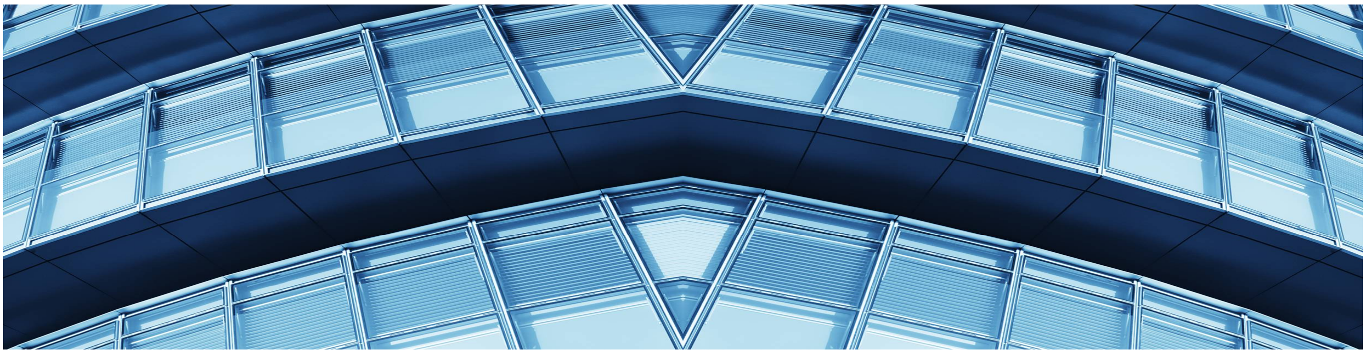
CORPORATE STRUCTURE

LLP or limited company: are you using the most appropriate corporate structure for your business?



The limited liability partnership (LLP) has been an extremely popular management vehicle amongst private equity houses since its inception in 2001. It has many benefits when compared to a limited company, not least the flexibility it offers in relation to management, governance and incentivisation. The relationship between LLP members can be governed almost exclusively by a private contract, with very limited statutory overlay. This note focuses exclusively on the considerations applying to management entities; we will write separately about the issues to consider in terms of carry vehicles.

There is, for example, no imposed separation between shareholders and directors – the members of an LLP are able to structure the equilibrium between ownership and management in whatever way they consider most appropriate for their business.

Provided the business is not facing an insolvency risk, the members are also free to distribute profits at their discretion, whereas dividends in a limited company are likely to be more restricted and intermittent.

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Further, distinctions can be drawn between the amount and timing of distributions to different LLP members without the need to create separate share classes. Capital can also be returned by an LLP to its members at their discretion (again subject to any insolvency threat).

Interests in an LLP can be issued and transferred amongst members by contract with less formality than that applying to shares in a company. Provided the LLP members are self-employed, the complex employment-related securities legislation should not apply. This, in particular, offers a significant advantage when planning for succession in the business – equity interests can gradually be bequeathed to the "next generation". There are also fewer conditions restricting the availability of entrepreneurs' relief.

In short, management, ownership, incentivisation and sharing in capital growth can be regulated in an LLP in a very flexible and creative manner which can, if structured well, contribute to the establishment of a cohesive partnership culture.

It is the recent scrutiny of partnerships by HM Revenue & Customs as a result of certain aggressive tax planning which has, however, led some businesses to reconsider whether the LLP is still the right vehicle for them.

Tax traps

The tax transparency of an LLP means that the profits are taxed in the hands of the members only – the LLP itself is not taxed. This avoids the double layer of tax suffered by a company at a corporate as well as a shareholder/employee level. In addition, provided the members of an LLP are self-employed, their remuneration will not be subject to the 13.8% employers' national insurance charge.

It was this employers' national insurance saving which, in part, prompted the changes to partnership taxation introduced by the 2014 Finance Act.

The so-called "salaried member rules" provide that an LLP member will be treated as an employee for income tax purposes if the following three conditions are each satisfied:

- more than 80% of his or her income from the LLP is "disguised salary" (essentially income which is referable to his or her own personal performance and not the performance of the LLP as a whole);
- he or she has no significant influence over the affairs of the LLP; and

- his or her capital contribution to the LLP is less than 25% of his or her disguised salary.

Should an LLP member be deemed to be an employee, the LLP will be required to pay a 13.8% employers' national insurance charge in respect of that member's remuneration.

The Finance Act also introduced another change to the taxation of partnerships consisting of both individual members and one or more corporate vehicles owned by those members. Referred to as 'mixed partnerships', limited companies have been admitted to the membership of LLPs as a mechanism for retaining profits in the business at (lower) corporation tax rates. This addressed a disadvantage in relation to the tax transparency of LLPs, namely that the members are required to pay tax on the profits in the year in which they are earned, notwithstanding that they may be reinvested in the business and not distributed to the members.

In a mixed partnership where a limited company owned by the members is introduced purely for tax planning reasons any profits allocated to the company are now likely to be taxed at the income tax rates applying to the individual members, rather than the corporation tax rate applying to the company. For a business that reinvests significant amounts of profit this therefore makes the LLP less attractive than a company, particularly if corporation tax reduces further still as a measure by the Treasury to mitigate the impact of the UK's exit from the EU.

A further partnership tax consultation was also published in August (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/544520/Partnership_taxation-proposals_to_clarify_tax_treatment.pdf) which considers tiered partnership structures, investment income and allocation of partnership profit.

Structure review

These tax changes have understandably caused many LLPs to review their structure. With careful planning the adverse impact of the changes can be managed, however, and a knee-jerk decision to restructure based purely on prevailing tax rates should be resisted if the other benefits of being an LLP continue to apply to your business.

For some businesses currently structured as an LLP the advantages of reverting back to limited company status may be indisputable. The restructuring process is well-established but can be quite involved, requiring a number of legal and administrative steps, including the transfer of each asset owned by the LLP and the assignment or novation of employment contracts, leases, trade agreements, data agreements, finance documentation etc, as well as the renewal of regulatory permissions.

Other businesses operating as limited companies may not yet have considered the benefits of a partnership structure for their business. If the outcome of carrying out such an analysis is that an LLP may provide a better platform for the business, there is also an established process for a limited company to LLP restructuring.

Final thoughts

The characteristics of the LLP are well-suited to the business and strategic needs of some private equity houses for many reasons. Their flexibility remains compelling but their tax benefits have become less unequivocal.

Ultimately, the decision as to which corporate structure to adopt is one that should be made following a holistic review of a series of practical and strategic factors, and the general requirements of the business as a whole. Whilst it is acknowledged that tax considerations have a significant influence in such decisions, they ought not to be determinative.

Who to contact and how we can help

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