taylorcocks

The complete guide to partnerships

We've thought of everything so that you don't have to.

Introduction to partnerships

Even the strongest relationships can suffer in times of adversity. Good planning is an essential part of creating a successful business partnership. Our guides provide information on important aspects of your partnership, such as setting up a formal agreement and planning for the unexpected. It is essential to seek our advice with regard to partnerships matters.

Limited liability partnerships

An LLP is a form of separate legal business entity that gives the benefits of limited liability but allows its members the flexibility of organising their internal structure as a traditional partnership. They are intended for businesses which carry on a trade or profession, and are particularly attractive to larger professional partnerships.

Read more

Partnership agreements

Did you know that if you have no partnership agreement, then the provisions of the Partnership Act of 1890 apply?

Read more

The tax system for partnerships

If you form a partnership, 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 through the HMRC website.

Read more

Interest and tax payments

HMRC charge interest on underpayments of tax, and pays interest (repayment supplement) on overpayments.

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Limited liability partnerships (LLPs)

An LLP is a form of separate legal business entity that gives the benefits of limited liability but allows its members the flexibility of organising their internal structure as a traditional partnership. They are intended for businesses which carry on a trade or profession, and are particularly attractive to larger professional partnerships.

LLPs are in law regarded as 'bodies corporate' and are subject to aspects of company law, but for tax they will generally be treated as 'partnerships'. The members provide working capital and share any profits. Members who are individuals will be liable to pay income tax under self-assessment, and self-employed Class 2 (ceasing in April 2018) and Class 4 National Insurance contributions. Members who are companies will be liable to pay corporation tax on their share of profits.

The members of an LLP have limited liability, but the LLP is liable for all its debts to the full extent of its assets. To the extent that the members have contributed to those assets, a member risks losing that amount should the creditors claim those assets. An LLP has unlimited capacity which means that third parties need not be concerned about any restrictions or activities.

An LLP has complete flexibility as to the internal structure which it wishes to adopt; there are no requirements for board or general meetings or decision-making by resolution. Unlike a company, but similar to a partnership an LLP does not have a memorandum or articles of association.

LLP disclosure requirements are very similar to those of a company, including the filing of annual accounts (audited where necessary). There are also similar rules for the filing of annual returns, and notifying changes in members' details or the location of the Registered Office. However, the LLP agreement remains confidential.

Every LLP must have at least two, formally appointed, Designated Members, who carry responsibilities similar to those of a Company Secretary. These designated members have statutory responsibility for certain tasks and are personally liable in the event of a default to any fine or penalty. Responsibilities include:

- Signing accounts
- Delivering accounts to the registrar of companies
- Appointments and removal of auditors (if required)
- Notification of membership changes (and changes to the registered office) to the registrar of companies
- Preparing, signing and delivering the annual return
- Applying for the LLP to be struck off the register

LLP Agreement

A comprehensive agreement governing the duties and responsibilities of the members is a necessity, therefore, and it will need to include provisions for:

- The management of the LLP
- The decision-making process
- The capital contributions required of the members, both while a going concern and (if any) on liquidation
- The division of profits
- Changes to the membership
- Dispute resolution
- Termination of the LLP
- Provision for the amendment of the LLP agreement

Advantages of an LLP:

- Limited liability – reduced risk to personal wealth from creditors' claims
- Internal flexibility – facilitates participation in management and maintenance of ethos of the partnership

Disadvantages of an LLP:

- Lack of privacy – financial information must normally be disclosed
- Requirement for an LLP agreement – this is needed to avoid default provisions applying and to cover situations not addressed by default provisions

Partnership agreements

Your agreement should set out the rules governing how the partnership operates, and should cover the main ´What happens if …´ situations. If there is no agreement, there will be a large element of uncertainty, and applying the underlying law, such as the Partnership Act 1890, may well lead to undesirable results.

It is usually best to have a partnership agreement drawn up by a solicitor, but before you reach that stage you should think about exactly what you want the agreement to cover. In particular, you should consider:

Running the business

- Partners' duties
- Working hours and holidays
- Decision-making procedures
- Business premises
- Cars

Financial matters

- Profit-sharing arrangements and drawings on account
- Partnership capital (and interest arrangements)
- Banking and financial arrangements
- Accounting arrangements
- Making provision for tax payments
- To identify what is partnership property for the availability of 100% (as opposed to 50%) business property relief for inheritance tax purposes

Special circumstances

- Partner retirement procedures
- Death of a partner
- Providing for partners' retirements and dependants
- Disability of a partner
- Establishing the right to expel a partner
- Arbitration for unresolved disputes
- Business valuation procedures

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 2017/18 could be based on accounts for a year ending on various dates ranging from 6 April 2017 to 5 April 2018. 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 tax collected?

Tax Returns

Tax returns covering income for the year ending 5 April 2017 have to be submitted to HMRC by 31 October 2017 for paper returns or 31 January 2018 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 2017. You can ask for this provided you owe less than £3,000. The final date for filing your 2017 tax return is midnight on 31 January 2018. 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 2017 or file online by 31 January 2018. 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 2016/17 is due on 31 January 2018 (along with the first interim payment for 2017/18 and any capital gains tax for 2016/17). 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 years' worth at one go can be quite an unpleasant surprise.

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 £2.85 per week, payable against a quarterly bill or collected via the tax return, if earnings exceed £6,025 per annum (the small profits thresholds). These contributions secure your right to the state pension.

Each partner's profits between £8,164 and £45,000 are subject to Class 4 contributions at a rate of 9%. Profits in excess of £45,000 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.

Saving 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.

Class 2 contributions are to be abolished in 2018.

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 these 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.

Interest and tax payments

HMRC charges interest on underpayments of tax, and pays interest (repayment supplement) on overpayments. The rate of interest paid on overpaid tax is lower than the rate charged on underpayments, and interest rates are adjusted frequently in line with commercial interest rates.

Detailed calculation of interest and supplement are not shown on Statements of Account, so it is worth checking when these items are large.

Income tax and capital gains tax

Interest is charged on underpaid payments on account and balancing payments from the due date to the date of payment. Repayment supplement is paid from the date of overpayment to the date the repayment is issued. The interest or supplement is based on the final amount of tax and Class 4 national insurance contributions, taking into account all later adjustments.

Interest is also payable on late-paid penalties and surcharges (but not on interest!).

For individual taxpayers interest charged by the HMRC is not tax-deductible, but neither is interest paid by the HMRC taxable income.

Corporation tax

Similar principles apply with regard to corporation tax. However, interest rates are not necessarily the same as those applying to income tax and capital gains tax. In addition, there are different rates of interest for companies required to make quarterly payments of corporation tax.

In contrast to the position with personal taxpayers, under corporation tax self assessment interest charged is allowed against company profits and interest received is treated as taxable income.

Typical interest rates

For rates of interest on overpaid and unpaid tax prior to the above, please visit the HMRC website:

[Interest on repayments]

[Interest on late payments]

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