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Structuring a law firm: what does it actually mean to be an LLP?

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What are the pros and cons of using a limited liability partnership structure?
For lawyers looking at how to practice and on the assumption that they would like to operate with a likely limit on their personal liabilities, there are two main options: the limited liability partnership (LLP) or a limited company. Both are now well established business vehicles, so which option should be used?

Both are reasonably easy to establish, both provide a level of limited liability and both are separate legal entities distinct from their owners. An LLP is perhaps somewhat more flexible in ownership terms as the rights to income and capital can be adjusted reasonably easily and new partners can be admitted or existing ones removed with relative ease. In a company, the shareholders have a fixed shareholding. Convertible shares or options may provide some flexibility but essentially, the share ownership structure is fixed. Additional members can be admitted by issuing new shares or via the sale of shares by existing members. Retiring partners may have their shares purchased by the company or its shareholders.

Remuneration
In a basic LLP it is likely that the members will be worker/owners and therefore they will receive a share of the profits as one amount. Conversely, in a company the worker/owner may receive income as an employee of the company (the day job) plus a dividend to reflect his or her ownership interest, a return on the capital invested and a return for the level of investment risk assumed. This distinction in a company can be especially useful if outside or relatively passive shareholders are involved as they get no day-job income, merely a dividend related to the level of investment made. This makes a clear distinction between the two types of return which are, in effect, bundled in an LLP.

Tax
Inevitably, no structure can be considered without considering the tax implications. An LLP is effectively tax transparent; ie the member's share of the LLP's profits are taxable in the hands of the member whether those profits have been distributed to him or not. In a company, the profits are taxed at 20% (reducing to 19% from 1 April 2017 and 17% from 1 April 2020) and, as a general rule, only taxable in the hands of the member when distributed. There are other key differences:

• Income paid to an employee of a company by way of salary is subject to Employers National Insurance Contributions (NIC) of 13.8% on any amount above £8,112 per annum.

• Employee NIC contributions peak at 12% before reducing to 2% over £42,385 whereas self-employed (ie LLP member) class 4 NICs peak at 9% before reducing to 2% over £42,385 (Class 2 NIC will be abolished in 2018 but the amount of these is immaterial).

• Profits retained in a company are only taxed at 20% whereas profits retained in an LLP will be taxed at the partner's highest marginal tax rate (up to 45% plus 2% class 4 NIC).

• Non-deductible expenses, including such items as business entertainment, are effectively taxed at 20% in a company but at the partner's highest marginal rate in an LLP.

• A shareholder owning 5% or more of a company, subject to certain conditions, can sell his or her shares and benefit from entrepreneur's relief (ER) on the first £10m of any gain on which the capital gains tax rate will be 10%. ER may also be available for an interest in an LLP, subject to certain conditions. It should be noted that the £10m ER limit is a lifetime amount and any amounts previously utilised will affect the remaining amount available. As a result of changes announced in the 2016 Budget, all external investors in an unlisted trading company will be subject to capital gains tax at 10% on shares purchased after 17 March 2016 that are held by individuals for at least three years from 6 April 2016.

• For inheritance tax purposes, subject to certain conditions, shares in an unquoted company or an interest in an LLP can benefit from business property relief (BPR) of 100%. BPR at 50% may also be due on personally owned assets used for the purposes of the business carried on by the company or partnership.

• Investment in a company, subject to certain conditions, can qualify for Enterprise Investment Scheme (EIS) relief or Seed Enterprise Investment Scheme (SEIS) relief. These reliefs are not available for investments in an LLP. Certain activities are excluded from qualifying for SEIS/EIS and this includes the provision of legal services.

This produces a potentially bewildering range of factors that participants may need to consider when devising the right structure for their business.

If owners are to receive a total income of less than approximately £55,000 it is almost always more tax efficient to use a company. Although the balance of income taken via employment or dividends will also impact the overall tax rate.

Clearly, a myriad of variables will complicate the picture. If a significant level of retained earnings are needed in the business, this will tend to make a company more attractive. Similarly, a high level of non-deductible expenses will tend to make a company more attractive. The use of passive shareholders may also encourage the use of a company. However, the flexibility of an LLP may also appeal as it tends to be easier to change ownership and profit-sharing interests in an LLP than in a company. The LLP also seeks to replicate a partnership structure and some professionals feel more comfortable with this approach. Depending upon an owner's other interests, the tax transparency of an LLP may also be appealing. Unfortunately, the tax goalposts keep changing, recently including the level of corporation tax and the tax payable on dividends.

In the absence of other special factors, currently the higher the level of earnings derived from the business, the more appealing the LLP. However, when considering the right structure to use, owners need to consider not just the current impact on earnings from the business but the possibility of other owners joining or leaving the business and even a possible sale of the business. This can make the decision much more nuanced, as reflected by the changes announced by the Chancellor in his 2016 Budget.

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