Undergoing conversion

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discusses the various taxation issues that can arise when a partnership changes to a limited liability partnership.

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Limited liability partnerships (LLPs) have been around for almost 16 years now. In many cases unincorporated partnerships that wished to convert have already done so, but there is still a steady trickle of conversions, with the clear driver in most cases being the limited liability available through an LLP.

As a general rule, LLPs are, of course, taxed in the same way as unincorporated partnerships and the conversion from one to the other will, in most cases, be straightforward. However, an LLP is a separate legal entity. In some respects, the tax rules that govern these are subtly different from those that govern unincorporated partnerships – and for both these reasons there are various issues to consider, as well as some traps for the unwary.

This article discusses the most significant tax issues that might arise when a partnership is converted into an LLP. Naturally, every situation is different and due consideration should be given to the specific facts and circumstances. The various legal and administrative issues that will need to be dealt with as part of any conversion are not discussed here.

Income tax

For income tax purposes, ITTOIA 2005, s 848 provides that a partnership is not, unless otherwise indicated, regarded as an entity separate and distinct from the partners. ITTOIA 2005, s 863 provides that if an LLP carries on a trade, profession or business with a view to profit it is regarded for income tax purposes as if it were a partnership.

Therefore, when a partner carries on a trade through a partnership and then, without pausing for breath, starts to carry on the same trade through an LLP, they are regarded for income tax purposes as continuing to carry on the same trade. There will be no cessation or commencement of trade and, as long as the accounting reference date does not change, there will be no impact on overlap profits. Capital allowances will continue to be given on qualifying assets as if nothing had occurred.

There are, however, some complications that can arise where things are not so straightforward.

A partnership is defined as the relationship between 'persons carrying on a business in common with a view of profit', whereas an LLP can be formed by any two or more persons regardless of what they are planning to do together (if anything).

When the business of a genuine partnership is transferred into an LLP, the latter should always be transparent for tax purposes because it should by definition meet the requirement in ITTOIA 2005, s 863 to be carrying on a trade, profession or business with a view to profit.

However, two or more individuals who come together to hold investments may regard themselves as being in partnership, even if technically they are not doing enough to be regarded as carrying on a 'business'. For tax purposes, the issue of whether these individuals are in partnership may not be particularly important because in either case they are likely to be taxed on their share of the investment income. However, if these individuals were to transfer their activity into an LLP, they could be surprised to find that this is not transparent and is, instead, subject to corporation tax on its income.

It should perhaps go without saying that, before conversion, it would be well to check that the LLP will in fact be carrying on some kind of business with a view to profit.

KEY POINTS

- An LLP is a separate legal entity and there is a subtle difference in the tax rules compared with unincorporated partnerships.
- If the same trade continues through a partnership and then an LLP, they are regarded as the same for income tax purposes.
- A partnership must carry on a business with a view of profit' but an LLP can be formed for any or no purpose.
- A member of an LLP can be treated as an employee for tax purposes if specific rules in ITTOIA 2005 are met.
- VAT and stamp duty land tax issues can also arise on a change of format.

Salaried members

The next complication to mention is that the 'salaried member rules', which were introduced from 6 April 2014 (ITTOIA 2005, s 863A to s 863G), relate to LLPs only and not to unincorporated partnerships.

Whether an individual who purports to be a partner in an unincorporated partnership is to be treated as an employee – and therefore subject to PAYE and class 1 National Insurance contributions – is determined using tests based on case law. By contrast, a member of an LLP is treated as an employee for tax purposes if the specific rules in ITTOIA 2005, s 863A to s 863G apply. These rules contain three tests, relating to:

- the proportion of a member's expected profit share that is not variable with reference to the results of the LLP as a whole;
- whether the member has 'significant influence' over the affairs of the LLP; and
- the member's capital contribution to the LLP.

These tests are completely different from the usual case law principles. It is perfectly possible that, after conversion, a partner could – without any change to the partnership arrangements – find that he is now a 'salaried member' and taxable as an employee.

The final complication to note at this stage arises in situations where the whole of the business of the partnership is not transferred into the LLP. This may occur, for example, because it is not possible to agree that all client relationships can be transferred. If some part of the activity is not transferred, HMRC's guidance in the *Business Income Manual* (at BIM82125) states that the tax treatment depends on whether – as a question of fact – the 'business carried on by the LLP is recognisably the business previously carried on by the old partnership'. If it is, there will be no cessation in the partnership and no commencement in the LLP (although there will be a commencement in the partnership because it is regarded as beginning to carry on the activity that was left behind as a new activity). If the LLP has not taken on 'the business', there will be a cessation and a commencement, bringing with it all the consequent implications for losses, overlap profits, and capital allowances. There will be cases where, in practice, it is not clear whether the activity that has been transferred is sufficient to be regarded as 'the business'.

Interest and borrowings

Considering income tax more broadly, many partners borrow to invest in their partnership and are able to obtain tax relief for the interest they pay in accordance with the provisions of ITA 2007, s 383 and s 398. For practical purposes, the rules relating to loans taken out to invest in an LLP are the same as those that apply to partnerships.

HMRC has confirmed in its guidance (at BIM82130) that, on conversion from a partnership to an LLP, 'there is no event causing statutory relief to be withdrawn, and existing relief continues undisturbed providing the partner/member continues to meet the qualifying conditions'.

For completeness, it is worth noting that there is a specific statutory provision at ITA 2007, s 409 which, under particular conditions, allows interest relief to continue when a business transfers from one partnership to another. For those who do not like to rely on HMRC's guidance, this provision will provide certainty of this treatment in some cases. However, the conditions will not be met in other cases (for example, when the old partnership is not dissolved) and so reliance on HMRC's guidance may be required.

Loss relief

The final point to make on income tax is that rules relating to sideways loss relief differ as between trading losses of a partnership and those of an LLP.

Most significantly, losses relating to a trade (but not a profession) carried on by an LLP can only be offset against other income to the extent of the member's interest in the LLP; if this issue is not flagged before the conversion, an LLP member could get a nasty surprise.

Capital gains tax

A partnership is transparent for capital gains tax purposes under TCGA 1992, s 59. Further, TCGA 1992, s 59A complements this by, in essence, treating an LLP that carries on a trade or business with a view to profit as if it were a partnership for capital gains tax purposes. The provisions of Statement of Practice D12 apply to LLPs that are 'fiscally transparent' in the same way as they do to partnerships.

Therefore, a partner with an entitlement to 20% of partnership assets, who on conversion has an entitlement to 20% of the same assets through an LLP, will not be regarded as having made any acquisition or disposal for capital gains tax.

The conversion of a partnership to an LLP might take place at the end of an accounting period, with retirements and appointments of members taking place at the same time. In this case, disposals for capital gains tax could arise at the time of conversion, but the effects of these should be the same as those that would have arisen had the business continued through the old partnership.

If a partner in a partnership, or a member of an LLP, disposes of their interest in the partnership or LLP such that a capital gain does arise, entrepreneurs' relief may be available if the 'business' has been owned throughout the one year ending with the disposal. In light of TCGA 1992, s 59 and s 59A, a member will be regarded as continuing the same business on conversion of an unincorporated partnership to an LLP and, accordingly, a conversion should not interrupt the one-year qualifying period.

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Other tax issues

Stamp duty land tax (or the Scottish land and buildings transaction tax, which is not specifically considered in this article) should also be considered if the partnership owns any UK land or buildings. FA 2003, s 65 allows the transfer of a chargeable interest to an LLP to be exempt from charge if:

- the transfer is made in connection with the incorporation of the LLP and takes place not more than one year after the incorporation;
- there is complete identity between the partners of the partnership and the members of the LLP;
- the ownership proportions in the partnership and LLP are the same or, if they are not exactly the same, the difference is not due to tax avoidance reasons.

The second of the above requirements can be problematic, particularly if the conversion is to take place at the same time as retirements and appointments of partnership members. If FA 2003, s 65 does not apply, the provisions of FA 2003, Sch 15 should instead apply so that SDLT would arise on the market value of the portion of the chargeable interest that ultimately changes hands. Careful planning may be required to ensure that s 65 applies wherever practically possible.

VAT and other issues

VAT and employment taxes will both need to be considered, but in most cases these should simply give rise to a few administrative requirements and nothing more.

On VAT, since the business is being transferred to a separate legal entity consideration will need to be given as to whether the conversion is a transfer of a going concern. This should generally be the case as long as a fully viable and operational business is being transferred directly to the LLP. However, vigilance is advised if any changes in the nature of the business, or any break in the business, are proposed. Care will also be required if any properties are being transferred as part of the conversion. When there is a transfer of a going concern, the transfer will be outside the scope of VAT and, if desired, the VAT registration of the partnership can be transferred to the LLP.

From an employment tax point of view, the procedures in the Transfer of Undertakings (Protection of Employment) Regulations 1981 (TUPE) must be followed on the transfer of staff from the partnership to the LLP, which itself will need to obtain a new PAYE reference. In almost all cases, however, the LLP will be able to pick up where the partnership left off, taking on the records of the partnership and dealing with the year-end requirements for the whole of the tax year in which the transfer took place.

Inheritance tax

On inheritance tax, business property relief can be available on the transfer of an interest in a partnership or an LLP. To qualify for this, one requirement is that the interest must have been owned by the transferor throughout the two years immediately preceding the transfer. HMRC has confirmed (in the *Inheritance Tax Manual* at IHTM25094) that the period of ownership will not be regarded as having been interrupted when a business is transferred from a partnership to an LLP.

Self-assessment and more

On the incorporation of a new LLP, a new self-assessment record will be set up automatically in HMRC's records. By default, the LLP will thus have a separate tax reference from that of the existing partnership. However, HMRC will allow the tax reference of a partnership to be transferred to the LLP, such that one single partnership return will be prepared and submitted for the year of the conversion. This approach is likely to make sense in most cases, although clearly the nominated partner should be prepared to contact HMRC quickly – and to go through a little bit of hassle – to ensure that the Revenue properly updates its records.

During the conversion process, the business is likely to incur various professional fees. Some of these – such as those for assisting in preparing the new LLP agreement and the business transfer agreement – are likely to be capital in nature and may well be disallowable.

Having now considered almost all aspects of the UK tax regime, it is clear that conversion from a partnership to an LLP needs at least some consideration. Although in most cases the transfer should be fairly seamless from a tax point of view, it cannot be assumed that this will automatically be the case. ■

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