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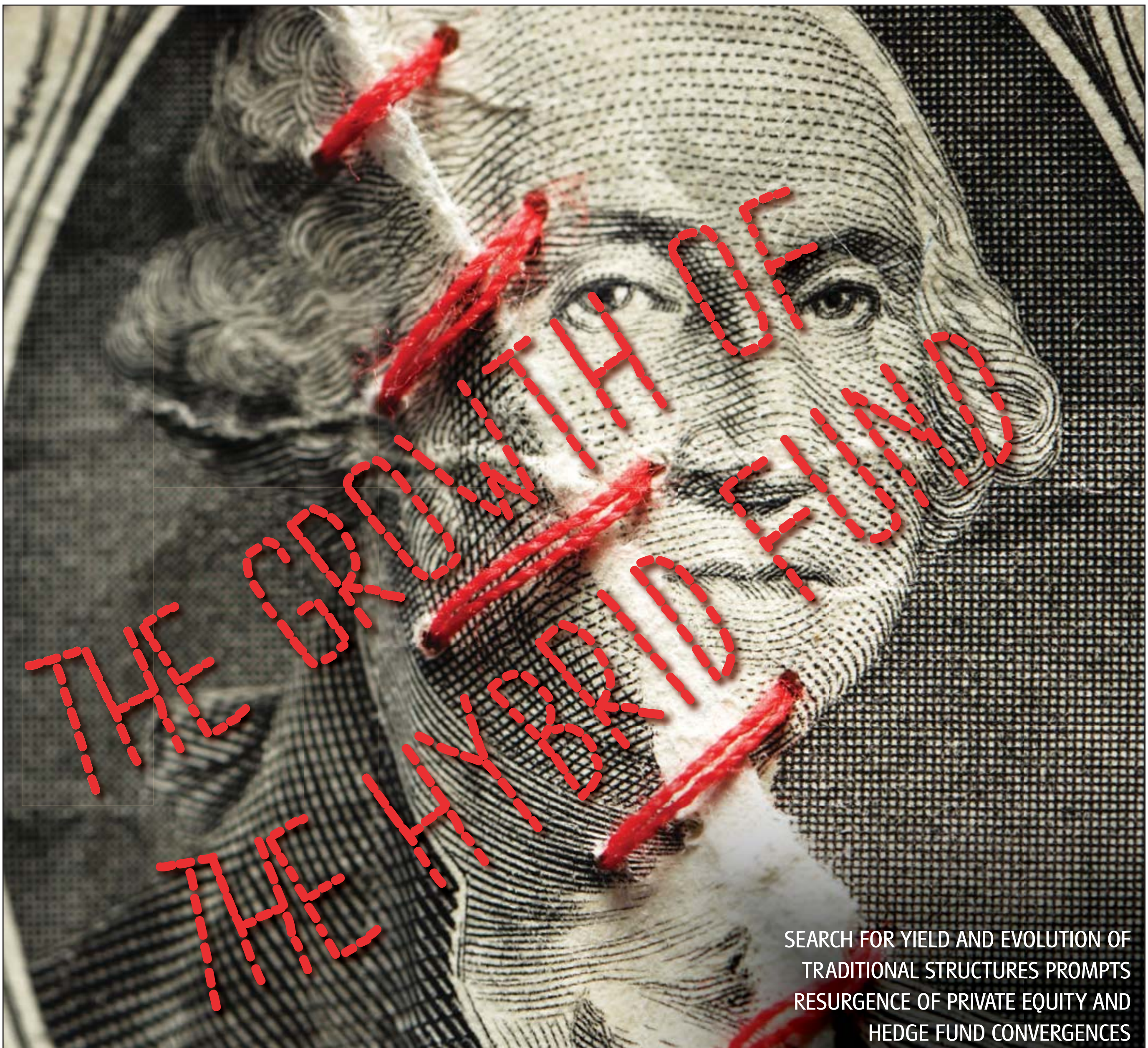

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STRUCTURING FOR SUCCESS: LLP OR LTD?

By Neil Simpson, partner, Haysmacintyre

The first requirement of the hedge fund business structure is limited liability. Without this protection many businesses would not assume the commercial risks of failure and it is little wonder that the LLP has been the more popular structure in recent years.

The choice of structure is essentially a binary one: an LLP or a Limited Company. In terms of hedge fund business success the structure needs to be both flexible and tax efficient, but choosing between an LLP or Limited Company structure is not as clear cut as one might assume

Both are corporate bodies and provide limited liability to their members or shareholders. Significantly, the LLP has no share capital or capital maintenance requirements and it is this that makes it the more flexible (and potentially attractive) structure.

The profits of an LLP may be allocated on a wholly discretionary basis, while the allocation of profit by a Limited Company is necessarily constrained by the fixed shareholding percentages held by the owners (although this can be overcome by arranging for different classes of share, so-called alphabet share arrangements, to target profit distributions to individual shareholders).

Making distributions is a further area of flexibility for the LLP. Subject to the cash being available, the LLP may freely distribute profits, advance loans and return capital with minimum formality. The Limited Company, subject to capital maintenance rules, requires available reserves to distribute and must meet restrictive company law requirements in making loans and returning share capital whether by way of share buyback or liquidation.

A further flexibility available to the LLP, is the ease with which new members may be admitted (and removed). This flexibility may be compared with the relative difficulty in introducing new members in a Limited Company (in funding the acquisition of shares or in dilution of other shareholders interests) and of removing director shareholders and in recovering their shares (employment rights, valuation and funding the purchase of the departing shareholder's shares).

Most significantly, the above flexibility is available to the LLP on a tax neutral basis. The distribution of profits, the return of capital, the introduction and removal of members may all be achieved without tax costs for the LLP or its members. By comparison, the payment of dividends, the return of capital, the transfer of shares between members and the admission of new shareholders on favourable terms are all occasions of potential tax charge to shareholders. On the face of it, the LLP is more flexible and outperforms the Limited Company in tax efficiency.

But the LLP's apparent tax efficiency comes at a price. It's described as a partnership not because of its company law status but because it is treated as a partnership for tax purposes. Therefore its profits are charged directly on its partners as they arise and irrespective of whether the profits are distributed or retained in the business. If profits are taxed on the partners on an arising basis and at their marginal rate of income tax (which may be 47% for an additional rate tax payer) their subsequent distribution has no tax significance. Hence the apparent tax efficiency.

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A Limited Company pays corporation tax at a rate of 20% on its profits with no further tax charge on the shareholders until those profits are distributed as dividends or returned on liquidation. It offers a material tax deferral of as much as 27% where shareholders are taxed at the additional rate.

The LLP has been the business model of choice in recent times: this is largely because the impact of the arising basis might be avoided by adopting a hybrid structure (by arranging for a share of profit to be allocated to an individual member's Limited Company). Such structuring is now ineffective for tax purposes.

So when deciding between two structures, there is no longer a "correct" answer. Much will depend upon individual circumstances and may extend to such "soft" benefits as to whether a partnership or corporate ethos better reflects the relationship between the owners. ■