Limited Liability Partnership (LLP) versus Limited Company

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Since their introduction in 2000, LLPs have become an increasingly popular choice of entity for both trading and investment businesses.

Until recently, the fact that an LLP is treated as being transparent for tax purposes meant that it was an efficient way of enabling the owners of a business to enjoy limited liability whilst also removing the “double layer” of tax encountered when operating a business through a limited company (namely, the company paid corporation tax on its profits and the shareholders then paid income tax when the post-tax profits were paid out as a dividend by the company). The alternative was for a company to pay salaries and bonuses to reduce its taxable profits, but this resulted in Employer’s NIC being due and the director/shareholder would be subject to income tax and NIC through PAYE.

However, as income tax rates have increased over recent years, corporation tax rates have steadily decreased. There is now such a difference between income tax and corporation tax rates that it may be more beneficial to operate through a limited company than an LLP in many instances.

Alternatively, it may be possible to obtain the benefits of both an LLP and a limited company through the use of a service company which provides services to the LLP in return for an arm’s length fee. This is described in more detail further below.

The notable differences between LLPs and limited companies are considered further below. For the avoidance of doubt, the comments below are based on the following assumptions:

1. The shareholders of the company will be UK tax resident individuals.
2. The members of the LLP will be UK tax resident individuals.
3. The LLP/company will be carrying on a trade in the UK, rather than carrying on an investment business.

**Tax Rate – Trading Profits**

The members of the LLP will be liable to income tax and Class 4 NICs in respect of the profits of the LLP at rates of up to 52%. The income tax and Class 4 NIC liability is payable regardless of whether the LLP profits have been drawn from the LLP by the individual member or left in for working capital.

It should also be noted that the members of an LLP will need to pay Class 2 NIC in addition to Class 4 NIC. Since Class 2 NIC are not linked to income and are payable at a flat rate of £2.65 per week, they are not considered further.

Class 4 NIC are payable at 9% on profits between £7,606 and £42,475 inclusive, and 2% on all profits above £42,475.

The LLP does not itself have a tax liability.

For a limited company, the profits realised will be subject to corporation tax at rates currently between 20% and 24%. The Government has announced its intention to reduce the main corporation tax rate to 23% from 1 April 2013 and to 22% from 1 April 2014.

If the limited company does not distribute its post-tax profits to shareholders (or pay them a salary), there will be no additional tax to pay.

Consequently, in instances where the owners of the business do not have a need to withdraw profits from the business immediately, there will be a significant deferral of tax by allowing profits to roll-up in a limited company rather than operating through an LLP.
**Tax Rate – Capital Gains**

As with trading profits, any capital gains realised by an LLP are taxable in the hands of the individual members. For higher rate taxpayers, the rate of capital gains tax is 28%, subject to any tax reliefs that may be available (such as Entrepreneurs’ Relief). As with trading profits, the capital gains tax liability is payable regardless of whether or not the individual member has drawn their full profit allocation from the LLP.

For a limited company, any chargeable gains are subject to corporation tax at the normal rates as set out above.

The differential in tax rates is not so pronounced for capital gains. Accordingly, a business that expects the majority of its profits to be in the form of capital gains may still find that an LLP structure is the most appropriate. However, for trading businesses, it is unlikely that capital gains will constitute the majority of the profits.

**Extraction of Profits**

It is when examining how to extract profits that an LLP often appears to be the most favourable entity.

As the members of an LLP are immediately taxed personally on the trading profits and capital gains realised by the LLP, there are no further tax or NIC liabilities when they withdraw their profit allocations from the LLP. However, it should be borne in mind that the individual members will have already been subject to an effective tax/NIC rate of up to 52% on trading profits.

The position is different for shareholders in a limited company. The company will have paid corporation tax on its profits. If it then distributes its post-tax profits by way of dividend, the shareholders may have additional income tax liabilities to settle. However, dependent on the level of the dividend and the shareholder’s other income (such as directors fees or salary), this may still be marginally more tax efficient than being a member of an LLP.

For example, if the shareholder has no other sources of income and full personal allowance for the year ended 5 April 2013, a net dividend of up to £38,227 can be paid without any income tax liability being payable by the shareholder. The shareholder has therefore suffered an effective tax rate of only 20% – 24% on the cash received, representing the corporation tax paid by the company. It should be noted that if the shareholder is also a director of the company and has received fees or a salary, this will use up the personal allowance and basic rate tax band in priority to the dividend income. As a result, there would be less scope to take dividends from the company without having to pay additional income tax.

Using the same example, if an LLP was used and the member had a profit share of £38,227 for the year ended 5 April 2013, the combined income tax and NIC liability would result in an effective tax rate of 23.33%.

If more substantial dividends are received, the choice between an LLP and a limited company becomes more marginal.

A longer term strategy would be for shareholders to permit excess profits to accumulate in the limited company over a number of years. Provided the accumulation of cash in the company is not so significant as to result in the company ceasing to be a trading company (and becoming an investment company or a hybrid company), and the other conditions for Entrepreneurs’ Relief are met, the company could be liquidated so as to withdraw the value/money/accumulated profits tax efficiently. Upon liquidation, the company’s accumulated profits could be distributed to shareholders and would be expected to be subject to capital gains tax rather than income tax in the hands of the shareholders – if Entrepreneurs’ Relief is available, the effective capital gains tax rate will be 10% (based on current rates). The overall effective tax rate on extracting the profits would therefore be 31.6% (after taking account of 24% corporation tax and an effective 10% capital gains tax rate).
Salary v Drawings

If a shareholder of a limited company also wishes to receive a regular salary (or a bonus) from the company, this will be less tax efficient than receiving a profit allocation from an LLP. The income tax/NIC liability for the shareholder will not be materially different to that of a member of an LLP, but the company will be liable to Employer’s Class 1 NIC, currently at the rate of 13.8%.

An LLP does not have a liability to NIC in respect of profits allocated to a member of the LLP.

Losses

There are significant differences between being a member of an LLP and a shareholder in a limited company in the event that the business incurs a trading loss.

As an LLP is treated as being transparent for tax purposes, any tax loss accrue to the members in accordance with their profit sharing entitlement. This may permit the member to offset the trading loss against other income in the same year (this is known as sideways loss relief). However, there is a restriction – a member of an LLP can only claim sideways loss relief for an amount up to the capital that has been contributed to the LLP. Therefore, a member who has only made a minimal capital contribution to the LLP will be unable to offset the majority of the trading losses incurred by the LLP against other income. Instead, the loss is carried forward for offset against future trading profits of the LLP.

In addition, it is proposed that, from 5 April 2013, the amount of sideways loss relief that can be claimed by a member of an LLP will be restricted to the higher of £50,000 and 25% of their taxable other income.

For a shareholder of a limited company, there is no opportunity to utilise any of the limited company’s trading losses against the shareholder’s personal income. The limited company is a separate legal entity and any trading losses can only be utilised by the company itself. The company can use the trading losses in a number of ways:

- It can deduct the trading loss against its total profits in the same accounting period. The trading loss can therefore be deducted from capital gains, property income, interest receivable and other non-trading income and gains.
- Carry back the trading loss against total profits in the preceding 12 months on the same basis as above.
- Carry forward the trading loss against future profits from the same trade, but not against non-trading income such as capital gains, property income and interest receivable.
- If a member of a group of companies, surrender the loss to another group company to offset that company’s total profits in the same accounting period.

Allocation of profits to the owners

An LLP is considerably more flexible than a limited company in terms of varying the allocation of profits made by the business. It is usual for the LLP Agreement to define the arrangements for allocating profits between the members and such allocations can be different for income profits and capital profits. It is also possible to vary the profit allocations from year to year and this may be provided for in the LLP Agreement.

For the shareholders in a limited company, the profit sharing arrangements are governed by the rights attached to the shares. In most instances, the issued shares of a company will be of the same class and with the same rights. Therefore, if the company declares a dividend, it is payable at the same level in respect of each share in issue and this is not straightforward to vary.
**Use of a service company**

By introducing a service company into an LLP structure, the benefits of both an LLP and a limited company ownership structure may be available.

The service company would be a limited company established by members of the LLP and its role would be to provide services to the LLP that are commercially required. For example, the service company may employ all of the staff whose services are then provided to the LLP in return for a fee. The service company would pay corporation tax on its profits, whilst the fees paid to the service company would be an expense for the LLP, thereby reducing the profits of the LLP that are shared amongst, and taxable on, the members of the LLP.

The introduction of a service company must be commercially justifiable and the fees that it charges to the LLP must be at arm’s length rates. However, it does provide flexibility and allows the owners of the business to withdraw the profits that they need whilst deferring personal tax liabilities on excess profits.

**Summary**

The choice as to whether to trade through an LLP or a limited company is not straightforward and needs careful evaluation. The correct choice can result in substantial tax savings and cashflow benefits but will be dependent on the facts in each case.

HW Fisher & Company is a leading provider of professional services in the UK, and one of the 25 largest accountancy practices in the country. Our tax experts are ideally placed to advise on the appropriate structure for your business with a view to both minimising tax liabilities and ensuring that the structure complements the commercial objectives of the business.

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<th>Summary of advantages and disadvantages of an LLP v Limited Company</th>
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<tr>
<td><strong>Limited Company</strong></td>
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<tr>
<td>Retained Profits taxed at up to 24%</td>
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<td>Distributed Profits subject to additional income tax of up to 36.11%. Thus total tax on distributed profit could be as high as 51.44%</td>
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<td>Employers NIC of 13.8% on salaries paid to shareholder employees</td>
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<td>Chargeable gains within the company taxed at up to 24%.</td>
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<td>Chargeable gains on a disposal of shares taxed at between 10% to 28% (ignoring annual exemption)</td>
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<td>Losses can only be used within the company against certain profits.</td>
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<td>More restrictive if wish to change profit allocation between shareholders.</td>
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*Please note:* It is proposed that the top rate of income tax will be reduced from 50% to 45% on earned income and the top rate on dividends from an effective rate of 36.11% to 30.56% as from 6 April 2013.
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