

CLIENT MEMORANDUM

LIMITED LIABILITY PARTNERSHIPS

The purpose of this Memorandum is to give details of a recently introduced medium for carrying on business – the Limited Liability Partnership (“LLP”). This medium has been available since 6 April 2001, and it offers some interesting advantages, both for people who are already in business and for people who are about to set up in business.

WHAT IS AN LLP?

An LLP is in some ways a “cross” between a conventional partnership and a company.

One of the problems of a partnership is that each partner has unlimited liability for all the debts of the partnership. Operating through a limited liability company overcomes this problem, of course, but one of the draw-backs is that a company is taxed as a separate entity. This can lead to high National Insurance contributions on drawing remuneration and a possible double charge to Capital Gains Tax when a company realises a capital gain and the shareholders wish to share in the benefit.

A partner in an LLP has liability only to the extent of his (or her) investment in the LLP unless negligence is involved. Although an LLP is a separate entity, tax is charged on a “transparent” basis, i.e. profits are taxed to Income Tax on each partner.

In the case of an LLP which carries on a trade or profession, it is possible therefore to avoid the “double Capital Gains Tax effect” which applies to companies (whereby a gain is taxed in the company and there is further tax to pay if profits are removed from the company).

HOW DOES IT WORK?

An LLP has to be registered at Companies House, and it has to file audited accounts along similar lines to a company.

The minimum number of partners is two, and these can be individuals or companies. An LLP does not have share capital, nor does it have a Memorandum and Articles of Association.

An LLP does not have a company secretary, but it does need two designated partners to deal with legal and compliance formalities on an ongoing basis.

It is permissible to have a partners’, or what the legislation characterises members’, agreement setting out the terms on which the partnership operates. If there is no agreement, or if there is only a limited agreement, the LLP will be deemed to operate in accordance with terms laid down in the Limited Liability Partnership Act 2000 (and various Statutory Regulations modified in 2006).

HOW ARE LLP'S FINANCED?

The individual partners can inject capital into the LLP in the same way as with a conventional partnership. They can borrow this money, if desired, and obtain tax relief on interest paid, assuming that certain criteria are met.

The LLP can itself borrow money or operate overdraft facilities. In many cases, of course, the bank will require collateral or personal guarantees from the individual partners.

WHAT HAPPENS ABOUT PARTNERSHIP CHANGES?

A partner can join or leave an LLP without undue formalities. However, special rules apply if the LLP goes into liquidation. Many of the provisions of the Insolvency Act 2000 apply to an LLP which goes into liquidation.

CAN AN LLP OWN PROPERTY?

Yes, an LLP can own freehold and leasehold property in its own right, unlike a conventional partnership.

WHAT IS THE TAX POSITION?

As previously mentioned, each individual partner will be taxed to Income Tax on his or her share of the taxable profit. The basis of assessment is similar to that which applies to a conventional partnership. The LLP has to file a tax return and each partner also has to include relevant details on his (or her) own individual return form. National Insurance Contributions are payable under class 2 and class 4, i.e. on the self-employed basis.

If the LLP disposes of a capital asset any gain or loss will be allocated to each of the partners.

If the partners have "overdrawn" loan accounts, there is no special tax liability – contrast this with the treatment of directors' loan accounts where both the company and (if the loan exceeds £5,000) the director may be liable to tax.

A company can be a member. If so, it will pay Corporation Tax on its share of the profits including gains, and that element of the profits will be computed on normal Corporation Tax principles (including the availability of indexation allowance).

If a partner leaves the LLP, this will constitute a disposal of the partner's interest in the various assets of the LLP.

It should be particularly noted that the "transparent" tax treatment will not apply if the LLP does not carry on a trade or profession, or if it ceases to do so. This can pose problems when a LLP ceases to trade, prior to liquidation.

If an LLP makes tax losses when carrying on a profession, these will be treated in the usual way for partnerships. However, losses incurred in a trade are relieved on a more restrictive basis.

ARE THERE ANY TAX PROBLEMS IN CONVERTING TO AN LLP?

If a trade or profession is being carried on in a normal partnership and is then transferred to an LLP there should be few problems, as long as the entire business and assets are transferred. The transfer will not give rise to a disposal for Capital Gains Tax purposes provided that certain conditions are met.

The following points should be noted in these circumstances:-

- The transfer may be treated as a “transfer of a going concern” for VAT purposes, and it may be possible to use the same VAT registration.
- Stamp Duty will apply to the transfer, but a claim for exemption can be made in certain circumstances. This would normally apply if the transfer is made within one year after setting up the LLP.
- Taper Relief of partners, where appropriate, will not usually be prejudiced.
- For Inheritance Tax purposes, the two-year qualification requirement for Business Property Relief can take account of ownership both in the partnership and in the LLP.

It should be noted, however, that the costs of conversion to an LLP may not fully qualify for tax relief.

ARE THERE ANY OTHER POINTS TO BEAR IN MIND?

If an LLP creates a charge or mortgage over any of its assets, details must be registered at Companies House. If this is not done within 21 days, the charge will be void against creditors, an administrator or a liquidator.

It is also necessary to pay attention to contractual arrangements.

If the LLP replaces an existing business carried on as a sole trade or as a conventional partnership, then the following matters will need to be dealt with (after consulting the LLP's legal advisers).

- New letters of engagement will be needed as between the LLP and its clients. If the LLP does not supply professional services, then existing contracts with customers will almost certainly need to be revised.
- It will also probably be necessary to consult suppliers, lessors etc and arrange for new contracts to be drawn up.
- If employees are being transferred to the LLP it is important to comply with Employment Law. New service contracts will probably be required. It will also be necessary to deal with pension arrangements and to ensure continuity of entitlement.

SUMMARY

The LLP concept has proved popular so far, especially with the construction industry, pharmacies and garages. The concept has also been embraced by professionals, including solicitors, accountants, engineers and surveyors.

It has also been popular in cases where trusts are involved. This is not normally possible with a conventional partnership, due to the problem of unlimited liability.

As previously mentioned, considerable care is needed when setting up an LLP, and – before reaching a final decision – the tax and legal implications should be fully researched.

There are no special tax reliefs for “disincorporation” of an LLP, so a change of mind after setting up an LLP could prove costly.

It should be emphasised that the profits of an LLP are taxed on the respective partners and may attract higher rate Income Tax liability (currently at 40%). Companies, which may represent an alternative vehicle, are taxed as an entity and the current rates of Corporation Tax vary between 21% and 29.75% depending on the level of profit. In addition, there are a number of anti-avoidance rules to be considered when forming an LLP.

We will be happy to advise whether an LLP would be advantageous in your particular circumstances.

FOR GENERAL INFORMATION ONLY

Please note that this Memorandum is not intended to give specific technical advice and it should not be construed as doing so. It is designed to merely alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.