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EMPLOYEE VS. PARTNER: TAX STATUS CHANGES

WHAT YOU NEED TO KNOW

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There are a number of tax and legal differences to be aware of when your employment status changes from employee to Partner. For tax purposes, as a Partner within a partnership, you are seen as a self-employed individual in the eyes of HMRC, this can have a significant impact on how you are taxed and when you are taxed, alongside future potential cashflow implications.

The table below highlights some of these differences:

Employees	Partner (self-employment)
1. How you are taxed?	
Employees are taxed on employment income when it is paid to them (on a paid basis).	Partners are taxed on an allocation of profits during a 12-month accounting period ending during the tax year and reported on a 'Page 7'. As a first year Partner you are subject to the 'opening year rules' (this is discussed on page 4). The amounts paid to you may differ from the allocation detailed on your page 7. This is because certain expenses that are claimable at the partnership level, are disallowable for income tax purposes. In practice, the difference is usually immaterial. You should consult the partnership if there is a significant difference.
2. Rates of income tax	
Income tax rates are currently the same, regardless of your employment status. Currently the marginal income tax rates are 20/40/45.	
3. How will my National Insurance contributions differ?	
Employees receive their employment income net of Income tax as National Insurance Contributions (NIC's). Income Tax and NIC's are withheld at source via the PAYE system. Other deductions such as certain taxable benefits, pension contributions and student loan repayments may also be deducted via payroll.	Partners receive their allocation of profits on a gross basis. Income tax and National Insurance Contributions are calculated via a self-assessment tax return. Tax is then due at 31 January following the tax year-end. Partners are also subject to the Payment on Account (POA) regime, making tax payments at 31 January and 31 July following the tax year-end (this is discussed on page 4). You will not receive any taxable benefits, rather any benefits, such as private medical insurance, will continue and costs will be accounted for by way of a reduction of your allocation of profits.
All employees are subject to NIC's on earnings paid by the employer. Employees are subject to Class 1 primary NIC's, and the marginal rates are 12/2%. Class 1 NIC's are collected via the PAYE system.	Partners are subject to NIC's on their allocation of profits during the year. Partners are subject to Class 4 NIC's on their allocation of profits, and the marginal rates are 9/2% - this is calculated via the self-assessment process. There is a small saving of NIC's, roughly equivalent to £1,240 per year as a Partner. As a Partner, you are also subject to Class 2 NIC's. This is a flat weekly charge of £3.05 per week and is collected via self-assessment.
Employers are also subject to NIC's on an employee's earnings at 13.8%.	The partnership is not required to make any NIC's on your allocation of profits - this can be a significant saving for the partnership.
4. Administration	
Employees are only required to file a self-assessment tax return where they have additional income outside of their employment (such as rental income) or where their income exceeds £100,000.	All Partners are required to file a self-assessment tax return. You will also need to let HMRC know about your change of employment status for National Insurance Contributions (NIC) purposes.

ADMINISTRATIVE ITEMS TO CONSIDER WHEN YOU APPOINTED AS A PARTNER

Registering as a Partner

To register for self-assessment as a Partner, you are required to complete and submit form SA401. When completing this form, you will need the following information:

- Your National Insurance Number (NINO)
- Your Unique Taxpayer Reference (UTR) if you currently file self-assessment tax returns.
- The partnership Unique Taxpayer Reference (UTR)
- The address of the partnership
- The date you joined the partnership

An external adviser can complete this form on your behalf.

Cash flow planning

It is recommended that you set-up and administer a separate 'tax account' that contains around 47-50% of your expected tax liability arising as a result of your LLP profit allocation. Where partnership profits are invested, it is recommended that these investments are liquid to ensure that payments can be made to HMRC on finalisation of your tax returns. An external adviser can provide estimated tax liabilities based on estimated LLP allocations throughout the year.

In instances where you do not fall into the payment on account regime in the first year, your tax liability can effectively be 150% in the year that you do fall into the payment on account regime. Please see applied one example - no first-year payments to provide an illustrative example.

UK tax rates

Personal Allowance

The standard Personal Allowance is £12,500 (for 2020/21), which is the amount of income you do not have to pay tax on. Where a taxpayer's income exceeds £125,000, they will lose their entitlement to the Personal Allowance. The Personal Allowance is tapered (reduced) by £1 for every £2 that a taxpayer's income exceeds £100,000.

Income tax rates

Band	Taxable income	Tax rate
Basic rate	£0 to £37,500	20%
Higher rate	£37,501 to £150,000	40%
Additional rate	Over £150,000	45%

The above table assumes no Personal Allowance.

Dividend tax rates

Taxpayers are entitled to a dividend allowance of £2,000, meaning the first £2,000 of dividends received tax free.

Band	Tax rate
Basic rate	7.5%
Higher rate	32.5%
Additional rate	38.1%

Dividend income is your 'top-slice' of income, meaning it is considered after all other income.

National Insurance

As a Partner, your allocation of profit is subject to Class 2 & Class 4 National Insurance contributions. The Class 4 main rate differs from that of the Class 1 National Insurance contribution rate (for employees) as detailed below:

- **Class 1 National Insurance** (employee): If you earn more than £719 per month and up to £4,167 per month, you will pay 12% on your earnings between £719 and £4,167.

  All earnings over £4,167 are subject to tax at 2%.

- **Class 2 National Insurance** (Partner): Class 2 NIC is paid at a flat rate of £3.05 per week.

- **Class 4 National Insurance** (Partner): Class 4 NIC's are payable on annual profit allocations. If your profits are more than £9,500 per year and up to £50,000 per year, you will pay 9% on your earnings between £9,500 and £50,000.

  All profits over £50,000 are subject to tax at 2%.

Capital Gains

Your employment status has no impact on the rate at which you pay capital gains tax. We have provided a short summary below of the current capital gains tax rates:

Band	Ordinary	Carry/Residential property
Basic rate	10%	18%
Higher rate	20%	28%

UK resident, arising basis taxpayers are also entitled to a Capital Gains Annual Exemption of £12,300. This works similarly to the dividend allowance, effectively the first £12,300 of gains are tax free.

Payments on account

A Partner is paid on a gross basis (i.e. no taxes are withheld at source). As a result, you will fall into the 'payment on account' regime.

Taxpayers fall into this regime where less than 80% of their tax liability for the year was collected at source, i.e. via PAYE.

Payments on account are made twice a year at 31 January and 31 July, and each payment is 50% of the tax due for the previous year.

You may or not be subject to payments on account in your first year as a Partner. This is dependent on the level of your untaxed income during the year (such as partnership allocation, interest, dividends, rental income etc).

After year one, you will likely be subject to the payment on account regime each year whilst Partner.

Opening year rules

The first tax year that an individual becomes a Partner, they are subject to HMRC's opening year rules.

Under the opening year rules, a Partner is subject to tax on their allocation of profits from the date they are appointed as Partner, through to the following 5 April (end of the tax year), regardless of the accounting period end date.

For this reason, a portion of the profits included on your tax return is estimated, based on when the partnership accounts are finalised. If final figures are not available prior to the filing date for a return, provisional figures will be added to the return rather than miss the filing deadline. Once the correct/final figure is available, an amended self-assessment tax return will need to be filed with HMRC.

When in the second tax year, HMRC will tax a Partner on their share of profits relating to the first 12 months of profits. This may result in an 'overlap' of profits being assessed in your first and second tax year. The example on the next page will help to explain this.

Overlap profits

Overlap profits will likely be generated in the second tax year you are filing a tax return as a Partner. The term 'overlap profits' relates to a portion of your profits that have been subject to tax twice.

A simple example of this is set out below:

You join a partnership 1 January 2020, and the partnership accounting period is on a calendar year basis i.e. 1 January 2020 – 31 December. Profits for the period 1 January 2020 through to 5 April 2020 will be included on your 2019/20 tax return.

Although, as HMRC tax 12 months of profits in the second tax year we look to see if an accounting period ended in the 2020/21 tax year. In this case it did – 31 December 2020. Therefore the 12 months of profits arising from the 1 January 2020 to 31 December accounting period are subject to tax on your 2020/21 tax return.

You can see that profits relating to the period 1 January 2020 through to 5 April 2020 have been subject to tax twice. This is an anti-deferral method introduced by HMRC.

These overlap profits are 'unwound' when you leave the partnership or the partnership ceases to trade. The overlap profits are deducted from your final year profit allocation.

APPLIED EXAMPLE ONE - FIRST-YEAR PAYMENTS ON ACCOUNT

Assumptions:

- You joined the partnership 1 January 2020
- The partnership year-end is 31 December 2020
- You profit allocation for the period ended 31 December 2020 is £1,000,000
- Assume a tax rate of 47% [45% income tax + 2% NIC's]
- Fall into payment on account regime.

Year 1 (opening year):

Under the opening year rules you are subject to tax on your profits through to the end of the tax year, 5 April 2020 (2019/20). There are 96 days between 1 January 2020 through to 5 April 2020.

Your profit allocation for the 2019/20 tax year is therefore **£262,295** [£1,000,000x 96/366].

Tax due of **£123,279**, payable by **31 January 2021** [£262,295 x 47%].

Your first payment on account towards the 2020/21 tax year is also payable at 31 January 2021. This payment is equivalent to 50% of your prior year tax bill, in this case the 2019/20 tax year. As a result **£61,639** is also payable at 31 January 2021 [£123,279 x 50%].

The total payment that should be made to HMRC by 31 January 2021 is therefore £184,918. [£123,279 + £61,639]. Your second payment on account should be made to HMRC by 31 July 2021 is **£61,639** [£123,279 x 50%].

Year 2 (12 months of profit):

Your second tax year as a Partner is therefore 2020/21. As there is a partnership accounting period ending within the tax year (31 December 2021) a full 12 months of profits relating to that period will be taxed.

Your profit allocation for the 2020/21 tax year is therefore **£1,000,000**.

Tax due of **£470,000**, payable by **31 January 2022** [£1,000,000 x 47%].

However, payments on account totalling £123,279 [£61,639 x 2] have already been paid towards your 2020/21 taxes.

Your first payment on account towards the 2021/22 tax year is also payable at 31 January 2022. This payment is equivalent to 50% of your prior year tax bill, in this case the 2020/21 tax year. As a result **£235,000** is also payable at 31 January 2022 [£470,000 x 50%].

The total payment that should be made to HMRC by 31 January 2022 is therefore **£581,721**. [£470,000 - £123,279 + £235,000]. Your second payment on account should be made to HMRC by 31 July 2021 is **£235,000** [£470,000 x 50%].

We will also amend your 2019/20 tax return at this point, based on finalised partnership allocations for the period ended 31 December 2019.

Year 3 (current year basis):

Your third year (2021/22) would be on a current year basis, and 12 months of profits relating to the 31 December 2021 would be subject to tax.

Overlap profits:

Your overlap profits arising as a result of joining the partnership 1 January 2020 are therefore £262,295. These profits have been assessed in both year 1 and year 2 (above).

APPLIED EXAMPLE TWO - NO FIRST-YEAR PAYMENTS ON ACCOUNT

Assumptions:

- You joined the partnership 1 January 2020
- The partnership year-end is 31 December 2020
- You profit allocation for the period ended 31 December 2020 is £1,000,000
- Assume a tax rate of 47% [45% income tax + 2% NIC's]

Year 1 (opening year):

Under the opening year rules, you are subject to tax on your profits through to the end of the tax year, 5 April 2020 (2019/20). There are 96 days between 1 January 2020 through to 5 April 2020.

Your profit allocation for the 2019/20 tax year is therefore **£262,295** [£1,000,000x 96/366].

Tax due of **£123,279**, payable by **31 January 2021** [£262,295 x 47%].

The total payment that should be made to HMRC by 31 January 2021 is therefore **£123,279**.

Year 2 (12 months of profit):

Your second tax year as a Partner is therefore 2020/21. As there is a partnership accounting period ending within the tax year (31 December 2021) a full 12 months of profits relating to that period will be taxed.

Your profit allocation for the 2020/21 tax year is therefore **£1,000,000**.

Tax due of **£470,000**, payable by **31 January 2022** [£1,000,000 x 47%].

Your first payment on account towards the 2021/22 tax year is also payable at 31 January 2022. This payment is equivalent to 50% of your prior year tax bill, in this case the 2020/21 tax year. As a result **£235,000** is also payable at 31 January 2022 [£470,000 x 50%].

The total payment that should be made to HMRC by 31 January 2022 is therefore **£705,000**. [£470,000 + £235,000].

Your second payment on account should be made to HMRC by 31 July 2021 is **£235,000** [£470,000 x 50%].

We will also amend your 2019/20 tax return at this point, based on finalised partnership allocations for the period ended 31 December 2019.

Year 3 (current year basis):

Your third year (2021/22) would be on a current year basis, and 12 months of profits relating to the 31 December 2021 would be subject to tax.

Overlap profits:

Your overlap profits arising as a result of joining the partnership 1 January 2020 are therefore £262,295. These profits have been assessed in both year 1 and year 2 (above).

How A&M Taxand can help?

Our Private Client Services team provides clients with an integrated solution to deliver proactive advice on all planning, cash flow and compliance issues, saving time and allowing partners to make informed choices.

The team is also US/UK dual tax qualified, so can also assist with taxpayers who have a US connection to their taxes also, be that needing to layer on US tax advice or compliance.

A&M Taxand has extensive expertise in all areas of UK, US and international tax through the global firm, and the Taxand network, which covers many other jurisdictions.

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ABOUT ALVAREZ & MARSAL TAXAND

Alvarez & Marsal Taxand, an affiliate of Alvarez & Marsal (A&M), a leading global professional services firm, is an independent tax group made up of experienced tax professionals dedicated to providing customized tax advice to clients and investors across a broad range of industries. Its professionals extend A&M's commitment to offering clients a choice in advisors who are free from audit-based conflicts of interest, and bring an unyielding commitment to delivering responsive client service. A&M Taxand has offices in major metropolitan markets throughout the U.S., and serves the U.K. from its base in London.

Alvarez & Marsal Taxand is a founder of Taxand, the world's largest independent tax organization, which provides high quality, integrated tax advice worldwide. Taxand professionals, including almost 550 partners and more than 2,500 advisors in 50 countries, grasp both the fine points of tax and the broader strategic implications, helping you mitigate risk, manage your tax burden and drive the performance of your business.

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