inbrief

LEWIS SILKIN

Converting to an LLP

Inside

Introduction

Originally conceived as a vehicle for use by professional practices to obtain the benefit of limited liability while retaining the tax advantages of a traditional partnership, limited liability partnerships (LLPs) have a far wider use as is evidenced by their increasing popularity as an alternative business vehicle in a wide range of sectors. Led by the conversion of the major accountancy practices and a significant number of law firms, many small owner managed limited companies have also decided to convert into LLPs.

This client guide considers the steps that need to be taken to convert an existing partnership or limited company into an LLP.

Key features of an LLP

A Limited Liability Partnership is a different legal structure to both a traditional partnership established under the Partnership Act 1890 and a limited partnership established under the Limited Partnerships Act 1907. In fact, as a general principle, partnership law does not apply to LLPs. However, an LLP has some of the characteristics of both a traditional partnership and a private limited company and in many ways can be described as a company on the outside and a partnership on the inside. Legally, it is defined as a body corporate with a legal personality separate from that of its members.

The key features of an LLP are:

- limited liability for its members;
- a separate legal entity;
- taxed as a partnership;
- organisational flexibility;
- any members' agreement is a confidential document;
- the accounting and filing requirements are essentially the same as those for a company.

The tax treatment of an LLP resembles that of a partnership rather than for that of a company and for this reason smaller owner managed limited companies have been attracted to the idea of converting to an LLP. Rather than being treated as employees, the members of an LLP are treated as self-employed for tax purposes. Consequently, income tax and national insurance contributions are payable on a member's share of profits and because such payments will not fall within the PAYE regime, the member's earnings will not be subject to employer's national insurance contributions. Therefore, key personnel within smaller owner managed businesses can be remunerated more tax efficiently. In addition, because an LLP is transparent for tax purposes, it is the members who pay income tax on their profit shares, the LLP does not pay any corporate tax on any profit it makes. An LLP will need to prepare an annual balance sheet and profit and loss account giving a true and fair view of its position in accordance with the Companies Act. This will involve complying with the applicable accounting standards issued by the Accounting Standards Board and with the Statement of Recommended Practice for LLPs. Partnerships do not have to necessarily comply with the same standards. It is therefore a good idea for partnerships which are thinking about converting to go through the exercise of producing accounts in the formats required for LLPs by the Companies Act and applicable accounting standards. Given that an LLP's accounts will be published at Companies House, the public (and therefore its clients and suppliers) will be able to form a view as to how strong an LLP's balance sheet is.

The conversion process

Although the process is referred to a conversion, it is actually the incorporation of a new entity which will be separate from the old partnership or limited company. This new entity, an LLP, will be incorporated at Companies House and the process will then involve transferring all or most of the existing business of the partnership or limited company to this new LLP.

The first step to take is to review the existing constitutional documents to check what kind of decision, if any, is required to transfer the business to an LLP. Will a majority vote be required? If so, what type of majority and which partners / shareholders will be entitled to vote? In the absence of such a provision, it is likely that a unanimous vote will be required for a partnership, in which case, it is important that all the partners of the partnership are in favour of the proposal to convert to an LLP. Depending on the size of the business, it may be important to manage the communication process carefully. Indeed, if the partnership is large, it may be advisable for management to conduct roadshows or presentations to partners to highlight the advantages and benefits of conversion in order to receive a positive vote for the conversion. This may be necessary in any event if the existing business has offices spread across a number of locations.

The communication process is also important as it will allow a partnership or company to deal with any objections to the conversion before significant time and money is spent. It is possible that disgruntled partners may see conversion as an opportunity to secure more favourable terms particularly if a unanimous vote is required. Should they decide to use any leverage to their own advantage, careful thought and planning will need to be given as to how best to deal with their concerns.

The second step will be to identify all the business' suppliers and customers and to assign or novate the existing contractual arrangements to the new entity. The following are the most important contractual relationships to consider:

Clients/Customers

Consider amending any existing terms of engagement so that it specifically provides that the services may be provided to a client by a successor LLP. Otherwise, the client engagement will have to be assigned or novated in favour of the LLP. The manner in which this is conducted will depend on the type of client retainer in place. Letters of notification will have to be prepared and sent to the clients and it is advisable that clients are given advanced notification in order to deal with any queries they may have.

Property - Landlord

Depending on the terms of the lease, it is normal to obtain the consent of the landlord to transfer the lease to the LLP. It is possible that a landlord may seek personal guarantees from the members. Any freehold property may have to be transferred to the LLP. Consideration needs to be given to securing the exemption from stamp duty and from stamp duty land tax on transfers of property from the partners of a partnership to an LLP.

Employees

The Transfer of Undertakings (Protection of Employment) Regulations, widely known as TUPE, apply on a conversion. This means that all employees will automatically transfer to the LLP and their employment contracts will not be taken to have terminated but will be deemed to have been made by the LLP. The employees' continuity of employment remains unaffected. It may be necessary to comply with the consultation requirements under the TUPE regulations. For firms where staff are employed by a service company, no change is necessary.

Banks

Bank accounts, overdrafts and banking facilities will have to be transferred to the LLP. This will require the consent of the bank and it is possible the bank may insist on ongoing personal guarantees from the members.

Annuitants

A partnership may have obligations to pay former partners annuities. If so, consideration will need to be given to whether the conversion to LLP will terminate the annuity which may involve a breach of contract. It is possible annuitants may not be prepared to accept the LLP in place of the partners and may insist on personal guarantees from the members of the LLP. From an accounting perspective, thought will also have to be given to the impact which the annuity liability will have on the LLP's balance sheet. Whereas a partnership can keep such liabilities off its balance sheet, LLP accounts have to comply with accounting principles as referred to above and therefore have to include such liabilities on their balance sheet.

Other Suppliers

Any contracts with important suppliers, such as IT providers, consultants, insurers, hire-purchase providers will need to be reviewed carefully to ascertain whether they need to be novated in favour of the LLP.

Main documentation

The main documentation required for a conversion is as follows: -

Transfer Agreement

This will document the transfer of the business of a partnership or limited company to the LLP. It will set out the assets and liabilities that are to be transferred to the LLP and will usually contain an indemnity from the LLP in favour of the partners of the transferring partnership or the transferring company against all the liabilities taken on by the LLP. In the case of a conversion from a partnership, typically no financial consideration will be provided for the contribution of assets to the LLP but the contractual requirement for consideration in the transfer agreement will be fulfilled by:

i. the LLP's agreement to procure that each partner becomes a member of the LLP;

ii. the LLP's agreement to credit certain accounts maintained by the LLP for partners in their capacity as members of the LLP.

In the case of a conversion from a limited company, the company will often contribute its business in consideration for its appointment as a member and the crediting to its capital account with the LLP of an amount representing the value of the business.

LLP Agreement

The terms of the existing partnership agreement will have to be redrafted as an LLP Agreement. In relation to companies converting to an LLP, a review of the company's articles of association and/or shareholders' agreement will be necessary in order to ascertain which provisions will be retained in the LLP Agreement. Existing arrangements (whether for a partnership or company) will most likely form the basis of the LLP Agreement. Like a partnership agreement, an LLP Agreement is a private document, and it need not be filed at Companies House. It is important that the LLP Agreement is comprehensive and properly drafted as otherwise the default provisions prescribed by law will take effect which may lead to unintended consequences, for instance that all members will share equally in the capital and profits of the LLP. Although an existing partnership agreement will provide a useful starting point for an LLP Agreement, there are significant differences between the two types of agreement. The main fundamental difference is that whereas a partnership agreement deals with the relationship between individual partners, the LLP Agreement will cover not only the relationship between individual members, but also the relationship between the members and the LLP itself.

Conclusion

When LLPs were first introduced, it was said that the price for limited liability for LLPs is the requirement of disclosure of financial information. For anyone operating as a company, this will make little practical difference. In an age of increasing transparency, many partnerships already disclose some financial information. Initially, the process of converting was often seen as being too lengthy and expensive. Several years on from the birth of LLPs the process of converting has become more streamlined (with a commensurate saving on costs) and, more importantly, LLPs are now widely accepted as credible business vehicle.

For further information on this subject please contact:

Fergus Payne
Partner
T + 44 (0) 20 7074 8005
fergus.payne@lewissilkin.com

Clive Greenwood
Partner
T + 44 (0) 20 7074 8007
clive.greenwood@lewissilkin.com