CHAPTER 21
LIMITED LIABILITY PARTNERSHIPS

In this chapter you will learn about Limited Liability Partnerships (LLPs) including:
- setting up an LLP;
- members of an LLP;
- accounts and audit;
- income tax implications;
- LLP losses;
- ‘disguised employment’ within LLPs;
- capital taxes;
- transfer of a partnership to an LLP;
- disadvantages of an LLP compared to a company.

21.1 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 an LLP is very similar to a general partnership.

LLPs were originally intended for use 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.

However, they have been utilised by a wide variety of businesses and there are few restrictions on the type of business carried out by an LLP provided all the members are carrying on the business with a view to making profits. 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.

21.2 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.

The members of an LLP can be individuals or companies. In this chapter we will just consider LLP members who are individuals.
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, Scotland or Northern Ireland;

c. The address of the LLP’s registered office;

d. The full names, addresses and dates of birth 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.

### 21.3 Members of an LLP

The rights and duties of the members of an LLP may be governed by a separate LLP members’ agreement. This is advisable as it clarifies each member’s obligation to the LLP and to each other, but is not obligatory. The LLP members’ agreement also allows them to determine the allocation of profits between the members.

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 or withdrawn** by the member.

### 21.4 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**, i.e. an LLP may qualify for an audit exemption if it meets 2 of the following:

- an annual turnover of not more than £6.5 million
- a balance sheet total of not more than £3.26 million
- 50 or fewer employees on average.
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.

21.5 Tax Implications

For tax purposes LLPs are treated as if they are transparent and are not taxable entities. They are taxed in the same way as partnerships and all the members are generally treated for the purposes of income tax and capital gains tax as if they were partners carrying on a business in partnership. This is subject to the anti-avoidance provisions relating to ‘disguised employment’ covered later in this chapter.

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 general partnership members salaries are not deductible in arriving at the taxable profits of the LLP.

Also like a general partnership, it is the members who are liable to tax on their share of the profit, not the LLP. However, a trading LLP must file a partnership annual tax return in a similar manner to a general partnership. The individual members must also file their own tax returns.

Interest paid by a member of an LLP on a loan taken out to invest in the LLP is a deductible payment (provided the LLP is not an investment LLP).

LLP profits are also liable to Class 4 National Insurance payable by each member, and each member will also be liable to Class 2 where their earnings from the LLP exceed the small profits threshold. Again, this is subject to the ‘disguised employment’ rules covered below. LLP profits qualify as relevant earnings for pension purposes.

Where the following exceptions apply the LLP will not be treated as transparent and will instead be chargeable to corporation tax on its income and gains as if it were a corporate body. In this case the members are not subject to income tax on their share of the profits.

The exceptions referred to above are where the LLP:

• does not carry on a business with a view to making a profit, (non trading LLPs such as not for profit organisations and clubs fall within this exception), or
• is in liquidation, or is being wound up by order of the court.

21.6 LLP Losses

Every partner in a general 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 general 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.71 ITA 2007 and s.261B of TCGA 1992 (i.e. sideways loss relief) are restricted for member’s of a trading LLP 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 loss relief purposes the member’s “contribution” means the capital introduced into the LLP by the member plus any further amount the member has agreed to pay in the event of the LLP being wound up. ITA 2007, s.108

In other words, the LLP does not have to be wound up for the LLP member’s potential liability on a winding up to be included in their definition of member’s contribution.

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.

These loss relief restrictions that apply to LLP members are in addition to the general loss relief restriction which applies to claims made against net income under s.64 or s.72 ITA 2007 for losses incurred from 2013/14 onwards.

Illustration 1

Steve is a member of an 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 2015, the LLP makes a loss for the first time of £100,000.

Show how much of the loss is available to Steve and discuss the loss claims available.

Steve’s share of that loss is 40% ie £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 to 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 s.64 for the whole £30,000 of loss in 2015/16, he will not then be able to make any future sideways loss relief claims unless he increases his contribution to the LLP in the future. The sideways loss relief restriction applies to his total sideways loss relief claims, it is not an annual limit.

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.

If Steve increases his contribution to the LLP in the future then these carried forward losses may also be set against his other income to the extent that his contribution to the LLP allows.

**Non-active LLP Members**

A further restriction applies to “non-active” LLP members. The definition of a non-active LLP member is the same as for a non-active partner in a general partnership.

The £25,000 annual limit for the amount of sideways loss relief that can be claimed by a non-active partner 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 any tax year is the lower of:

- £25,000; and
- the member’s ‘unrelieved’ contribution

As a member of an LLP, sideways loss relief can never exceed the member’s unrelieved contribution to the LLP, and as a non-active member of an LLP the annual loss relief limit of £25,000 applies. Therefore, for a non-active member of an LLP the sideways loss relief restriction is the lower of £25,000 and their unrelieved contribution in every tax year.

The definition of ‘contribution’ for a non-active LLP member in the first four tax years of trade only differs to that used for active LLP members. For a non-active LLP member claiming relief for a loss in any of the first four tax years of trade, their ‘contribution’ for loss relief purposes only includes amounts which have actually been contributed on a winding up of the LLP by the non-active member. ITA 2007, s.103C

If, in the previous illustration, Steve had been a non-active member of the LLP and 2015/16 had been one of his first four tax years of trade, the maximum sideways loss relief claim he could have made in 2015/16 would have been for £20,000 of the loss. In this case we ignore the £10,000 he has agreed to contribute if the LLP were to be wound up.

Alternatively, if Steve had been a non-active member of the LLP for many years, the maximum sideways loss relief claim he could have made in 2015/16 would have been for £25,000 since this is lower than his unrelieved contribution of £30,000. Remember that from the fifth tax year onwards, a non-active member’s
contribution for loss relief purposes is the same as that of an active LLP member, so we include the £10,000 which would be payable if the LLP were to be wound up.

In both cases, the remainder of his loss will be carried forward and set against his future trading income from the LLP.

21.7 ‘Disguised Employment’ Within LLPs

Introduction

As a general rule, members of an LLP are treated as self-employed. However, HMRC considered that some of the ‘fixed profit share’ members of LLPs were not in fact true partners and should instead be taxed as employees. This situation is often referred to as ‘disguised employment’.

Previously a member of an LLP who was engaged on ‘salaried partner’ terms was treated as self-employed, whereas a salaried partner in a general partnership is taxed as an employee. This situation was perceived to be unfair. For example, an employee suffers higher rates of national insurance under class 1 primary and, in addition, the general partnership is also liable to pay employer’s class 1 secondary national insurance contributions on the salaried partner’s remuneration.

As a result, legislation was introduced to prevent avoidance of employment taxes by use of LLPs. ITTOIA 2005, ss.863A-G; SSCBA 1992, s.4AA

Consequences of legislation

Where a member of an LLP meets all three conditions set out in the legislation, the member is treated for tax and NIC purposes as being employed by the LLP. Any income from the LLP will be treated as employment income. PAYE will need to be applied as normal and any benefits provided by the LLP such as a company car will be subject to tax and national insurance as a benefit in kind.

The LLP will receive a deduction for the salary and associated employment costs in arriving at their taxable trading profits for the accounting period.

Conditions

The three conditions are:

1. Condition A - Disguised salary
2. Condition B - No significant influence over the affairs of the LLP
3. Condition C - No significant investment (ie capital) in the LLP

If any of the above conditions are not met then the member remains self-employed for tax purposes. Members of an LLP who used to be genuine partners in a general partnership that is now carried on in the same way but as an LLP will not be affected by these rules. However, the rules will apply to members of an LLP who are more like employees.

If all three of these conditions are met the member will be taxed as an employee.

Condition A Disguised Salary

Condition A is met if the member performs services personally for the LLP in his capacity as a member, and it is reasonable to expect that at least 80% of the total
amount paid by the LLP to the individual will be ‘disguised salary’. ITTOIA 2005, ss.863B

An amount is disguised salary if it:

• is fixed, or

• is variable, but is varied without reference to the overall profits or losses of the LLP, or

• is not, in practice, affected by the overall amount of those profits or losses.

Benefits in kind are not taken into account when determining whether Condition A is met.

For example, if a member expects at least 80% of his remuneration to be provided through a fixed salary and/or variable bonus based on his performance, or the performance of a particular division within the LLP, rather than the performance of the LLP as a whole then the member’s profit share would fall under the definition of disguised salary.

If Conditions B and C are also met, then the member will be treated as an employee.

On the other hand, if the member is to be rewarded only on a basis that takes into account the overall profitability of the firm then Condition A will not be met.

Condition A must be considered when the member joins the LLP. For existing members, Condition A had to be considered at 6 April 2014 (when these rules came into force). Once the test has been applied, it does not have to be reapplied until there is a change in circumstances which could give a different result.

The test is applied by looking at the ‘relevant period’, being the period over which it is reasonable to expect that the current remuneration arrangements will remain in place unchanged. It is likely that in most circumstances the relevant period will be one year as remuneration arrangements are generally reviewed on an annual basis.

Provided the test for Condition A is applied reasonably, it is not revisited during the relevant period even if any of the assumptions are subsequently found to be incorrect.

**Condition B No significant influence**

This condition is met if the mutual rights and duties between the members, and between the LLP itself and its members, do not give the member significant influence over the affairs of the LLP. ITTOIA 2005, s.863C

If the member does not have a significant say in the running of the business as a whole then this condition is met.

Members who merely work in the business rather than carry it on will meet this condition.
Illustration 2

Legal Eagles LLP is a professional legal firm with 20 members. The members hold monthly meetings at which the major business decisions are discussed and made. All partners attend these meetings and all are entitled to speak. Junior partners are entitled to attend these meetings though not to vote.

Is Condition B met?

On the facts, the junior partners satisfy Condition B. No vote means no significant influence.

Condition C No significant investment

This condition is met if the member’s contribution to the LLP is less than 25% of the total amounts of ‘disguised salary’ which it is reasonable to expect will be payable to the member in the tax year concerned. ITTOIA 2005, s.863D

‘Contribution’ means capital and long term loans which cannot be withdrawn from the LLP while the individual remains a member without the consent of the other LLP members. In other words, it represents genuine ‘at risk’ funds.

Illustration 3

Sam is a member of an LLP. He receives the following profit share from the LLP:

- a fixed salary of £100,000
- a 5% share of the whole LLP profits in excess of £300,000. Sam’s profit share for this tax year is expected to be £15,000.

In accordance with the LLP agreement, Sam has contributed £26,000 of capital to the LLP which cannot be withdrawn without the consent of the other LLP members until Sam ceases to be a member of the LLP.

Is Condition C met?

To determine if Sam meets Condition C, we compare his capital contribution of £26,000 with his total disguised salary.

The 5% share of the whole LLP profits does not meet the definition of disguised salary since it is variable with reference to the overall profits of the LLP. Therefore Sam’s disguised salary is £100,000.

If we calculate Sam’s capital contribution as a percentage of his disguised salary:

\[
\frac{26,000}{100,000} \times 100 = 26\%
\]

Since Sam’s contribution to the LLP is at least 25% of his disguised salary for the tax year Condition C is not met and Sam will retain his self-employed status.

Condition C requires the capital contribution to be compared to the disguised salary for the year. If a member joins part way through a tax year, or is expected to cease to be a member before the end of the year, the capital contribution is proportionally reduced, on a pro rata basis, before it is compared with the disguised salary for the year.
The legislation recognises that members of an LLP may require time to obtain loan finance to invest in the LLP. Condition C will not be met if there is an unconditional requirement for a new member to provide ‘significant’ capital when they become members and it is contributed within 2 months of becoming a member.

Condition C must be considered when the member joins (or 6 April 2014 for existing members). Condition C must then be considered at the start of each tax year. It must also be considered when there is a reduction in the level of a member’s contribution in the tax year. This is to prevent a member making an additional capital contribution at the start of the year to ensure that Condition C is not met, then withdrawing it shortly afterwards.

Finally, Condition C must also be considered when there is any other change which would affect whether it is met. So, if the remuneration arrangements change such that the amount of disguised salary changes, Condition C must also be considered at that point.

It is likely that the level of capital contribution will be used by members to ensure that one of the 3 conditions is not met such that the member is treated as self-employed.

21.8 Capital Taxes

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

LLP members are also entitled to claim entrepreneurs’ relief or gift relief on the disposal of LLP assets assuming the relevant conditions are met.

Remember that where the LLP is not carrying on a business with a view to making a profit (or is in liquidation or the LLP is being wound up) then the LLP will be chargeable to corporation tax on its income and gains. In this case the members are not subject to capital gains tax on their share of the gains.

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

However, if assets are held outside the LLP, ie 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.

21.9 Transfer of a Partnership to an LLP

The transfer of a general 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. ITTOIA 2005, s.863

There is no cessation of trade, and no balancing allowances or charges will arise. The LLP will take over the plant and machinery at its tax written down value. There
will be no triggering of overlap relief. This is provided that the same trade is carried on by the new LLP 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.

21.10 Disadvantages of an LLP Compared to a Company

LLP profits are subject to income tax, which means that when we reach profits of around £42,000 per member, 40% tax is due. Some LLP members may also be subject to 45% income tax on some of their profits.

Conversely, company profits are subject to corporation tax and a rate of 20% applies to all the profits (from 1 April 2015).

The downside of this is that salaries from a company are subject to tax and Class 1 primary and secondary National Insurance (which is more expensive than Classes 2 and 4). Of course, if the disguised employment rules apply to income from the LLP, Class 1 NIC will be payable in any case. 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.

Where we set up an LLP, we cannot take advantage of the Enterprise Investment Scheme (“EIS”) or Seed Enterprise Investment Scheme (“SEIS”) 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 or SEIS relief.

Finally, LLPs cannot award share options under Company Share Option Plans (“CSOP”) or Enterprise Management Incentives (“EMI”) to key members of staff. CSOPs and EMIs have certain tax and NIC advantages provided they meet certain conditions. These low tax schemes generally enable a company to award shares to its workforce free of tax and National Insurance.
EXAMPLES

Example 1

Amir became a member of an LLP on 1 May 2015. For his first year as a member he will receive a fixed salary of £60,000 and a profit share of 10% of the whole LLP’s profits for the year ended 30 April 2016, to the extent that they exceed £400,000. His remuneration arrangement will be reviewed on 1 May 2016.

Explain whether or not Amir meets Condition A in s.863B ITTOIA 2005 if:

1. The LLP’s profit projections at 1 May 2015 are £500,000 for the year ended 30 April 2016.

2. The LLP’s profit projections at 1 May 2015 are £600,000 for the year ended 30 April 2016.
ANSWERS

✓ Answer 1

1. If the LLP’s profit projections at 1 May 2015 are £500,000 then Amir expects to receive the following profit share:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed salary</td>
<td>£60,000</td>
</tr>
<tr>
<td>Profit share (10% x £100,000)</td>
<td>£10,000</td>
</tr>
<tr>
<td></td>
<td>£70,000</td>
</tr>
</tbody>
</table>

85.7% (being 60,000/70,000) of Amir’s profit share is disguised salary therefore Condition A is met.

If Amir also meets Conditions B and C, Amir will be taxed as an employee of the LLP rather than as a self employed partner.

2. If the LLP’s profit projections at 1 May 2015 are £600,000 then Amir expects to receive the following profit share:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed salary</td>
<td>£60,000</td>
</tr>
<tr>
<td>Profit share (10% x £200,000)</td>
<td>£20,000</td>
</tr>
<tr>
<td></td>
<td>£80,000</td>
</tr>
</tbody>
</table>

75% (being 60,000/80,000) of Amir’s profit share is disguised salary therefore Condition A is not met as less than 80% of the total amount paid to Amir by the LLP for the year ended 30 April 2016 is disguised salary.

Amir will retain self employed status as all three of the conditions need to be met for the member to be treated as an employee.