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What does the future hold for the LLP in light of recent changes to UK tax law?

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Synopsis

Since its inception in 2001 the Limited Liability Partnership ('LLP') has held an unusual 'hybrid' status as far as British (tax) law is concerned, indeed it has brought the legal and tax aspects of partnerships face to face in a way that has not happened before (within England certainly). It has allowed traders and professionals the best of both worlds with the flexibility and tax-transparent status of an 'ordinary' partnership combined with the protection of limited liability along with the legal personality and veil of incorporation of a limited company and caused something of a revolution in the way professional businesses (especially accountants and solicitors) were structured.

However, a spate of recent reforms such as a mixed member rules, extension of the 'participator' definition in respect of close companies and, significantly, the disguised salary changes (aimed at preventing employees being re-labelled as partners) threaten to nullify the appeal. Further changes are mooted especially regarding corporate members. These changes have undoubtedly removed some of the perceived tax advantages of business operating an LLP (either individually or part of a group).

Following an overview of the LLP, its history in chapter 1 and a head to head comparison of the LLP with its nearest rival, the limited company, chapter 2 shall be examining whether the LLP is a victim of its own success following these recent bout of changes to the law and potential changes in the future; in particular the removal of the presumption that LLP members are self-employed for tax purposes and the potential issues this will raise. This will be an area of analysis looking at s.4(4) Limited Liability Partnership Act ('LLPA') 2000 and the

comments made by Rimer LJ in the case of *Tiffin v. Lester Aldridge*[1] amongst others. Another area of analysis will be H M Revenue & Customs' ('HMRC') interpretation that LLPs are not analogous to 'holding companies' when considering the availability of Business Property Relief ('BPR') to its members.

Chapter 3 will briefly look at some of the anomalies of the LLP when compared to the limited company; the uncertainties in the legislation about where the LLP fits in, and the legislation and HMRC's view of the availability of BPR for some LLP interests.

Chapter 4 will consider this when comparing the LLP's tax status to the tax treatment of partnerships in some foreign jurisdictions (including Scotland) and how they compare to the UK-wide LLP.

Chapter 5 shall outline my conclusions as to whether the flexibility and other benefits of the LLP could ultimately be its downfall in light of recent changes to the law. I will consider whether the LLP's relatively-advantageous tax status has changed to the point where they have lost their appeal and whether they have a future given the current anti-avoidance climate created by this government.

My conclusion shall be that in my view, whilst these reforms may force some businesses to think twice before becoming or remaining as LLPs, the simplicity and versatility of the LLP and the protection they offer their members with relatively little sacrifice from the tried and tested partnership model will ultimately mean that it will continue to stand alongside the limited company as a choice of business platform and should remain a favourite for many professions.

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[1] [2012] EWCA 35

The anomalies and uncertainties which still revolve around this relatively new structure could be largely resolved were it to be treated as a body corporate to a greater extent than it is already.

Chapter 1. Introduction

The LLP was the creation of the LLPA 2000 which came into force throughout the UK on 6 April 2001[2]. Within the 14 years following this Act around 70,000 LLPs have been established in the UK, whereas only 10,000 Limited Partnerships ('LPs') have been established since the Limited Partnership Act 1907 enabled an element of protection within an unincorporated entity.

Prior to the LLP, unincorporated businesses in the UK which required an element of liability protection for their (active) owners would have to revert to incorporating into a limited company. Of course lawyers were unable to do even this until the Incorporated Practice Regulations of 1988 and the Single Member Company regulations of 1992. In addition until the Companies Act 1967 partnerships were restricted to a maximum of 20 partners. Texas introduced the LLP in 1991 with virtually all other US states shortly following suit. Australia, Singapore and Canada all have their own LLPs. However the introduction of the LLP nearer to home in Jersey in September 1996 led to increased pressure and threats to relocate from the larger accountancy firms in particular for the UK government to introduce something similar within our own shores. Even before that time the threat of potentially ruinous negligence claims had led the larger accountancy firms in particular to call for some kind of limited liability mechanism for partnerships.

Once the LLP came into existence in the UK there seemed to be an opportunity for liberation from the confined choices of the past; a firm could enjoy the flexibility and tax transparency of a general partnership yet enjoy the separate legal identity and protection from unlimited liability of a company. The

[2] The LLP came into force in Northern Ireland by virtue of the LLPA (Northern Ireland) 2002

availability of losses from the LLP's business which could be offset against the members' other income and the lack of any P11ds and dividend minutes requirements (indeed all general compliance revolving around extraction of profits) are all luxuries of the ordinary partnership which stay with LLPs. But with that familiarity came the strange but comforting knowledge that members' personal assets were isolated from the business thanks to the protection of limited liability. The fact that companies could also become corporate 'members' (as LLP partners are called) made the concept even better, with LLPs' being able to slot into an existing corporate group structures.

In addition the imposition of joint and several liability (which partners in traditional partnerships have to bear) does not apply to LLP members who are only responsible for their own individual actions, as is the case with company directors. As a separate entity, it is the LLP itself which would get sued by third parties (and which can sue in its own name). This point alone has frequently been enough to convince many partnerships to become LLPs.

The majority of LLPs in existence are the professional, as opposed to trading businesses with solicitors' and accountants' firms in particular taking advantage of the new vehicle. Three out of five of the top fifty accountancy firms are now LLPs. Ernst & Young was the first major accountancy firm to become an LLP in 2001; KPMG and PwC in the UK followed suit the following year with Deloitte UK doing the same in January 2003. Grant Thornton UK converted to LLP status in July 2004. Whilst the uptake amongst the rest of the field was rather slow (largely down to the new requirement to file accounts and make them public), the traditional 'ordinary' partnership structure within the accountancy and legal professions is unlikely to remain as, according to Fergus Payne (partner at law firm Lewis Silkin):

"there is no good reason to trade with unlimited liability[3]".

The tax status of the LLP is very simple, that is its attraction. For tax purposes the LLP is treated exactly the same as a general partnership i.e. it is transparent, its trade/profession is deemed to be carried out by its members and the profits and capital gains are assessed to income tax and capital gains tax on the individual members according to their respective shares as they arise[4]. Whilst treated as a body corporate for legal purposes and for tax purposes on liquidation and for Stamp Duty Land Tax ('SDLT') group relief, the LLP completes a self-assessment income tax return each year which reports each members' share of their income and capital profit/losses. The LLP is not really a partnership at all largely thanks to the lack of joint and several liability (the hallmark of a traditional partnership); it is a company with partnership characteristics. Palmers[5] calls the LLP's name 'a breach of the Trades Description Act' and reminds us that s.1(5) LLPA 2000 says:

> *"Accordingly, except as far as otherwise provided by this Act or any other enactment, the law relating to partnerships does not apply to a limited liability partnership."*

This parity of tax treatment between the general partnership and LLP is further evident when you consider that a general partnership's becoming an LLP is a tax-neutral event. There is no cessation for the purposes of income tax, no disposal for either capital gains tax or capital allowances purposes and there is (usually) no SDLT on the transfer of property into the LLP[6].

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[3] Quoted in article 'Has LLP status worked?' by Nick Huber – AccountancyAge 22 March 2012
[4] ITTOIA 2005 s. 863, s.1273 Corporation Tax Act 2009 and TCGA 1992 s. 59A
[5] Palmer's Limited Liability Partnership Law, 2nd Edition (2011)
[6] Tax Bulletin December 2000 (Issue 50)

Whilst the introduction of the LLP was especially popular with the professional firms and a huge source of liberation for those partnerships faced with the prospect of having to become a limited company, the company is still the predominant vehicle from which to run a business (largely due to companies' having operated in the UK for hundreds of years e.g. the Whitechapel Bell Foundry is the oldest UK limited company still in operation, founded in 1570). The fact that companies have stood the test of time and are known to be a reliable platform from which to run a business immediately gives it an advantage over the LLP, a relatively new concept with uncertainties still surrounding it. With LLP transparency an individual member can still be exposed to income tax rates of up to 45% as well as potentially Class 2 and 4 National Insurance Contribution ('NIC') liabilities; whereas dividends from companies are effectively income tax-free at basic rate and top rate corporation tax has been 30% during the life of the LLP; from April 2015 a single rate of 20% prevails. Many businesses will wish plough their profits back into the business rather than withdraw them – with a partnership these profits would be taxed on the partners irrespective, whereas a company shareholder would only be taxed personally on those profits actually withdrawn. The ability to structure companies into groups, the lack of personal tax on retained profits within the company and the availability of Research & Development, Patent Box and Film Tax reliefs have all served to persuade many would-be LLPs to choose the limited company option instead.

Despite the many advantages of the limited company, so many professional firms in particular have opted to become LLPs rather than companies, the flexibility winning the day. However this flexibility and the attractiveness of the

LLP in the face of centuries of the tried-and-tested limited company could well be short-lived.

Chapter 2. Some of the recent changes

Whilst the LLP made, for many, the ideal business model the government was starting to have other ideas and were becoming increasingly aware of 'abuses' of this new-found flexibility. The three 'wrongs' as they saw it were: firstly that people who would ordinarily be employees (and thus subject to PAYE, Class 1 NIC, pension and other employment compliance rules) were being 're-badged' as members of the LLP with the lower NIC burden (there being no employers' NIC) and subject to the more liberal expenses regime which accompanies this automatic self-employment status. Secondly the ability of companies to act as corporate members of 'mixed membership LLPs' thus enabling LLPs to channel a disproportionally large share of the profits to the corporate member with its lower tax rate (at 20%) rather than be subjected to an individuals' income tax rate of 40/45%. Thirdly, and related to the corporate member issue, corporate members loaning funds to the LLP members without paying the s.455 charge (25% tax 'deposit' on loans under s.455 Corporation Taxes Act ('CTA') 2010) which would ordinarily apply were the LLP not part of the structure.

Along with the rule specifically concerning the use of LLPs' creating excess losses for individuals[7] (usually as part of a packaged tax avoidance scheme), the Finance Act 2014[8] introduced two 'anti-avoidance' measures designed to combat these perceived abuses, along with Finance Act 2013 amending the rules concerning loans and benefits to participators:

[7] Schedule 17 amends the Income Tax Act ('ITA') 2007 inserting a new s.116A so excess losses assigned to an individual member by a non-individual member cannot qualify for relief.
[8] Schedule 17 amends ITTOIA 2005 to include further sections after s. 850 (excessive profit allocation) and s. 863 (self-employment treatment of members)

Section 1: Disguised salary (s. 863A-G Income Tax (Trading & Other Income) Act ('ITTOIA') 2005)

Many professional firms would look to promote senior employees to partners, but initially just as 'fixed share partners' with little say on the running of the firm and essentially as junior partners. This would involve their receiving, as the title indicates, a fixed share of the end profits which they would get irrespective of the firm's profits and performance. This might seem a perfectly reasonable way of giving someone a good apprenticeship for full equity partnership; but also a fixed share partner would no longer an employee for either employment law or tax purposes with the firm no longer being obliged to pay Class 1 NIC nor make pension contributions nor indeed observe some of the legal niceties of employment law (about which the main cases regarding such partners revolve). From a tax perspective, partners (be they of general partnerships or LLPs and whether they be 'fixed share' or full equity) are automatically taxed on their profit shares on a self-employed basis with their actual drawings from the partnership being irrelevant. However a shareholder/director of a limited company is only taxed personally on what he takes out i.e. in the form of a salary and/or dividend. The difference between the company and the LLP from a personal tax and profit extraction perspective is absolute, yet they are both legally 'body corporates' with separate identities.

Whilst many shareholders are frequently directors and/or employees of their companies, there has always been a bit of a question mark about this issue of members potentially being employees of their LLPs. In his preface to Palmer's, Geoffrey Morse talks about the lack of clarity generally about LLPs, an 'in built tension between the application of corporate and partnership law' based on the fact that the LLP is more like a Limited Liability Company in the USA ('LLC', see

chapter 4, section 2) and that its basis is derived from one short piece of legislation and regulations which simply apply existing sections of the Companies Act 1985 and Insolvency Act 1986 et al. He states that:

> *“(the internal aspects of an LLP) arises from the fact that such relationships are not prescribed”.*

The question is often put whether an individual is a partner or an employee and this is based on looking at the circumstances in each case as it arises. The salaried partner and fixed share partner, although two different statuses, seem to be thrown together and put into the no-man’s-land of uncertainty. There are countless cases (usually within an employment law dispute setting) of partners being deemed employees and visa versa. In *Burgess v. O’Brien*[9] the individual in question was found to be a partner even though he received a salary and had no liability for losses; whereas in *Briggs v. Oates*[10] a similar arrangement resulted in that individual being branded an employee. In *Cobbetts LLP v. Hodge*[11], the individual was appointed as an “employed partner” and it was made clear in the agreement he was an employee – the court concurred; but in *Dainty v. Ellerton Knight*[12] an “associate partner” was held to be self-employed by the Employment Tribunal. Lindley & Banks[13] suggests that clarity could be brought in by a fixed share partner being paid ‘from’ profits (and not ‘irrespective of’ profits). This is what the new rules try to do.

The new rules, inserted into s.863 ITTOIA 2005 remove the automatic presumption that LLP members are self-employed for tax purposes. Instead

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[9] [1966] ITR 164
[10] [1990] ICR 473
[11] (2009) 153(17) SJLB 29
[12] UKEAT 0281 09 DM
[13] At para 5-59

HMRC would have to successfully point out certain characteristics which point toward an individual being employed rather than self-employed. Rather than there being the automatic assumption, a member would have to display criteria which would point to their being self-employed. There are three criteria, all of which HMRC must be satisfied are fulfilled before a member is deemed to be an employee rather than self-employed:

Firstly there must be a ‘disguised salary’ paid (or a reasonable expectation that it will be paid) for services rendered by the individual to the LLP. The ‘salary’ must be fixed (or variable without reference to the firm’s profits/losses) or in practical terms not affected by the firm’s performance.

Secondly there must be no ‘significant influence’. This means that the individual has no significant say in the running and/or management in the LLP. This is a rather typical badge of an employee, simply working in the business rather than carrying it on. A genuine partner would have a stake in the LLP and thus (almost by definition) have influence over the business.

The third condition is ‘capital contribution’. This is another major and obvious difference between someone who merely works for a business and someone who invests capital and becomes part of the business as a result. This condition will be met if the individual’s contribution to the LLP is less than 25% of their ‘disguised salary’.

If these conditions are met then HMRC will regard the individual in question as an employee (or ‘salaried member’) and be subject to PAYE and Class 1 NIC (employees’ and employers’) on their profit share. This will not affect their legal status as members, just their assessment to income tax and Class 1 NIC.

HMRC has published detailed guidance[14] on their interpretation of these conditions and how they will approach them. A 'common sense approach' is what they say will be adopted with numerous examples of hypothetical scenarios given where the rules would and would not be applied.

On the face of it, it seems reasonable to question the automatic presumption of self-employment. As said above, HMRC already scrutinise an individual's tax status as to whether they are under a contract of service or a contract for services using their Employment Status Indicator, so why should they not extend that to LLPs[15] especially when many professional firms were indeed essentially disguising their senior employees as members who were doing the same job, having the same responsibilities and earning the same salary as before. A genuine equity member would have nothing to fear by the three conditions - they are simply asking whether those characteristics (management participation, contribution of equity etc) are being reflected in reality. In many instances members will either be genuine equity partners running the business, or salaried partners in apprenticeship but already on the payroll as employees subject to PAYE, NIC and benefits in kind.

However, these new rules have meant that more LLPs are having to categorise their prodigies as 'salaried partners'/'associates' (employees) rather than the previously common 'fixed share partners' (self-employed members). Whether a fixed share partner might have been a better apprenticeship for equity status in some ways I cannot say, however the greatest objection will simply be that the

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[14] *"H M Revenue & Customs. Salaried Members Rules: Revised Technical Note and Guidance"*. 21 February 2014.

[15] Although in their article "Why becoming an LLP member could become more taxing" (legalweek.com – 17 February 2014), Alan Watts and Hayley Evans argue that the existing employee/self-employed cases already decide whether an individual would be taxed under PAYE or not.

LLP is having to pay the extra NIC (and pension contributions) for that employee and be subject to the strict letter of the UK employment laws. This extra cost and greater observation of employment compliance and regulation is bound to be another strike against a firm continuing as or becoming an LLP. Whilst a company would still most likely have to brand the same individual an employee, there is still greater flexibility with companies in that the individual could also be made a minority shareholder with a right to dividends and/or the possibility of being an office holder rather than employee.

The greatest objection to these new rules (or rather the logic behind them) however is purely academic and one which asks whether the legislation by which these rules were inspired has any intellectual weight or legal logical at all.

The reason why some judges and commentators have criticised the labelling of members as employees has been predominantly to do with the employment law and legal issues rather than tax consequences of such a re-categorisation. Most cases concern unfair dismissal and whether the individual in question has the legal protection of an employee under employment law. This dissertation will not go into matters of employment law, but it will look at the comments which some have made regarding the underlying concept of a member's actually being an employee.

Section 4(4) LLPA 2000 is at the centre of these debates. For tax purposes s.863 ITTOIA 2005 gave the warrant for the presumption of self-employment and that has now been tempered by the three conditions, but s.4(4) LLPA 2000 is still the founding piece of legislation – the constituent source of that principle which s.863 ITTOIA 2005 echoed as far as LLPs are concerned. Section 4(4) itself reads:

> *"A member of a limited liability partnership shall not be regarded for any purpose as employed by the limited liability partnership unless, if he and the other members were partners in a partnership, he would be regarded for that purpose as employed by the partnership"*

The precise meaning of this section is not entirely clear, but the consensus amongst judges and commentators is that one must pretend the member of the LLP is actually a partner in an ordinary (unlimited) partnership and then ask oneself whether in those circumstances that partner would actually be an employee. If they are deemed to be an employee in a partnership using the common law tests of employee status, then they are an employee in an LLP. This is certainly the view taken by Whittaker and Matchell[16]. This is also the view expressed in the case of *Kovats v. TFO Management LLP*[17] which in turn was supported by the Court of Appeal in *Tiffin v. Lester Aldridge*.

In the following cases the judges examine s.4(4) LLPA 2000 and pass comment on the approach it demands in respect to the employment law status of the individual in question according to the Employment Rights Act ('ERA') 1996. Whilst there is clearly a difference between the legal and tax status of an LLP and it members the decisions about whether someone is a partner or employee legally or for tax purposes revolve around the same issues in both cases i.e. the circumstance surrounding the relationship with the LLP, the duties, the nature of remuneration, contract of service or contract for services etc. The fundamental proposition of whether an LLP member can also be an employee (and following from that, a 'worker') straddles the law/tax divide (reflecting on what Palmer said about an 'in built tension' between the two laws). Section 4(4) LLPA 2000 is at

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[16] *The Law of Limited Liability Partnerships*, 2nd edition (2004) at para 8.27

[17] (2009) UKEAT/0357/08

the heart of that proposition as the constituent legislation (the section does say "*….shall not be regarded for <u>any purpose</u>…..*").

The *Kovats* case is the first one worth looking at. This was the first significant judgement concerning the employment status and unfair dismissal of an LLP member. There have been umpteen cases of deciding whether a partner was an employee based on the old common law employment status test, but this was the first following the passing of LLPA 2000. However thanks to s.4(4) it was ensured that the argument would not be advanced on the grounds of the LLP being a separate legal entity as one might expect, but the Courts (and Employment Tribunal in this case) had no choice but to follow the legislation which brought the LLP argument back into the employee/self-employed arena. In this case the Tribunal held that the correct test under s.4(4) LLPA 2000 had been considered and that on the facts of the case Mr Kovats was a self-employed partner and not an employee.

The Court of Appeal judgment in *Tiffin v. Lester Aldridge* concerned a complaint of unfair dismissal, breach of contract and redundancy brought by a member of an LLP claiming that he was actually an employee under the ERA 1996 which provided protection against those actions. The question was whether Mr Tiffin was a 'worker' under the Act whilst also being a member of the LLP and the court therefore examined s.4(4) LLPA 2000 and whether it would allow for such a scenario. Rimer LJ gave the main judgment and was obliged by s.4(4) to ask himself the question it posed i.e. whether in a notional partnership the individual would be an employee. However he gave some critical analysis of s.4(4) in doing so. In para 31 of the judgment he said:

"The drafting of s.4(4) raises problems. Whilst I suspect the average conscientious self-employed professional or business person commonly regards himself as his hardest master, such perception is inaccurate as a matter of legal principle. This is because in law an individual cannot be an employee of himself. Nor can a partner in a partnership be an employee of a partnership, because it is equally not possible for an individual to be an employee of himself and his co-partners. Unfortunately the authors of s.4(4) were apparently unaware of this."

The test in s.4(4) therefore cannot be applied literally – a direct comparison cannot be made with an ordinary partnership because if that were so the answer would always be that an LLP member can never be an employee. Rimer LJ therefore concluded that Parliament must have contemplated enquiry and examination of the facts in each case and thus the section must be interpreted accordingly. In the end, viewed through 'the prism of s.4(4)', it was held that Mr Tiffin would have been a self-employed partner (and thus not an employee so certainly not a 'worker') in a notional partnership based on the facts.

Clyde & Co. LLP v. Bates van Winkelhof[18] was a case recently heard in the Supreme Court and once again concerned an LLP member claiming employee status under the ERA 1996, this time focusing on the 'whistle-blowing' provisions contained within s.43A-L of that Act. Again the issue here was whether the appellant was a 'worker' within the definitions of that Act, but s.4(4) was still relevant and thus explored. Lady Hale confirmed Rimer LJ's

[18] [2014] UKSC 32

interpretation of s.4(4) whilst acknowledging that the section had 'caused bewilderment amongst English lawyers'.

In this instance the appellant was expressly excluded from being defined as a client or customer of the LLP within her contract, she was given a guaranteed salary along with a share of the profits but barred from working for anyone else. The Court held that the appellant was a 'worker' for the purposes of the legislation. Significantly, Lady Hale gave the example of the company shareholder also employed by his company as CEO as being a worker and his own boss.

The *Winkelhof* case, whilst not directly relevant, does highlight the potential issues that can arise out of the uncertainty of whether someone is an employee/worker or self-employed member. It is not yet clear whether the outcome of this case opens the possibility of an LLP member also being a 'worker' for the purposes of pension legislation (Pensions Act 2008) and the current auto-enrolment requirements, but under ERA 1996 an LLP member could now possibly have a claim to a wide range of statutory employee rights e.g. paid annual and sick leave, the benefit of a national minimum wage, being subject to maximum working time requirements etc.

Mark Blackett-Ord[19] called s.4(4) LLPA 2000 both 'odd' and 'remarkable'. He too points out that as a partner an individual cannot be an employee of his own firm simply because that would mean he is employing himself (the disguised salary rules do not contradict this – they apply exclusively to LLPs). He also quotes Proudman J[20] when the latter said:

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[19] *Partnership Law* (2011) at 25.72

[20] *Eaton v. Caulfield* [2011] EWHC 173 (Ch)

> *"There is no concept of a member in name only. Members are creatures of statute with statutory rights and obligations"*

Blackett-Ord also points out that whether someone is a partner in a partnership or not is a completely different test as to whether someone is a member of an LLP. The former can be a matter of speculation and investigation of the facts; whereas the question of whether someone is a member of an LLP or not can be easily answered: does their name appear in the Register of Members or not?

Palmer points out that in the absence of s.4(4) there would be no great difficulty with a member being an employee of their LLP since it is a separate legal person – company directors enter into service agreements with their companies so why should membership of an LLP be inconsistent with a contract of employment with the LLP? (echoing Lady Hale's comments in the *Winkelhof* case). However he repeats the principle that an individual cannot employ himself and so a partner in a partnership cannot employ himself; even Scottish partners seemingly cannot be employed by their partnerships (which have a separate legal identity – see Chapter 4 section 1) per *Fife County Council v. Minister for National Insurance*[21].

But with its separate legal personality there is no reason why an LLP cannot employ its members and the main objection to s.4(4) is that:

> *"it seems to address this question – if it addresses it at all – by reference to a form of business organisation which does not have a separate legal personality"*[22].

I think this is a crucial point.

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[21] 1947 S.C 629

[22] Palmer; at paragraph A5-21

Many of the texts, including Lindley & Banks simply look at the question of whether someone is a partner or an employee; however the focus needs to be brought back onto the fact that an LLP is a separate legal entity – ordinary (English) partnerships are not. In those latter cases there are only ever two possibilities – either someone is a partner by reference to their risking capital, managing the firm and taking a slice of the profits/losses; or they are an employee providing their labour/services in return for a fixed salary which they receive irrespective of the firm's performance. But for an LLP there is potentially a third option; as Palmer states, there is no reason why a member cannot be both a member and employee of a separate entity. S.4(4) forbids such a situation but then (as Rimer LJ pointed out) it has left the door open for the possibility of it being so; but based upon the test applicable only to general partnerships. General partnerships and LLPs are chalk and cheese, they are totally different things; as Palmer says, an LLP isn't really a partnership. It is closer to being a company than a partnership so it is totally illogical to apply the test for one onto the other.

Therefore I believe it is necessary to take a step back and simply look at the employment status of the individual – not as to whether he is a partner or employee, but whether he is simply an employee – just like any other employment status question. In *Kovats* it was also pointed out that just because someone is not a partner that does not automatically make them an employee – as they may be a contractor. Like Blackett-Ord said, as far as LLPs are concerned whether someone is a member is a simple question of fact – they are either registered as a member or they are not; just in the same way as someone is a shareholder of a company at Companies House. The individual might be a shareholder of a limited company so the question is: is he also a

director with a contract of service and thus entitled to a salary as well as dividends? Or if he is a member of an LLP, is he a member who is entitled to draw a salary as well as drawings. This is the question which the new HMRC conditions go some way to answer. They do not alter the legal status of a member – they simply say that from a tax perspective they can treat and tax a member as an employee.

The Law Commission[23] had previously recommended that even English general partnerships should become separate legal entities under a new Partnership Act. If LLPs are separate legal entities then they should also be so for tax purposes like limited companies – allowing members to be both owners and employees of their LLPs.

My view is that if LLPs are bodies corporate then they should be treated more as such in regards to this employee/partner question; they should be treated like limited companies which would allow members to enter into a contract of services in the same way as shareholders do as directors/CEOs. LLPs are already treated as companies for liquidation and SDLT group relief purposes. Membership of an LLP should be equated to that of a shareholding in a company, indeed it does in every other sense. In their recent report[24] the Department for Business, Innovation & Skills ('DBIS') stated that:

> *"LLP members have some parallels with company directors and company shareholders. An LLP member does not bear any responsibility for the other members' acts – unlike a general partner, but like a company director; and the government has already set out its intention*

[23] Law Commission and Scottish Law Commission – Partnership Law, A Joint Report. Law Com No 283. 18 November 2003.
[24] "Corporate Directors - Scope of exceptions to the prohibition of corporate directors". November 2014

that LLPs provide information on their control for the PSC (People with Significant Control) register[25]".

The LLP member could then choose whether or not to enter into an employment contract and receive a salary subject to PAYE and Class 1 NIC in parallel to receiving his profit share. This would remove the debate away entirely from the employee/partner issues of general partnerships – LLPs and general (English) partnerships cannot and should not be compared and s.4(4) should not have devised a test based on two totally different structures.

HMRC's new disguised salary rules have gone part way to answer my call. The rules do not effect s.4(4) or the legal status of members (it only amends s.863 ITTOIA 2005) but it does at least address my call that more simplistic and binary view be taken of a member's status for tax purposes. It is essentially putting into statute those employment status cases of the past and channelling them toward the LLP member. HMRC have three hurdles to clear, if they do then the individual in question is TAXED as an employee; if either one of the hurdles are not cleared then the individual remains as a member with no further questions asked. Certainly their legal status is not affected by this.

It would be quite right to point out that legal status and tax status do not necessarily need to act in harmony – indeed the very existence of the LLP proves that with its hybrid nature of being one thing legally and another as far as tax is concerned. However this has led to a degree of confusion and inconsistency with employment law and tax law being contaminated with each other for the first time. We now have a situation whereby an LLP member, registered as such at Companies House, can being taxed as an employee;

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[25] Ibid at paragraph 69

whereas s.4(4) and many legal cases point out that in law it is not possible for that to be so. For both tax and legal purposes there needs to be clarity as to whether someone is self-employed or employed as the two are mutually exclusive. The inconsistency needs to be cleared up but the recent changes go some way of doing this by clarifying purely the tax position without offending the legal principle that a member cannot be his own employee. Until a more fundamental rethink of the status of the LLP in relation to its members is carried out, the new rules seem a good compromise in the meantime.

Whilst the *Tiffin* and *Winkelhof* cases have given potential LLPs some cause for concern about the employment law and pension requirements of some of their members, I also think that far from potentially endangering the appeal of the LLP compared to the limited company, these changes might actually provide some clarity and certainty as far as their tax status is concerned. Undoubtedly there will still be some questions marks in certain individual cases and the position is certainly not as clear cut as a director/shareholder of a limited company who holds the role of both owner and employee, but a business looking to become an LLP can at least know what needs to be done to ensure their members are genuine members as far as HMRC are concerned – the grey area of the fixed salary partner has largely gone (for tax purposes certainly, although the concerns surrounding the implications of *Winkelhof* in particular on employment and pensions law still exist). There is nothing stopping a firm calling someone a partner to the outside world; the ‘salaried partner’ was always safe, they are employees taxed under PAYE but merely presented as

partners to everyone else. But a genuine partner must be just that. In their article[26] Alan Watts and Hayley Evans suggest:

> *"it would be disappointing if HMRC's attempt to establish a new set of tax rules dissipates the attraction of LLPs by singling out its members for different treatment"*

However the question about 'employed or not' would disappear entirely if LLP members could also enter into contracts of services with their LLPs just as a company director could do; then they would not be singled out at all. Whilst Watts and Evans are right in that cases have existed for many years to establish whether someone is employed or not, I do not think putting the criteria into statute is such a bad thing, LLP members need to be singled out to some extent currently because they are so unique and because that legal/tax divide should be maintained to provide certainty if nothing else. As well as providing yet more clarity regarding both the tax and legal status (e.g. under the ERA 1996), allowing dual member-employee status (equating members to company shareholders) would also provide the LLP member and LLP itself with some tax savings via salaries below the income tax personal allowance and the NIC employers' contribution band; and a taxable deduction in the profit and loss account for the LLP.

Section 2: Mixed Member LLPs (s.850C ITTOIA 2005)

Both general partnerships and LLPs are capable of having partners/members which are limited companies (or indeed any other body corporate). There are a number of perfectly good commercial reasons for having a 'mixed partnership' arrangement: the corporate member could be providing capital/investment, be

[26] Per note 12

another vehicle for a business with diverse activities (e.g. a farming partnership where a corporate partner undertakes a non-farming activity such as contracting or livery) or segregation for regulation purposes (e.g. within financial services one activity of a firm may not be regulated by the Financial Conduct Authority and thus need to be operated under a separate entity).

However there were a number of perceived abuses of the mixed partnership arrangement, especially in a situation whereby the shareholders in the corporate member were the same people who were the other members of the LLP. The lack of availability of an Annual Investment Allowance ('AIA') to a mixed-member LLP/partnership is perhaps an indication of the government's inherent dislike of such structures[27]. Essentially the principal mischief was a member of an LLP obtaining profits at lower tax rates (i.e. though the corporate member).

One of these abuses was that of a corporate member receiving a disproportionately large share of the profits in relation to its capital contribution and/or input into the LLP (or individuals receiving a larger proportion of losses). This was seen as a form of transfer pricing whereby the entity with the lower tax rate (i.e. the company paying tax at 20/21%) would shoulder most of the profits and thus reducing the income tax burden (at 40/45%) of the individual members (or the individual members receiving a greater share of a loss). Those same members own the company so the profits were not being lost – they would be extracted at a lower dividend rate or used to fund pensions.

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[27] Section 38A(3)(b) Capital Allowances Act 2001. In their final report of the review into partnerships in January 2015, the Office of Tax Simplification recommended that the AIA be made available to mixed member partnerships

In order to combat this, section 850C was incorporated into ITTOIA 2005 by Schedule 17 Finance Act 2014. These sections provide that if ‘excess’ profits are deemed to have been passed onto corporate members from individual members and an individual (whether a member or not) or someone connected to them can ‘enjoy’ those profits then the individual’s profit/loss share will be adjusted accordingly. Detailed guidance on these rules were issued by HMRC on 27 March 2014 but essentially the rules would apply if either of the conditions set out in sections 850C(2) and (3) were satisfied:

> *It is reasonable to suppose amounts representing A’s* (individual) *deferred profits are allocated to B* (the company of which A is a participator)*; so that A’s profit share is reduced and the tax is less than it would have been;* (850C(2))
>
> Or,
>
> *B’s profit share exceeds the appropriate notional profit* (being an appropriate notional return on capital plus consideration for services provided)*; A can ‘enjoy’ B’s profit share; it is reasonable to suppose that B’s profit share is attributable to A’s power to enjoy; and A’s profit share is reduced and the tax is less than it would have been.* (850C(3))

On the face of it these would seem rather draconian rules; there is no commerciality test as often accompany anti-avoidance measures (although HMRC’s detailed guidance notes of March 2014 state that the rules will not apply to parties genuinely working at arm’s length and with no intention to avoid tax). However in my view they actually seem perfectly reasonable. The only reason why an LLP would give a corporate member a greater profit share than its input would warrant would be to avoid tax, there is no commercial reason for

doing so. Whether the corporate member is providing capital to the LLP (and thus acting as more of a sleeping partner) or they are playing an active role, there is no reason why they should receive a disproportionately greater share. The greatest challenge will be purely practical in ensuring that the corporate member receives no more than they should i.e. calculating the 'notional profit' in light of their input. Quite how this is to be calculated would presumably depend on the precise role of the corporate member; if they are just a sleeping partner then their profit share would be a reasonable and commercial rate of return on their investment; if they introduced capital into the LLP then presumably a valuation-based and if it were that and an active involvement then a further valuation of the level of services (on a comparable basis) provided would also need to be calculated. (Various examples are given in the detailed guidance of March 2014). I dare say as long as it is reasonable then no profit adjustment would be required.

However when attempting to avoid the potential fallout of the s.850C measures, care must be taken to ensure no one is falling into another trap (applicable again to all forms of partnership). Further provisions were laid down in the Finance Act 2014 to combat disposal of income streams through partnerships and this would include the injection of income-producing assets into a partnership[28]. Using examples in the HMRC March 2014 detailed notes, one individual partner (A) would put an income-producing asset into a business and another corporate partner (B) would contribute a capital asset of similar value to the income stream. The partnership agreement could specify that B would be entitled to the income stream until the value of their capital asset is paid off. By

[28] Sections 809AAZA and DZA Income Taxes Act ('ITA') 2007 and s. 757A and 779A CTA 2010.

doing this A has effectively diverted their profits through to B. Likewise partner A sells an asset to B with proceeds left on a loan account. The partnership agreement states that B is entitled to a greater share of the profits in order to pay down the loan account which A can subsequently draw down tax free.

I do not believe that the imposition of the mixed-member rules under s.850C would be fatal to the LLP. They are tackling something which would potentially be abusive and which would ordinarily have no (or little) commercial justification. A structure within which the members receive reasonable returns for their investment and/or services would have nothing to fear by these rules. However the fact that that rules now exist and it is yet another thing which a business must bear in mind and keep an eye on to ensure compliance is maintained (e.g. ring-fencing the company's profits for use of the company only), might be enough to dissuade them from becoming an LLP as opposed to a limited company.

Section 3: Loans and benefits to participators (s.455(1)(c) and 464A CTA 2010)

This section refers to an earlier change to the legislation regarding loans to participators in close companies. Until the Finance Act 2013 loans were only subject to the 25% corporation tax charge if they were made to individual participators in the company. However the 2013 Act sought to ensure that the 'mischief' of companies providing finance to an LLP of which it is a member without paying a tax charge would be ground to a halt. Now under s.455 if a company does provide a new loan to a LLP at least one of whose members are also a participator in the company then that company will be subjected to a 25% tax charge as if the loan had been made to an individual. Under s.464A any benefit conferred directly or indirectly on a participator (or an associated party)

from a close company which participates in any tax avoidance arrangement will be chargeable as a s.455 charge on the company (unless the individual is taxed under income tax rules or the corporate member already paid the s.455 charge).

There have also been calls for corporate bodies to be barred from being LLP members in the first place. The matter was looked at by the government's report on corporate directors[29] and the conclusion was that corporate members are an important means of securing investment for LLPs and that as there was no strong body of evidence to suggest abuse facilitated by corporate members of LLP there was not a strong enough case to introduce a ban on corporate members. However, this recommendation was caveated by the recognition that the structure is open to abuse and such an arrangement is:

> *"an increasingly popular choice for those seeking opacity to facilitate illicit activity[30]"*

I therefore consider the recent measures to be merely an attempt to crack down this 'illicit activity'. There have been anti-avoidance provisions in place for many years which prevent an individual receiving funds in a manner which would lower the tax liability than would otherwise be due. These are no different. No LLP which has been operating within reasonably commercial lines should have anything to fear.

However, when pitted against the limited company in the competition to decide which entity befits the business, these rules under sections 2 and 3 could tip the balance in favour of the limited company. Several accountancy firms which

[29] Department for Business, Innovation & Skills, November 2014
[30] Ibid at paragraph 72

operated as LLPs with multiple corporate members have decided to simply become limited companies rather than undo or regulate the current set up. Not that the business would necessarily fall foul of any of the anti-avoidance measures, but that it is something else of which they must ensure they don't fall foul. Compliance measures may need to be put into place and in some cases tax avoidance (or certainly reduction) will be a decisive factor in choosing whether to be a company or an LLP. Whilst tax avoidance has become a moral evil in recent years it is still perfectly legal and tax considerations are an inevitable part of business restructuring.

Conclusion

To conclude this chapter, I believe that the recent changes will provide more in the way of light than darkness to those businesses considering whether to become LLPs. At the worst they are merely tightening up the rules on the LLP – its liberal structure being open to areas of abuse and these rules provide boundaries and rules for those businesses. Like any rules they require some extra monitoring and compliance, but they reign in the LLP, make it more mainstream and less prone to abuse.

The *Tiffin* and *Winkelhof* cases, whilst focussing on employment law, have effectively abolished the concept of the fixed-share partner (for those firms who wish to avoid the doubts regarding employment status and law which those cases brought to light). If the LLP were treated more like the limited company and a purely separate legal entity then a member could become an employee just as easily as a shareholder becoming an officer or employee of their company. In the absence of this, the new disguised salary rules provide greater clarity and certainty for managing members of LLP as to how senior employees can be promoted to partner and be treated for tax purposes whilst allowing the

legal status of an LLP member to remain untarnished (or at least remain in the hands of employment law to decide). In August 2014 it was announced[31] that Mishcon de Reya would be incorporating into an LLP with all partners becoming full equity members. Currently the international law firm is a partnership of 37 full equity partners and 65 fixed-share partners. Whilst the main motivation for the incorporation was reportedly the move to more expensive premises in Aldwych from Kingsway, the scrapping of fixed share partners within the firm coincides with these recent changes and perhaps demonstrates that the changes have not put many firms off the LLP vehicle after all.

As far as tax is concerned these new rules also seem to marginalise s.4(4) LLPA 2000, a piece of legislation which is not only confusing but which is intellectually flawed by comparing an LLP to a general (English) partnership. Whilst they are both transparent for tax purposes, one is a body corporate and one is not. Whilst the tax law makes no distinction between the two it is a purely artificial outlook – s.4(4) pretends that the LLP and partnership are the same things, but they are not – nor should they be, that was the whole point of introducing them in the first place.

These new changes may be seen with dismay by some – but those people have been used to the over-liberal structure of the LLP, something which was unsustainable as it got more popular with the large businesses with larger number of employees. Whilst LLPs need to retain their unique flexible status with tax transparency and the benefit of limited liability, some anomalies can be removed without jeopardising this status. By making it legally possible for a member to sign a service contract with their LLP they could be both employed

[31] In 'The Lawyer', 19 August 2014

AND self-employed, analogous to a company director/shareholder. The tax law has advanced part way to that stage by categorising a member one or the other using definitive statute. But the contention could be removed completely.

Chapter 3. Other issues.

In chapter 2 I concluded that the recent changes to partnerships might actually provide LLPs with more of a guiding light as to their own composition and status. However one area where clarity remains absent is where the LLP stood next to limited companies in group structures and as holding companies and the consequential capital tax implications on the members.

The Office of Tax Simplification ('OTS') has looked into the matter. Despite LLPs' being companies for SDLT group relief purposes[32], in the final report of their review into partnerships (dated January 2015) the OTS noted confusion amongst tax professionals as to the exact standing of LLPs with respect of group relief for corporation tax purposes.

The Institute of Chartered Accountants in England & Wales ('ICAEW') sent a question paper to HMRC in 2014[33] seeking clarification as to the Inheritance Tax ('IHT') treatment of LLPs acting as holding companies – holding shares in subsidiary (trading) limited companies. In particular the question was whether a member's interest in a 'holding LLP' within a trading group structure would qualify for 100% Business Property Relief ('BPR') just as the shares in a similar holding limited company would. In addition the OTS have sought clarification from HMRC as to whether members of an LLP which acts as a holding company of a trading group could benefit from Entrepreneurs' Relief ('ER') as a shareholder in a limited company could.

[32] Part 1, Schedule 7 Finance Act 2003

[33] TaxRep 1/14 (ICAEW Rep 01/14 Tax)

Section 1: Status of LLPs in a corporate structure for group relief and ER

Rather confusingly s.1273 CTA 2009 outlines the transparent nature of the LLP (mirroring the income tax legislation) with the trade being carried on by the members rather than the LLP itself; however s.188 CTA 2010 states that (for Part 5 – group relief) a company means any 'body corporate' (of which an LLP is one). However taking into account s.1273 and the requirement for LLP transparency there is some doubt as to whether an LLP could be head of a group. To add further to the confusion the capital gains group relief legislation specifically excludes the LLP from the definition of a company (s.170(9)(b) TCGA 1992). The LLP therefore seems to fall between the cracks of the various definitions and we are left with a sense that the LLP has no definite or consistent place within the corporation tax rules.

The OTS have recommended that HMRC give clear guidance within their partnership manuals as to their position as to LLPs and group relief and members' eligibility for ER for LLPs holding trading company shares. HMRC have thankfully agreed to do this.

This confusion is obviously not ideal and until HMRC give clarification on these areas it is perhaps another good reason why a business might not choose an LLP over a limited company as a vehicle - especially within a group structure and thus make the LLP less appealing particularly to larger professional firms. Were LLPs to be treated as companies in that they were separate entities in every sense with s.188 CTA 2010 and s.170(9)(b) TCGA 1992 being amended/clarified accordingly then the clarity would presumably restore the appeal of the LLP. Until then a lack of consistency will remain with an LLP being treated as company for some purposes (e.g. in SDLT groups and upon

liquidation), but being denied such status with others with an unacceptable degree of uncertainty for those in between.

Section 2: BPR treatment of LLP interests

Section 105 Inheritance Tax Act ('IHTA') 1984 lays down the basis for BPR and the definition of 'relevant business property'- subsection 1(a) stating that *"property consisting of a business or interest in a business"* would qualify for 100% BPR (assuming all other criteria are met). Subsection 1(bb) allows shares in unquoted trading companies to also qualify. Importantly, s.105(3) states:

> *"A business or interest in a business, or shares in or securities of a company, are not relevant business property if the business or, as the case may be, the business carried on by the company consists wholly or mainly of….dealing in securities, stocks or shares, land or buildings or making or holding investments."*

Another important piece of legislation is s. 267A IHTA 1984 which once again decrees that LLPs are to be treated as transparent for IHT purposes:

> *a. property to which a limited liability partnership is entitled, or which it occupies or uses, shall be treated as property to which its members are entitled, or which they occupy or use, as partners*
>
> *b. any business carried on by a limited liability partnership shall be treated as carried on in partnership by its members*

Shares in a holding limited company of a trading group would qualify for BPR as such a company would still be deemed as trading. However were an LLP to hold shares in trading company subsidiaries then instead of deeming the LLP's member as holding the underlying assets in the partnership (i.e. the LLP as transparent as the legislation would suggest), HMRC have determined

(according to their manual – IHTM25094) that the business nature of the LLP's assets should be looked at; in this case it would be the holding of company shares as an investment with BPR being denied accordingly[34]. HMRC's guidance (IHTM25094) confirms that for IHT purposes a partnership interest is a 'chose in action' based on the valuation of the underlying assets, with an interest in an LLP being a right in each of the underlying assets; either way LLPs/partnerships are treated as transparent for IHT purposes. In answering the ICAEW request for clarification HMRC state:

> *"We do not think that how a partnership or LLP's activities are regarded for the purposes of determining whether it is carrying on an investment business for the purpose of s.105(3) IHTA 1984 necessarily conflicts with our view that BPR is not available in relation to an interest in a partnership or LLP whose business is the holding of shares in unquoted trading companies (which would qualify for BPR if held directly by the individual partner)."*

However HMRC did acknowledge that IHTM25094 could be changed slightly; whilst an interest in the LLP merely taking the place of a holding company would still be denied BPR; but if the LLP had another business and the subsidiary company shares are used in the business then the LLP interest may qualify for BPR. Interestingly, HMRC ended their response with:

> *"Although we appreciate that at present there appears to be an anomaly between companies and partnerships/LLP in this regard, that is what the legislation directs us to and is a result of the drafting of the provisions".*

[34] ICAEW 01/14 Tax

It almost reads as if HMRC know that their stance is illogical but cannot admit it and wish to pass the blame onto Parliament. Indeed HMRC are just interpreting the legislation, s.267A IHTA states that LLPs are transparent and that the underlying business of the LLP needs to be looked at. Limited companies are not transparent. Notwithstanding that It does seem an illogical stance – why the shares of a holding company should potentially qualify for BPR when an interest in LLP in the exact same position would be denied that relief seems unreasonable. James Kessler QC and Oliver Marre[35] believe that this anomaly is probably down to HMRC's confusion between the concepts of 'transparent' and of 'opaque' which are essentially principals of income tax. HMRC's own international tax manual (IM180020) summarises the differences between the two:

> *"In the case of 'transparent' entity the member is regarded as being entitled to a share in the underlying income of the entity as it arises…in the case of an 'opaque' entity the member generally is taxed only on the distribution made by the entity"*

The article concludes that the use of 'transparent' and 'opaque' outside of an income tax context is misleading and that, at best, the words may be "useful shorthand".

This anomaly, which HMRC is unlikely to correct given their response to ICAEW's question, seems to be another inherent disadvantage to the LLP when compared to the limited company. The non-availability of BPR for members of a holding LLP is clearly not going to be much of an incentive when considering

[35] In their article "A Merry Dance", Taxation magazine 20 March 2014

the need for a group structure and a holding entity. Another point in favour of the limited company over the LLP in a head-to-head comparison.

Chapter 4. Comparison with other jurisdictions

The LLP is a lot like the limited company in that it applies uniformly to the whole of the UK, whereas general partnerships differ throughout this isle in that Scottish partnerships are already separate legal entities in the eyes of Scottish law. Scotland therefore is in an usual position in that their general partnerships and LLPs have a lot more in common – to the extent that my objections to s.4(4) LLPA 2000 would probably not apply within Scotland and the two are essentially the same for legal purposes (although see the *Fife County Council* case in note 21 within chapter 2 section 1 above) . I will have a quick look at Scottish partnerships in relation to LLPs, along with the position in some other countries.

Section 1: Scotland

Thanks to s.4(2) Partnership Act 1890 (the default governing Act for partnerships lacking a partnership agreement) a general partnership in Scotland is a separate legal entity – it is a 'firm' with the partners legally having a share in the partnership itself with its own identity and which can enter contracts in its own name, sue and be sued etc. In all other respects it is the same to its English, Welsh and Northern Irish counterparts (i.e. transparent for tax purposes and with unlimited liability for the partners).

In many ways therefore the introduction of the LLP made little difference north of the border other than providing partners with some limited liability – the major change which English, Welsh and Northern Irish businesses faced was much more radical i.e. the separate legal personality. The s.4(4) test, i.e. the comparison between LLPs and general partnerships, is therefore potentially a bit more feasible and reasonable when considered in light of the Scottish partnership. However it does not alter the fact that Scottish partnerships are still

transparent for tax purposes in exactly the same way as English partnerships and that a partner in a partnership (be it English or Scottish) or an LLP cannot be an employee of himself as a matter of legal principle.

Interestingly, the Law Commission report of November 2003 recommended that all (both Scottish and non-Scottish) partnerships be given a separate legal identity (though as a *sui generis* entity rather than a body corporate). The execution of this suggestion might certainly solve a lot of issues, i.e. those surrounding my objections to the s.4(4) test which currently compares incomparable entities and potentially the ability of partners to hold officer/employee positions as well as being partners from a legal perspective; and also allowing the LLP and limited liability to slot in nicely amongst the general partnership (unlimited liability) and the limited partnership (some liability for non-active partners).

Section 2: USA

As a common law country the USA is an interesting one to look at when comparing the UK LLP.

The USA has two main sorts of partnership – the Limited Liability Company (sic) ('LLC') and the Limited Liability Partnership ('LLP').

The LLC

The LLC is a lot like the UK LLP insofar as it is essentially a company but taxed as a partnership. All fifty states allow LLCs (Wyoming being the first the define them in 1977). Its members have limited liability (though Connecticut has stated that members can be personally liable[36]) and it is treated as a separate entity though it is not a corporation so there are no regulatory requirements; instead it

[36] *Sturm v. Harb Development* 298 Conn 124 2 A 3d 859 (2010)

is an unincorporated association with members having joint and several liability for each others' actions which is obviously a major difference to the UK LLP.

In some states, medical and legal professionals (indeed anyone needing a licence to practise) are barred from forming LLC's – rather they need to form 'Professional LLCs – or PCs'. Also the tax treatment can be like UK partnerships in that it is 'transparent' i.e. the partners as taxed on their share of the profits as they arise.

The standard is actually for the LLC to be treated as a 'C Corp' – an opaque corporation whereby the profits are taxed within the firm to corporation tax and dividends then taxed separately on the members.

However an LLC can elect to be an 'S Corp' giving the transparent treatment for tax purposes, though for HMRC purposes LLCs remain 'opaque' (i.e. members subject to UK tax are only taxed upon what they withdraw from the company and their profit share is treated as a dividend). Cases such as *HMRC v. George Anson*[37] and *Swift v. HMRC*[38] concern the UK-US double tax treaty. The US LLC, whilst potentially see-through for US tax purposes and whose members are thus taxed on their profit share, is opaque in the eyes of HMRC and so that same profit share in the USA is a dividend in the UK – and so the profits of the LLC and monies in the hands of the partner are not the same profits under the treaty.

The US LLP

The US LLP is very similar to the UK LLP in that it is also a transparent entity for tax purposes with members being protected from the liability of the other

[37] [2011] UKUT 318
[38] [2010] UKFTT 88

members. Also similar was the slow acceptance of the idea; in 1992 only two states allowed LLPs, but by the passing of the Uniform Partnership Act 1996 forty states had permitted them. Like in the UK the LLP has found favour with the professions, indeed in some states (California, New York, Oregon and Nevada) only professional practices can operate via an LLP.

However a major difference between the UK and US LLPs concerns liability. Degrees of liability with US LLPs can vary from state to state – in the majority of cases the protection of full liability is given but in some cases liability protection only extends to negligence claims and vicarious liability. Also, in a US LLP at least one managing partner must retain personal liability for the LLP's actions; in this sense it is identical to a UK LP rather than the LLP. Another notable difference is that unlike US LLCs and UK LLPs, US LLPs cannot have corporate owners.

Whilst comparisons between UK and US business entities are not entirely fair ones due to the federal nature of the USA, I believe one leaf the UK LLP could potentially take out of the US book is the ability to choose between opaque and transparent treatment like the LLC. If UK LLPs had the option whether or not to be transparent for tax purposes then that could potentially solve several of the anomalies such as BPR treatment for holding LLPs and indeed make the LLP more attractive to those businesses who 'recycle' a lot of their profits and keep them within the business rather than extract them (e.g. property development businesses). Geoffrey Morse in his preface to Palmers did compare the UK LLP to the US LLC (the two bear more similarities than that of the UK and US LLPs), so the comparison has clearly been considered before. One question this would

beg however is if an LLP becomes an opaque entity under such an election then the difference between the LLP and limited company would border on the non-existent, with the LLP losing its unique appeal. One answer would be that the ability for businesses to choose and that degree of flexibility might well be an attraction in itself.

Section 3: Germany

I thought it worth a quick look at a civil law country and how partnerships are treated there. In Germany there are three main relevant types of partnerships – none of which offer the uniform limited liability protection of the UK LLP.

There is the general partnership (*Offene Handelsgeschaft* – 'oHG') which equates to the English general partnership; the limited partnership (*Kommanditgesellschaft* – 'KG') which equates to the UK LP with a managing partner retaining full liability; and the Professional Limited Liability Partnership (*Partnerschaftsgesellschaft mit beschrankte Haftung*– 'PartGmbH') which is the closest to the UK LLP. Indeed the PartGmbH, introduced in 2012, is seen in Germany as a direct competitor to the LLP which was causing several businesses to form in UK as LLPs[39]. Whilst partners' liability is limited only to firm debts, the PartGmbH is exclusively for certain professionals and is able to hold property and sue (and be sued).

The single thing that all these German partnerships have in common is that none of them are separate corporate entities and all of them are taxed as transparent entities; although partnerships also have to pay a separate *Gewerbsteur* ('trade tax') on profits of 3.5% over EUR24,500 for which partners receive a credit for their personal tax.

[39] According to an article in 'Haufe.de/Recht' 19 May 2012

On the face of it there is no entity in Germany which is on the same footing as the UK LLP – indeed the LP is much more relevant. Whilst the PartGmbH comes the closest they have, it could be said that Germany is what the UK was prior to 2000 – if a partnership wanted anything other than uniform limited liability for all but the managing partner, the limited company was the main option – this is the only route in Germany currently.

Chapter 5. Conclusion

The question posed was: what does the future hold for the LLP in light of recent changes to the UK tax law?

The answer in short, I believe, is that the LLP will continue to thrive simply because of their versatility and utility, along with the fact that they give firms the protection of a company without actually having to become a company.

The changes which were discussed in chapter 2 are probably the most significant in the LLP's short history. Having had this 'bedding-in' period, the government have recognised that the utility of the LLP is such that it is open to abuse; and even perfectly-legal avoidance, and so with this in mind the loopholes have been closed and the whole structure tightened up. In many ways the LLP had become too popular and was running a bit too well; it was allowing employees to be re-badged as members thus costing HMRC employers' NIC, and shareholders to extract funds from companies via a membership in an LLP. It even allowed complex tax avoidance schemes to be operated through them. The LLP has been a victim of its own success as these recent reforms, in an ideal world, should not have been required. But the LLP is not dead nor is it likely to become so. The LLP remains the vehicle of choice for most professional firms, and having got over the shock of former partnerships having to file accounts, the initial reservations seem to have been unfounded. As Scott Barnes, (soon to be former) CEO of Grant Thornton put it:

> *"It just becomes part of the DNA that you file accounts and become a public interest entity[40]"*

[40] Quoted in Nick Huber's article 'Has LLP status worked?' – AccountancyAge 22 March 2014

The reforms themselves, as outlined in chapter 2, in my view do not (or certainly should not) cause LLPs to be discarded as a choice of business vehicle. Those firms who have been using corporate members to extract funds and those re-badging senior employees as members who do the very same job the following day probably would have cause for concern – but even then the situation could be easily remedied. Partnerships generally will always be a popular business structure for the professions. Jonathan Fox, managing partner at Saffery Champness states[41]:

> *"A partnership between like-minded individuals who recognise that they are all dependant on each one another….it promotes congeniality and a shared sense of direction that I know, having worked in much larger 'corporate' and structured professional services firms, can be lacking"*

Interestingly Saffrey Champness is one of the few top accountancy firms which has remained as a general unlimited partnership. However Mr Fox's comments are just as applicable to the LLP, the only difference being that there is a greater degree of protection; but the sentiment behind his comments would most probably be echoed by many others who would demur from becoming a limited company; the LLP is the perfect compromise.

Turning back to the disguised salary and 'employed member' point again. Section 4(4) LLPA 2000 is a flawed piece of legislation. The fact that senior judges have had to clarify its meaning is a poor start – the legislation should be made clearer and unambiguous. However the reason why it is flawed currently is because it applies a test to LLPs against general partnerships – two completely different entities in the eyes of the law. Despite the identical tax

[41] Ibid

treatment an LLP is a body corporate whilst (excluding Scotland) a general partnership is not – and that is a fundamental difference. The changes to s.863 ITTIOA have, in many ways, taken away the significance of s.4(4) – which is a good thing. LLPs now have their own piece of legislation which gives specific boundaries and some certainty for LLP members only as to their tax status. The introduction of the LLP caused partnership tax and partnership law to face each other for the first time. Prior to this they were kept apart but with the hybrid structure of the LLP the both rules have had to sit together; so the questions surrounding the legal employment status of members was bound to seep over into the tax status of members. The recent changes address this seepage into the tax realm, thus allowing the courts to deal with the employment and pension laws regarding the other aspects. However, many of these anomalies could be eradicated altogether.

I do believe that if an LLP were treated as a body corporate and separate entity to the extent that members could indeed take out service contracts with their LLPs (just as shareholders take out directorships with their companies) then all the uncertainties emerging from *Winkelhof* et al could be set aside. The next question could then be whether the LLP should be opaque like a company, profits taxed under corporation tax with members' drawings being replaced with dividends taxed only upon withdrawal. This may cause extra doubt to be cast upon the LLP as this 'double taxation' issue is often one which puts many businesses off incorporating. It may start people questioning the difference between the limited company and the LLP at all. For income and capital gains tax purposes the LLP could still remain transparent – the only change could be to confirm the LLP's status of being a body corporate to allow a member to also be an employee. However, if the UK LLP were to adopt the option open to the

US LLC and allow members to choose whether their LLP is to be taxed as an opaque or transparent entity (and allow that election to be revocable maybe after a number of years) then interest in LLPs could potentially increase further within certain businesses with that extra flexibility built in compared to the limited company.

Having an LLP confirmed as a body corporate in a more consistent manner might also help resolve the anomalies and inconsistencies outlined in chapter 3 – or at the very least give HMRC fewer reasons to deny LLPs their status as a body corporate for group loss relief (along with capital loss relief) along with denying BPR to the members of ‘holding LLPs’. The LLP is equated to a company for some tax purposes but not others, there needs to be some consistency; either the company and LLP are both bodies corporate or they are not. Denying BPR to members of ‘holding LLPs’ seems particularly harsh and unjustifiable when considering the same relief is available to company shareholders in an identical position.

The tax transparency which gives the LLP its unique edge would not be effected by that at all. An election to become an opaque entity might well do that, but the fact that the choice is available when it is not to companies or general partnerships makes the LLP just as unique.

The LLP has a good future, a solid base of support within the accountancy and legal professions in particular and these recent reforms are unlikely to change that. However the limited company will always have its appeal and unique features even if my suggestions were made real. The company remains the ultimate tried-and-tested separate legal entity and body corporate; the LLP will never be the same and nor should it be as the company will not suit every

business and the flexibility of a tax-transparent entity will remain in great demand. No doubt some businesses (and even LLPs) will have incorporated to avoid the hassle and extra care required as a result of these changes – but hassle is all they will cause. The ability for firms to have a loose partnership structure of like-minded individuals but with the benefit of limited liability means that the LLP will always be in demand. I do think that if the LLP could be more of a body corporate with members able to be officer/employees as well, with full parity with companies concerning BPR and group reliefs and maybe even the option to have the firm's profits taxed under corporation tax when desired then the LLP could even become the dominant business vehicle and complete the revolution.

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