The taxation of individual members of UK limited liability partnerships

Partnerships are very flexible entities from a tax perspective. If the profits of a business are to be paid in full to the proprietors, a partnership usually results in a lower overall tax burden compared with a corporate entity. Fewer tax issues arise when a new partner is introduced, or an existing partner retires, compared with the introduction or exit of an individual (as a shareholder) who is a director or an employee of the corporate entity. A limited liability partnership (LLP) combines these tax benefits with the commercial benefit of limited liability.

This factsheet outlines the main tax considerations for individuals who are partners (or members) of LLPs.

Registration of self-employed status
Members of an LLP are taxed as partners in a partnership and are treated as being self-employed. Each member must register with HM Revenue & Customs (HMRC) as self-employed within three months of being admitted as a member of an LLP using form SA401.

Income tax
Individual members of an LLP are liable to income tax on their share of the profits of the LLP, as calculated for tax purposes. The rate at which income tax is payable depends on the individual’s total income and the allowances and reliefs available to them.

For each income tax year (the year ending 5 April), the taxable profit of a trading LLP is calculated by reference to the accounts profit for the accounting year ending in the tax year. For example, if an LLP’s accounting year end is 31 December, the profit for the year ended 31 December 2017 is taxable in the tax year to 5 April 2018. In arriving at the taxable profit, the accounting profit is adjusted for certain items (such as depreciation and capital allowances). The LLP’s tax return shows the calculation of those taxable profits and the allocation of them between its members in accordance with the partnership agreement.

Income tax (on income) is generally payable in instalments with an amount equal to 50% of the prior year’s income tax liability payable on 31 January during the tax year and a further 50% on 31 July following the end of the tax year. A balancing payment may also be due on 31 January after the tax year if the instalment payments prove to be less than the actual liability for the year. Surcharges and interest can apply in respect of late payments.

Tax payments need to be budgeted for. If drawings are taken by members on a periodic (e.g. monthly) basis, the LLP may decide to operate a tax withholding arrangement to retain sufficient funds to pay the members’ tax bills.

Basis period rules
As noted above, for any given tax year, the trading profit arising is calculated by reference to the accounting year ending in the tax year. However, special rules apply on the commencement of a business (or where a new member joins an LLP) and on cessation of a business (or where a member leaves an LLP).

The operation of the opening year rules can lead to profits that are subject to tax twice. However, these profits will be carried forward as ‘overlap’ profits and relief can be claimed for them in the closing year of the business (or where a member leaves the LLP). However, this can create funding issues which need to be managed.

Non-trading income
The non-trading income of a trading LLP which is received without the deduction of tax (for example, rental income) is taxed in the same way as trading income. Investment income which is received (or treated as received) under the deduction of tax, together with dividends, is taxed by reference to the tax year in which it arises; this may require income included in accounts prepared to a date other than 5 April to be apportioned between the tax years concerned.
Members’ personal expenses
Generally, for expenses paid personally by members for the purposes of the trade to be tax deductible they have to be incurred ‘wholly and exclusively’ for business purposes. As HMRC will not accept supplementary claims for such expenses (or, if applicable, capital allowances) in an individual’s self-assessment personal tax return, any business expenses incurred personally by a member must be adjusted in the tax computation of the partnership before apportioning the net profit between the members.

National Insurance Contributions (NICs)
Individual members are regarded as self-employed for NIC purposes and therefore pay Class 2 and Class 4 NICs. For 2018/19, the Class 2 contribution is £2.95 per week and the Class 4 contribution is 9% of taxable trading profits between £8,424 and £46,350 plus 2% of the excess. Class 2 and 4 NICs are payable at the same time and on the same basis as income tax. The opening and closing year rules for income tax mentioned above also apply for class 4 NIC. Class 2 contributions are to be abolished from April 2019.

Losses
If tax losses are incurred in the trade of the LLP, these are allocated to the members in accordance with the partnership agreement. It should be noted that the losses that a member can offset against other income or gains are limited to an amount equal to their capital contribution to the partnership. Thus, if an individual makes a capital contribution to an LLP of £5,000, relief cannot be claimed for losses above this level. Loss relief is also restricted for non-active partners. Subject to these limitations, and the overall cap on sideways loss relief which has applied since 6 April 2013, partnership losses of any year attributed to an individual may be:
• offset against other income and gains of the individual of that year;
• carried back against income and gains of the prior year; and/or
• carried forward against the individual’s share of future profits of the same trade.

There are special rules for using losses in opening and closing years.

Special rules also apply to loss allocations to individuals, where they are members of mixed member partnerships (i.e. partnerships that include both individual and corporate members) and where there are arrangements in place that secure that losses are allocated to an individual rather than a non-individual member.

Where applicable, loss relief for the individual is restricted. Further information on mixed member partnerships is shown below.

Interest relief
Subject to the cap on tax reliefs, which has applied since 6 April 2013, members can claim tax relief for interest paid on borrowings to finance:
• the purchase of a share in an LLP; or
• a subscription of LLP capital; or
• the lending of money to an LLP if the funds are used wholly for the purposes of the LLP’s business, or
• the repayment of an existing loan taken out for any of the above purposes.

Tax relief for interest paid is proportionately restricted if the member receives, either directly or indirectly, a repayment of partnership capital (as defined) whether or not this repayment is used to repay the underlying loan.

Capital gains tax
Members are liable to UK taxation on their share of the realised gains of the LLP. To the extent that the LLP realises chargeable capital gains these are apportioned between members, who aggregate those gains with their other personal (i.e. non-LLP) capital gains and losses of the same tax year. Capital gains are taxed on an actual basis (i.e. on the basis of the gains made in each year ending 5 April), and capital gains tax is payable on 31 January following the end of the tax year. To ensure that no tax charge arises on a change in membership of the LLP there must be no revaluation of the partnership assets in the accounts and no value placed on transfers of interests in the capital profits of the LLP between members. This will require careful consideration before any changes are made.
**Mixed member partnerships**

In addition to the measures noted above in relation to losses, further rules apply to mixed member partnerships where excess profits are allocated to non-individual partners.

It is common for individuals to include companies of which they are shareholders in partnership arrangements. These rules were introduced to counter arrangements where it is considered that profits allocated to non-individual members exceed what is reasonable for the services/capital provided by the non-individual member, or where allocation to the individual member is deferred and either of these result in a tax saving (mainly because the current rate of corporation tax is significantly lower than the combined income tax and NIC rates).

Where the rules apply, the individual member’s taxable profit share can be increased.

Mixed member partnerships are also unable to benefit from the Annual Investment Allowance (AIA) for capital allowances purposes.

**Salaried members of LLPs**

There are also special rules that treat members as employees (for tax purposes only), if all of the conditions set out in the legislation are met. Where applicable, the effect is that the national insurance burden for both the individual and the LLP is increased, and PAYE also needs to be operated by the LLP on payments to the employee.

The above is a general guide to the taxation of individual members of a trading LLP who are resident and domiciled in the UK. Professional advice should always be sought in relation to the structuring of any business activity. Non-UK members may be subject to UK taxes and NICs and advice should be sought by them on their personal tax position.

For more information, please contact your usual Moore Stephens representative:

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