Lambert Chapman
Chartered Accountants

The tax system for partnerships

Registering with HMRC

If you form a partnership to carry on a business, you must register it separately with HMRC even if the partners have previously been self-employed. If the partners are new to business, they must also register individually. Registration for both partnerships and individual partners is now done online.

As a partner in a business you become liable for class 2 national insurance contributions and must notify HMRC by 31 January after the end of the tax year in which you became a partner. You may register online, by telephone or by using the form (CWF1) incorporated in leaflet SE1 (Are you thinking of working for yourself?).

Partners in firms are taxed on their share of the profits of the firm for the tax year, and the basis of tax is similar to that for the self-employed. Each partner is effectively taxed as if he were a self employed business, with profits equal to his share of the profits of the firm. So, instead of tax (and national insurance) being deducted from your earnings at source, you must be prepared to receive a bill at some time in the future. This can be an unwelcome surprise if you haven't put enough money aside.

We aim to give you as much warning as possible of the likely timing and amount of tax payments, but it is not easy to do this during the first year of your new business, or if you do not keep your records up-to-date.

What profits do HMRC tax?

The starting point for the calculation of taxable profits of the partnership is the profit and loss account, in the same way as for a sole trader. In calculating taxable profits the firm is entitled to claim deductions from your business income in respect of any expenses incurred for the purposes of trade (with a few minor exceptions). Partners will need to ensure that all of the expenses they wish to claim for are included in the profit and loss account as there is no option to deduct these from your share of the profits after allocation between the partners. So if any partners also run an office from home, or they bear mobile telephone or other costs personally, these need to be accounted for through the profits of the firm in order for them to benefit from tax relief.

When you buy equipment or motor vehicles, you will be entitled to deduct a proportion of the cost each year you own them and use them in your business. Claims for such capital expenditure are known as capital allowances.

If partners take stock for their own use, the disposal should be shown in the accounts at **market value**, and not at original cost. It may be possible to avoid this by arguing that such items never actually formed part of your stock and showing the original purchase as private expenditure (drawings).

Tax is payable on the whole of the profits of a trade, which is divided up between the partners according to the profit sharing agreement. Payments for partners' own 'wages' (drawings) are not deductible. However, if a partner's spouse works in the business, the wages are an allowable deduction, provided they are actually paid and are a reasonable reward for what is done.

How does HMRC allocate profit to tax years?

The aim of the system is that over the lifetime of your business the profits will be taxed in full, once, and once only. But to make the system fair, there are certain complications you will have to cope with.

The general rule is that the tax for a particular tax year is based on the profits of the twelve months to your accounting date in that tax year. For example, the tax for 2018/19 could be based on accounts for a year ending on various dates ranging from 6 April 2018 to 5 April 2019. This demonstrates that you get more time for the tax to be worked out if your accounts end early in the tax year, which is why 30 April remains a popular year-end for self-employed people, including partners.

How is the tax collected?

Tax returns

Tax returns covering income for the year ending 5 April 2018 have to be submitted to HMRC by 31 October 2018 for paper returns or 31 January 2019 for online returns if you wish HMRC to collect any tax you owe through your code. If you wish HMRC to collect any tax you owe through your tax code if you also receive income which is subject to PAYE you must submit the return online by 30 December 2018. You can ask for this provided you owe less than £3,000.

However, HMRC is now more likely to issue an in-year tax coding update in order to capture the outstanding tax earlier. The final date for filing your 2018 tax return is midnight on 31 January 2019. The return will include a self assessment of your liability to income tax and capital gains tax.

There is a partnership return which shows the profit and loss account of the partnership and any adjustments made for tax, including the capital allowances. This shows the profit shares allocated to each partner on the Partnership Statement. Each partner then also completes a return on his own behalf showing the share of partnership profits corresponding to the partnership return.

If you don't want to work out your own liability, you must send the tax return back by 31 October 2018 or file online by 31 January 2019.

There are automatic penalties for late filing of tax returns.

Partnership returns may also be filed online, but HMRC does not provide free software to do so. If you wish to file a partnership return online you will need to purchase suitable software – there are details of approved providers on the HMRC website.

Payment of tax

Payments on account of income tax and Class 4 NIC will be due on 31 January and 31 July. These interim payments will be based on one half of the total liability (less any tax deducted at source). You will have the right to reduce payments on account if you believe the income tax for the current year is less than the previous year.

The balance of income tax for 2017/18 is due on 31 January 2019 (along with the first interim payment for 2018/19 and any capital gains tax for 2017/18).

Interest and surcharges will be levied for late payment.

In the first year of the business, or your first year as a partner of an existing business, you will not have made payments on account towards your tax liability, as these are based on the previous year’s tax liability. This means that the first tax bill can be a real shock, as a full year’s tax, plus a payment on account towards the following year can all become due at once. After quite a long period without paying tax, paying one and a half year’s worth at one go can be quite an unpleasant surprise.

What about the complications?

Opening years

In the first tax year of your business, (which might be the year that the partnership starts up, or may also be the year you become a partner in an existing partnership) the tax payable is based on the profit arising

between the starting date (or the date you joined the firm) and the following 5 April. Say a partnership starts up on 1 June 2018 and the first accounts run to 30 June 2019 with a profit of £13,000, shared equally between the two partners then tax will be worked out (to the nearest month) on the profits of the following periods:

2018/19 1 June 2018 to 5 April 2019 - 10/13 x £13,000 i.e. £10,000
2019/20 1 July 2018 to 30 June 2019 - 12/13 x £13,000 i.e. £12,000

Each partner is then allocated his share of the amounts taxable on the firm for the two years. You can see that the profit from 1 July 2018 to 5 April 2019 (9 months) has been taxed twice on each partner. The 'overlap' profit of £9,000 (£4,500 each) will be available for deduction when the partnership comes to an end, or one of the partners leaves the firm. Overlap profits also change when the firm changes accounting date. In a partnership, overlap profits are personal to each partner, rather than applying to the firm as a whole, as each partner will generate overlap profits on joining the firm, depending on his share of the profits at the time he joins.

For example, C joins the firm of A & B (above) on 1 January 2019, and takes a share of the profits for the period to 30 June 2019 of £10,000, his tax will be based on the following calculation :

2018/19 1 January 2019 to 5 April 2019 3/6 x £10,000 i.e. £5,000
2019/20 1 January 2019 to 30 June 2019 £10,000

Because his second tax year does not run for a full 12 months, he would be taxed on the first six months of his share of the profits for the accounts to 30 June 2020 in 2019/20, bringing that year to 12 months, and creating overlap profits of the three months from 1 January 2019 to 5 April 2019, and the six months from 1 July 2019 to 31 December 2019, which will be taxed again in 2020/21.

What about national insurance?

The self-employed including partners are subject to a two-tier system of national insurance contributions. Class 2 contributions are at a flat rate of £2.95 per week, payable with the self-assessment liabilities, if earnings exceed £6,205 per annum (the small profits thresholds). These contributions secure your right to the state pension.

Each partner’s profits between £8,424 and £46,350 are subject to Class 4 contributions at a rate of 9%. Profits in excess of £46,350 are liable to Class 4 contributions at the rate of 2% without any upper limit. Class 4 contributions are collected by HMRC and are payable at the same time as the instalments of income tax.

If you do not register your liability to Class 2 National Insurance your liability will be up to a maximum of 100% of the lost contributions for a deliberate and concealed failure; deliberate but not concealed failure 70% and all other cases the penalty is 30%. There will be no penalty if there is a reasonable excuse for the failure to notify.

Save for your tax

It is essential that you make proper provision to ensure the availability of funds to pay income tax and Class 4 national insurance. Interest on unpaid tax is chargeable by HMRC, and is not deductible from business profits.

Tax for LLPs

Limited liability partnerships (LLPs) provide the flexibility of a partnership with the limited liability of its members. They have proved to be very popular, particularly for professional entities.

An LLP must be distinguished from an ordinary partnership and the rare limited partnership.

For all types of partnership, the general rule is that tax is not payable by the partnership itself but by each partner. Each partner's share of the partnership income is added to his or her other taxable income. The

partner pays tax on the total of his or her earnings, including their share of the partnership profits. Similarly, any capital gain made by the partnership is generally apportioned to each partner. This means that a partnership of any type is generally said to be ‘transparent' for tax purposes.

Each partner is generally taxed on a self-employed basis, and not at source under PAYE. Any national insurance liability is collected under classes 2 and 4, rather than class 1 for employees.

Special tax rules for some LLP partners

There is an exception to this general rules for some LLP partners. Please note that this exception does not apply to partners in other types of partnership.

The change is that a salaried partner is taxed as an employee and not as a self-employed person. It should be noted that these changes apply for tax and national insurance. They do not apply for other purposes, such as for employment law. The fact that a partner comes within the salaried partner rules does not in itself mean that the partner could, for example, claim unfair dismissal if the partner is subsequently dismissed.

Conversely, provisions in a partnership agreement that provide for payments during sickness, maternity, holidays etc. do not in themselves establish that the partner is to be taxed as an employee.

It should also be noted that the new provisions are not primarily concerned with professional qualifications or experience. The consideration is whether the partner receives an income related to the overall profit of the LLP, including receiving nothing if the LLP makes a loss.

An LLP partner is only taxed as an employee if all three conditions are met, so breaking one of the following conditions allows the partner to remain taxed as self employed.

Condition A is that the partner performs services for the partnership for a "wholly, or substantially wholly, fixed" amount. Condition A is also met if the partner receives an amount that varies but not in relation to the overall profit of the LLP. Such a payment is called "disguised salary".

The legislation does not define "substantially wholly", but subsequent guidance from HMRC makes clear that this means that it applies when at least 80% of the amount paid to the partner is disguised salary.

Condition A is not met if the partner simply receives a bonus based on the overall profits of the LLP. The legislation is not intended to prevent normal profit-sharing.

However, the condition is not met if the share of profits is not related to the overall business, such as being related to the branch where the partner works, or to the personal performance of the partner.

For all these provisions, HMRC looks at the amounts the partner may reasonably expect to receive. This includes amounts where there is no contractual right to receive payment.

Condition A only applies if the partner provides services to the LLP. It does not apply where the partner's involvement is limited to investing money.

Condition A is also disapplied if the partner provides services in a different capacity, such as through a separate business. This disapplication is subject to anti-avoidance provisions.

Condition B is that the partner does not have "significant influence" over how the LLP is run.

HMRC guidance makes clear that merely voting for a management committee does not, in itself, constitute "significant influence". Being a member of the management committee would be sufficient to break Condition B, but all of those partners who are not on the management committee meet Condition B.

Condition C is that the partner's contribution to the LLP is less than 25% of the "disguised salary" which it is reasonably expected the LLP will pay for the partner's services in the tax year being considered.

A partner may have contributed less than 25% but be prepared to contribute more to avoid Condition C being met. In such cases, HMRC will accept a firm commitment to contribute sufficient capital within 2 months of joining the firm.

HMRC has published detailed guidance on what constitutes a capital contribution. For example, it excludes:

- sums which the partner may be required to pay at a future date (other than the three-month or two-month transitional periods mentioned above)
- undrawn profits that have not been converted into capital
- sums held by the LLP for the partner, such as in a taxation account
- sums provided by the partner to avoid Condition C but in conditions that indicate that such provision is not permanent or where the partner otherwise does not share in the economic risk of the LLP.

We can advise on whether a capital contribution meets the conditions to avoid Condition C.

Further observations

Any arrangement made between the partner and the LLP designed to circumvent any of these conditions are disregarded.

These rules relating to LLP incomes can also apply to someone who is not directly a partner in the LLP but who performs services indirectly, such as by being director of a company which is a partner.

It should be understood that these provisions may apply even when the LLP has no intention of avoiding or reducing a tax liability. It can, for example, introduce a tax charge where the partners agree to take a fixed amount rather than a full share of the profits as a means of allowing the LLP to accumulate profits for future expansion. We may be able to assist in preventing this from happening.

Practical impact

Members of LLP's who are affected by this rule must be included on the payroll, and any benefits in kind provided to them will also be taxed on them as income.

Expenses

The new rules do not allow the salaried partner to claim expenses that are not otherwise claimable by an employee of an LLP. The self-employed may claim a wider range of expenses than employees.

Implications

This treatment can be particularly significant for high-earning individuals such as London-based practices of American law firms.

Many such LLPs have complex profit-sharing arrangements. We can assist in determining whether those arrangements bring a partner within the salaried partner rules.

While the principles of the new rules for LLP partners may seem clear, there are many anti-avoidance provisions and many specific details in detailed guidance. We will be pleased to help you in ensuring that you meet your fiscal obligations and avoid any unexpected tax charge.

Please call us if you would like further help or advice on this matter.