skills and sharing of profits. However, in the past one of the main barriers has been that the words 'partnership' and 'limited liability' were mutually exclusive. This made a partnership an unattractive option for businesses which manufactured goods or could be sued for wrongful advice!

During the 1990s however, pressure gradually grew for a change to the law after a number of scandals that pressure resulted in the creation of LLPs after the Limited Liability Partnerships Act 2000 and the Limited Liability Partnerships Regulations 2001 were passed by Parliament. LLPs were attractive as an alternative business structure for professional firms such as lawyers and accountants, and many of the largest of these firms have subsequently incorporated as LLPs. It is now clear, however, that LLPs can be used by any business that wishes to combine the benefits of limited liability provided by limited companies, with the benefits of flexibility and tax transparency enjoyed by traditional partnerships.

What is an LLP?

An LLP is a body corporate which exists as a 'legal person' independently from its members and it can enter into contracts and hold property just like a limited liability company. The membership of an LLP combines both ownership and the right to manage the business. This contrasts with companies, where a distinction is made between the owners (shareholders) and the managers (directors) although these may be, and often are, the same people.

An LLP is fully liable for its own debts and obligations but the liability of the members is limited to the amount of capital that they have each contributed. The owners of a limited company are allotted shares in the business representing the amount of capital that they have contributed. An LLP does not have shares so the default status under the Act is that each member will have an equal stake in the business and equal voting rights. As discussed below this is easily altered by agreement.

An LLP does not need to have a memorandum and articles of association instead the members normally agree on the rights and duties that they owe to each other. This 'members agreement' is not, technically, obligatory and there are certain default provisions contained in the Limited Liability Partnerships Act, such as how members share in the capital and profits of the business, in the event that such an agreement is not in place.

The agreement does not have to be published and so can remain confidential, and the members of the partnership have considerable freedom to agree to whatever terms they wish.

How is an LLP taxed?

For tax purposes an LLP is treated as a partnership and members as partners. Tax is charged on a 'transparent' basis, in other words profits are subject to tax on each partner. For a trading LLP the profits are taxed under the rules which apply to the members ie income tax, national insurance and capital gains for individual members and corporation tax for a corporate member.

The diagram below shows how a potential move to an LLP might be structured. The first step would be the formation of a new LLP. The existing company would then contribute some or all of its business to the LLP in exchange for an interest in the LLP.

The current senior employees of the company would have their existing employment contracts terminated and would instead become members of the LLP where they will be self-employed and will receive a share of the trading and/or capital profits of the business. The other employees would have their employment contracts transferred from the company to the LLP.

What might the structure look like?

So what has made increasing numbers of businesses consider operating through an LLP?

Efficiencies

The addition of a LLP structure can enhance rewards to key individuals within a business. As previously mentioned, each individual member of the LLP will be chargeable to tax on their share of the taxable profit. Members are self-employed rather than employees and as such, there is no liability to Class 1 employer's national insurance contributions (NIC). This affords the business significant NIC savings. In addition, there maybe cash-flow savings for the members since they would settle their tax liabilities through self assessment rather than through the pay as you earn system.

As the LLP would not be subject to tax in its own right, this provides for a single layer of taxation on profits.

For the members receiving the profit share, the LLP structure could provide for a reduced overall rate, as illustrated in the table below using the rates applicable from 6 April 2013:

	LLP	Company
Profits vs salary	100	100
Employers NIC (13.8%)		(12.1)
Tax & Employee NIC (47%)	(47)	(41.3)
Net cash received	53	46.6
Overall tax rate	47%	53.4%

[Illustration assumes tax and associated NICs are payable at the additional/higher rates and ignores the primary Class 1/Class2/Class4 NICs payable up to the various thresholds]

Members of an LLP do not have shares or employment contracts, instead their rights and responsibilities are set out in the members' agreement.The agreement is a private document which does not need to be filed with Companies House. It offers flexibility for profits to be shared in a myriad of different ways. Income profits and capital profits can be shared differently amongst different members and it is possible to alter the way profits are shared year-on-year.

Typically, the agreement will cover such matters as:

- formalities, for example the name of the organisation and place of business
- admission of new partners and retirement/leaving/removal of existing partners
- management of the LLP
- rights and obligations of partners including sharing of profits and liabilities.

Flexibility

A key benefit of this type of company/LLP structure is being able to provide key individuals with a stake in the underlying business without disturbing the share ownership in the company. This can be the case for instance with family owned or private companies where shareholders are unwilling to dilute their shareholdings but recognise the need to provide long term incentives to staff.

An LLP can also offer greater flexibility around the organisational structure. Unlike a limited company, an LLP may have a profit-sharing and decision-making structure written uniquely for its business and participants. None of the companies act legislation on share capital, management, or meetings and resolutions, applies to LLPs and there is no distinction between the roles of owners and managers of a business.

Participation

In many instances it will be simpler to admit new members to the LLP than to issue new shares in a company. This could potentially be used to allow for wider participation in the business which may engender a greater sense of loyalty and responsibility towards the business and help to reinforce a stronger link between company performance and reward.

The members' agreement can also be specifically drafted to deal with the procedures for withdrawal from the partnership, providing greater organisational flexibility.

Challenges

There are no specific tax exemptions relating to the transfer of a business from a limited company to an LLP and there are a number of potential pitfalls which need to be avoided to ensure the restructuring does not crystallise a capital gain. In addition, careful consideration would need to be given to the VAT position to ensure no cost arises as a result of the reorganisation. However, with some careful planning these potential risks can be managed. A restructuring gives rise to a number of employment related considerations. The impact on employment rights would need to be addressed where employees become members of the LLP. In addition, the Transfer of Undertakings (Protection of Employment) Regulations (TUPE), which preserve employees' terms and conditions when a business or undertaking is transferred to a new employer, would also need to be taken into account so that staff cannot claim constructive dismissal.

Depending on the nature of existing arrangements, there may be implications for individuals' pension arrangements when moving from employment to membership of an LLP. In particular, it should be noted that the individuals who are members will not be able to benefit from employer's contributions. It would also be necessary to consider any existing benefit arrangements.

The LLP will not be able to take advantage of the various approved share schemes enabling employees to own a small stake in the business and which also enables the employee to generate a value taxed at capital gains rates. With the current differential between capital gains tax rates and income tax rates the effect could be significant. Any existing share schemes or share options in issue would need to be considered

To the extent that the profits of the LLP are allocated to the corporate member the effective rate on those profits, if they were subsequently to be distributed, may be higher than if they were allocated to the individual members. However, whilst profits need to be retained, using a corporate member may reduce the effective tax on the undistributed profits.

In return for members' limited liability, an LLP must observe various regulatory requirements designed for the protection of creditors, mirroring that applicable to companies. As with a company, an LLP must file annual accounts and an annual report.

Process

The process of restructuring the business around an LLP will involve a number of different workstreams and it is important that these are identified from the outset. There will be some one-off costs arising from the transaction along with a considerable amount of management time invested in a project of this nature. These will need to be quantified as part of a feasibility study in order to determine whether or not to proceed.

The formal legal process for forming an LLP is relatively straightforward and involves completion of a form with information on the founding members, the proposed name and location of the LLP, and submitting it to Companies House with a small fee.

For regulated businesses the FSA will require notice of the proposed change in the status of the company and will wish to be certain that there is a bona fide reason for the change and that no customer detriment will ensue. Firms will need to complete a 'change of legal status' form and, depending upon the circumstances, individual and controller forms if the information on these is different going forward.

Appropriate notification will need to be given to customers and suppliers and any contracts or terms of business amended accordingly.

A final point which should be considered is whether any potential legal issues exist under trust law requiring attention, for instance where a business holds client monies. In this case, certain consents may be required from clients before any monies could be transferred to a new legal entity.

In addition, there will be a number of changes required to website information, stationery, signage and other templates which must all reflect the LLP status from day one.

Review of partnership tax rules

The 2012 Autumn Statement included an announcement of a review of the tax rules applying to partnerships as part of the examination of perceived high risk areas of the tax code.

It has now been confirmed that there will be a consultation process concerning two specific aspects to counter their use to secure tax advantages – the use of LLPs to disguise employment relationships and the artificial allocation of profit/loss. It is hoped that the Government will target any anti-avoidance measures at artificial arrangements and that the use of partnership structures, which are underpinned by sound commercial rationale, will not be affected.

Conclusions

The potential benefits of restructuring as an LLP need careful consideration in the context of the business in question and it may not be appropriate in all circumstances. Thought needs to be given to the tax profile of the business and its senior employees, along with the regulatory and commercial considerations. However, an LLP can provide greater flexibility around decision-making and profit-sharing arrangements, with scope to flex these to best meet the needs of the business going forward.

The advantages of converting to LLP are:

- increased flexibility in incentivising and rewarding key team members
- different rates of national insurance providing payroll savings
- delayed tax payments providing cash flow benefits
- flexibility on amending profit sharing ratios
- ease of admitting new members
- potential for Entrepreneurs Relief on exit for Partners reducing the charge to capital gains tax to 10% (subject to meeting certain requirements).

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