CHAPTER 22

LIMITED LIABILITY PARTNERSHIPS

Statutory references are to ITTOIA 2005 unless stated otherwise.

22.1 Introduction

The Limited Liability Partnerships Act introduced limited liability partnerships with effect from 6 April 2001. The words **limited liability** deal with the **legal implications** of being a Limited Liability Partnership (LLP). For legal purposes, an LLP is very similar to a limited company. The word **partnership** relates more closely to the **tax treatment** and for tax purposes a LLP is very similar to a normal partnership.

LLPs are generally set up by firms of professionals such as accountants and lawyers, who are required by the rules of their professions to operate as partnerships but who seek to have the protection of limited liability.

ITTOIA 2005, s. 863

In this chapter we will look firstly at the legal implications and then move on to the tax treatment of LLPs.

A great deal of detail on LLPs is given in the HMRC Press Release December 2000 which is reproduced in Tolley's Yellow Tax Handbook Volume 2.

22.2 Formalities on setting up

Forming an LLP is like forming a company. Two or more persons, known as **initial subscribers,** must deliver an incorporation document to the Registrar of Companies.

The subscribers of an LLP are known as **members**. Thereafter new members can be added by agreement of existing members, and members may leave as long as at least two remain. There is no upper limit. The members of an LLP are very similar to the **shareholders** in a company.

LLPs must have at least two **designated members** – they are very similar to **directors** of companies. They are the members who are responsible for the management of the LLP. Their responsibilities include filing certain notices with the Registrar (such as when a member leaves), signing and filing accounts and appointing auditors (if required).

The **incorporation document** must show the following information:

a) The name of the LLP;

b) The place of registration, either in England and Wales or in Scotland;

c) The address of the LLP's registered office;

d) The names and addresses of the members of the LLP;

e) Who the designated members are - the incorporation document may simply state that every member is also a designated member.

22.3 Members of an LLP

The rights and duties of the members of an LLP may be governed by a separate agreement. This is advisable as it clarifies each member's obligation to the LLP and to each other, but is not obligatory. Each member is an **agent** and may bind the LLP, so consequently if I sign a contract in my capacity as a member of an LLP, that will not only bind me but **all** of the other members.

The **members' interest** is basically the share capital of the LLP. Each member's interest must be separately analysed and must show the following:

a) **Capital contributed** by each member;

b) The **loans to the LLP** by each member;

c) **Monies owed by the LLP in respect of profits** for each member - basically this is any undrawn profit;

d) Any **other amounts contributed** by the member to the LLP.

22.4 Accounts and Audit

There are also accounting and audit requirements that LLPs must adhere to. LLPs are subject to **similar audit requirements to those of limited companies,** ie. where turnover exceeds £5.6 million an audit will be required.

Where profits of the LLP exceed £200,000, the accounts must **disclose** the amount attributable to the highest paid member. When computing this profit, this is profit **before** members' remuneration.

LLPs must **file accounts** and an **annual return**. On **insolvency,** the rules that apply to companies also apply to LLPs under the Insolvency Act 1986.

22.5 Income Tax Implications

The profits of a **trading LLP** are subject to **income tax** based on **each member's share** of the underlying profit.

ITTOIA 2005, s. 863

For example, assume an LLP is owned 40% by Arthur, 30% by Brian and 30% by Colin. Together, acting as an LLP, they generate £50,000 worth of profit in an accounting period. This is taxed on each member in relation to their respective share of that profit.

Arthur is subject to tax on his Trading Income which is 40% of the profit (£20,000), and Brian and Colin are subject to tax on 30% of the profit (ie, £15,000 each). This profit is entered on to their personal income tax return and is subject to income tax in the usual way.

Like a normal partnership it is the **members who are liable to tax, not the LLP.**

Also like a normal partnership, member's **salaries are not deductible** in arriving at the taxable profit.

LLP profits are also liable to **Class 4 National Insurance**, and each member will also be liable to **Class 2** where the earnings of the LLP exceed the small earnings exception. LLP profits **qualify as relevant earnings** for pension purposes.

However, profits of a **non-trading LLP** are **subject to corporation tax** within the LLP - they are not subject to income tax on the members.

22.6 LLP Losses

Every partner in a normal partnership has unlimited liability for all the debts and obligations of the partnership incurred while he is a partner. If a partnership has insufficient funds to meet its liabilities, the partners must contribute additional monies to ensure the liabilities are settled. It is therefore justified that, for tax purposes, loss relief is available in full for a normal partner.

However, a member of an LLP has limited liability for the debts and obligations of the LLP incurred while he is a member. He enjoys limited liability. His liability is limited to the amount of capital he contributes to the LLP plus any further amount he has agreed to pay if the LLP is wound up.

It is therefore justifiable that, for tax purposes, **loss relief claims under s.64 or s.72 of ITA 2007 and s.261B of TCGA 1992** (ie. sideways loss relief) are **restricted to each member's 'contribution' to the LLP.** These loss relief provisions set the member's share of the LLP loss against non-LLP income and gains, which is why the restriction applies.

ITA 2007, s. 107

For this purpose the **member's "contribution"** to the LLP is calculated as:

ITA 2007, s. 108

	£
Capital introduced	X
Amount member would have to pay on a winding up of the LLP	X
	X

Cumulative sideways loss relief for LLP losses **cannot exceed** the **member's contribution to the LLP**. In other words, the maximum sideways loss relief available for LLP losses equals the maximum amount the LLP member would personally stand to lose if the LLP was wound up.

There is however no restriction on the relief available for LLP losses against trading income from the LLP.

Illustration 1

Steve is a member of a LLP. He has a 40% share and works full time in the LLP. He has subscribed for £20,000 worth of capital in the LLP and has agreed to contribute a further £10,000 if the LLP is wound up.

In the year ended 31 December 2010, the LLP makes a loss for the first time of £100,000.

Steve's share of that loss is 40% i.e. £40,000. However, under a s.64 or s.72 ITA 2007 or s.261B TCGA 1992 claim he **can only utilise a total of £30,000** worth of the losses against non-LLP income and gains. That is the £20,000 that he has already subscribed in the LLP, plus £10,000 that he has agreed to contribute if the LLP were to be wound up.

If Steve claims loss relief under s64 for the whole £30,000 of loss in 2010/11, he will not then be able to make any future sideways loss relief claims. The sideways loss relief **restriction applies to his total sideways loss relief claims**, it is not an annual limit.

Additionally, the **£25,000 annual limit** for the amount of **sideways loss relief** that can be claimed by a non-active partner (that we saw in the previous chapter) also applies to a non-active member of an LLP.

ITA 2007, s. 103C

This means that **the maximum** sideways loss relief which can be claimed by a **non-active member of a LLP** in a tax year is the lower of:

- £25,000; or
- 'Unrelieved' capital contribution

The non-active member's unrelieved capital contribution is simply the member's contribution to the LLP which has not already been used up by previous sideways loss relief claims.
If, in the previous illustration, Steve had been a non-active member of the LLP, the maximum sideways loss relief claim he could have made in 2010/11 would have therefore been for £25,000 of the loss.

There is **no restriction of losses carried forward under s.83** against future trading profits from the same trade. Consequently in the illustration above, the unrelieved **balance of Steve's loss may be carried forward** and set against future profits from the LLP in respect of the same trade.

22.7 Capital Taxes

For Capital Gains Tax purposes, **each member owns an underlying share of each LLP asset. This is the same principle as for normal partnerships.**

TCGA 1992, s. 59A

Assume an individual has a 40% share in a trading LLP. The LLP owns a property which is sold realising a capital gain of £100,000. This particular member will be liable to CGT on £40,000 of gain. He will disclose this gain on his tax return for the relevant tax year. However, this £40,000 will be eligible for **roll-over relief** if a replacement asset is found within the roll-over relief period.

However, **non-trading LLP gains are subject to corporation tax within the LLP.**

For Inheritance Tax purposes, a share in an LLP **qualifies for business property relief (BPR) at 100%.** Again this same principle applies for normal partnerships.

However, if **assets are held outside the LLP**, i.e. in an individual member's own name, and are used for trading purposes by the LLP, then **50% BPR** will be available in those circumstances.

22.8 Transfer of a Partnership to an LLP

ITTOIA 2005, s. 863

The transfer of a normal partnership to an LLP is often known as the **incorporation** of a partnership. As an LLP is treated as a partnership for tax purposes, where it is a trading LLP there is a very smooth transition of a partnership into an LLP.

There is **no cessation** of trade, and **no balancing allowances or charges** will arise. There will be **no triggering of overlap relief**. This is provided that the transfer **creates an LLP identical to the partnership,** i.e. the same trade is carried on by the new LLP, involving the same partners and there is not a de-merger.

For instance, assume an accountancy practice offers audit, accounting, and tax consultancy services. If just the tax consultancy arm of the practice is transferred to an LLP, that would be a "de-merger" and this would trigger a cessation of that tax consultancy trade in respect of the partners. If however, everything is transferred into the new LLP, that would not trigger any cessation provisions.

For VAT purposes, the transfer is treated as a **transfer of a going concern**, and is **outside the scope of VAT**.

22.9 Disadvantages of an LLP compared to a Company

LLP profits are subject to **income tax**, which means that when we reach profits of around £45,000 per member, **40% tax** is due. Some LLP members may also be subject to 50% income tax on some of their profits.

Conversely, company profits are subject to **corporation tax**. The **small companies rate of 21%** applies to profits as high as £300,000.

However, the downside of this is that **salaries** from a company are subject to tax and **Class 1 primary and secondary National Insurance** (more expensive than Classes 2 and 4). However, if we extract profits from a limited company by way of a dividend, we do not have to pay any National Insurance at all.

Finally, where we set up an LLP**, we cannot take advantage of EIS or Enterprise Management Incentive reliefs** as these are only available with companies. Consequently, it could mean that it is **more difficult for us to find external investors** because they will be unable to claim EIS relief.

LLPs cannot award CSOP or EMI options to key members of staff.