

Legal Focus

DRIVING LIFELONG PROSPERITY

Spring 2019

SPOTLIGHT ON PARTNERS

Welcome...

Welcome to the spring edition of our Legal Focus. In this edition, we look at matters to consider for incoming partners, the new SRA Accounts Rules and, as we approach the end of the tax year, we take a look at year end tax planning tips.



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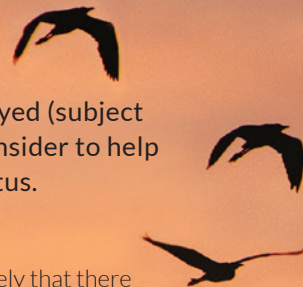
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DRIVING LIFELONG PROSPERITY

Congratulations on becoming a partner!



When you join a partnership or LLP, you cease to be an employee and are classed as self-employed (subject to certain conditions - see our article on LLP members). Here are some matters you need to consider to help you understand how your income is taxed and some tips to help you benefit from your new status.

INCOME

Your income tax is no longer collected by your employer through the PAYE scheme. Instead, you must complete a tax return each year, declaring your share of the partnership's taxable profit and the tax you owe on this profit and any other income you receive.

The partnership's taxable profit is different from the accounting profit because some expenses in the accounts are disallowed for tax purposes. This includes depreciation, client entertaining and any personal expenses paid by the partnership, such as motor expenses.

DRAWINGS

Instead of receiving a salary, you are likely to have agreed a monthly payment to your bank account. This is treated simply as an advance of your profit share and is not reported on your tax return.

The main distinction here is that you are taxed on the whole of your profit share, regardless of whether you have received all of it in cash or left part in the business to fund working capital or future growth.

You will also need to remember to save for your tax bill, if your firm is not retaining some of your profit share in a separate tax reserve.

PAYING TAX

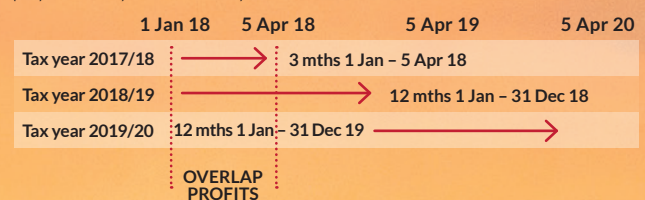
In general, you pay tax on your profit share for the accounting year that ends during the tax year. For example, if your partnership's financial year ends on 31 December 2018, then your profit share from this year will be included in your tax return 2018/19.

Your tax liability on this is paid in three instalments:

31 January 2019	First payment on account (an estimated amount based on your 2017/18 tax liability)
31 July 2019	Second payment on account (as above)
31 January 2020	Balancing payment arising from the final calculation on your tax return 2018/19

In your first year of self-employment it is likely that there will be no payment on account (unless you have previously had other taxable income to declare). Instead, you will pay tax on the proportion of the first year up to 5 April.

For example, if you became a partner on 1 January 2018, your first tax return will be due for the tax year ended 5 April 2018. This will include three months' profit share for January to 5 April 2018. The tax arising on this income will be due for payment by 31 January 2019.



For tax year 2018/19, you will be taxed on your profit share for the 12 months ended 31 December 2018. There may be small payment on accounts due on 31 January 2019 and 31 July 2019. On 31 January 2020, a potentially substantial tax liability becomes due. The balancing payment from the first 12 months profit is added to the first payment on account for the year ending 31 December 2019, which is 50% of the total tax liability for 2018/19. You can see that having paid very little tax since you became self-employed on 1 January 2018, you may be facing a significant bill in January 2020.

Payments	31 Jan 19	31 Jul 19	31 Jan 20	31 Jul 20	31 Jan 21
3 mths to Mar 18	£X				
12 mths to Dec 18	POA 50% £X	POA 50% £X	£Y less POAs		
12 mths to Dec 19			POA 50% £Y	POA 50% £Y	£Z less POAs
12 mths to Dec 20					POA 50% £Z

In our example, you can see that three months' profits have been taxed twice. This is referred to as overlap profits. When you retire from the partnership, your overlap profits are deducted from your final profit share, so that you are only ever taxed once on each profit share. However, depending on the current tax rates prevailing and your own personal circumstances, the rate of tax paid can vary significantly.



ALLOWABLE EXPENSES

As a partner, if you incur business expenses personally and are not reimbursed by your practice, you may be able to deduct them from your taxable profits and reduce your tax bill.



Motor running costs

If you have a car or motorbike that you use for work, you can claim the business proportion of the running costs, such as servicing, repairs, fuel, road fund licence, MOT, insurance and any interest on finance leases.



Funding of capital

If you borrow money to buy into the practice, or invest capital in the future, you can claim a deduction for the interest paid on the loan.



Working from home

If you work from home, you can claim for the business use of your home telephone and broadband, as well as utility bills and mortgage interest.

Other common expenses likely to attract tax relief are computers, bikes, books and journals, professional subscriptions, stationery and training courses.

OTHER OPPORTUNITIES TO REDUCE YOUR TAX BILL

Pension contributions

Any contributions to a personal pension plan will attract relief at your highest rate. In 2018/19 the higher rates are 40% and 45%, but if your income falls within £100,000 and £123,700 your marginal rate is 60%.

For example, suppose your income is £120,000 and you decide to make a gross pension contribution of £20,000. You will pay a net contribution of £16,000 to your pension fund and your fund receives the other £4,000 directly from HMRC. You will receive further tax relief of £8,000 via your self-assessment tax return. So your pension fund increases by £20,000 at a total net cost to you of £8,000.

Donations

Any gifts to registered charities will also reduce your tax liability by extending your basic rate band. For example, if you donate £800, on your tax return this is grossed up to £1,000 and your basic rate band is extended by this amount. If you are a higher rate tax payer, this will reduce your tax payable by at least £200.

CONCLUSION

All of the above is a fairly brief overview of some of the main issues that you need to be aware of when becoming a self-employed partner for the first time.

We would encourage you to speak to us to find out more, to ensure you benefit from all the opportunities that may be available to you.

NEW SRA ACCOUNTS RULES – WHAT YOU NEED TO KNOW

The Legal Services Board has recently approved sweeping regulatory reforms proposed by the SRA under its Looking to the Future programme. The changes are expected to be effective from July 2019.

Included within the changes is a new set of Accounts Rules. The new rules are shorter, less prescriptive and much more outcomes-focused. All of the old timescales (14 days, 2 days, etc) have been removed, and firms will be given the freedom to decide on their own time frames. The rules also give firms the option of using Third Party Managed Accounts (TPMAs), instead of holding money in client account.

Key points to note include the following:

1. The new rules run to just 13 rules over six and a half pages, compared to the current 52 rules, several appendices and over 80 pages.
2. All of the rules are considerably shorter than they are now. For example, the current rule 20 (withdrawals from client account) has been reduced from nine sections and six guidance notes to three short paragraphs.
3. All of the old guidance notes to the rules have been removed. The SRA has promised to issue new guidance soon.
4. The SRA had initially proposed a new definition of client money, so that money received in advance for fees and disbursements for which the firm was liable would have to be held in office account. Following widespread objection, the SRA changed its mind on this one, although the new rules do allow firms to hold these funds in office account where they are the only client monies that they hold, and provided they inform clients in advance. The SRA believes that this will allow some firms to operate without a client account in future.
5. Money received from the Legal Aid Agency for costs can in future be held in the office account.
6. Cease to hold audits will no longer be required when firms cease trading or change status, unless the SRA request one.
7. A significant change relates to transfers for fees and disbursements. Currently, the rules allow firms to transfer money from client account to reimburse themselves for amounts spent or incurred on disbursements without first issuing a bill. Under the new rule 4.3, firms will have to give a bill of costs, or other notification of costs incurred, to the client or paying party before they can transfer funds from client account. The SRA's definition of costs includes disbursements.
8. The concept of professional disbursements has been removed. It seems that all disbursements will be treated in the same way in future.
9. The concept of agreed fees has also been removed. Currently, money received for an agreed fee can be held in office account, even if a bill has not been raised. In future, the money will need to be held in client account until a bill is raised, unless the firm can take advantage of the change in point 4 above.
10. The new rule 8.3 formally requires the COFA or a manager of the firm to review and sign off the client account reconciliations. It also states that any differences on the reconciliation should be investigated and resolved promptly.
11. Another big change relates to client's own accounts. In future, firms that operate client's own accounts will need to reconcile them every five weeks. It is not entirely clear what firms are supposed to reconcile the balances to though, as in our experience it is unusual for client's own accounts to be recorded on client ledgers.



12. The new rules permit the use of TPMAs for the purpose of receiving payments from or on behalf of, or making payments to or on behalf of, the client in respect of regulated services.
13. Finally, the current exemption limits for not needing an Accountant's Report are unchanged in the new rules. However, the definition of statement or passbook balance for the exemption test has been changed, and will in future include balances held in any joint accounts or client's own accounts operated by the firm. This could mean that firms that are currently exempt will not be exempt in future.

WHAT NEEDS TO BE DONE IN ADVANCE OF THE NEW RULES?

With the removal of all of the current timescales, firms need to give some thought to what could work best for them and their clients. They also need to consider whether to adopt the current rules (with suitable changes) or come up with their own approaches. Areas to consider include the following:

1. Banking of client monies received. The new rules move from same or next working day to "promptly". What does this mean, particularly if a firm has several offices, or there is no local branch to pay money into?
2. Transfer out of office money paid into client account. Moving from 14 days to "promptly". Again, what does this mean?
3. Transfers for costs. The new rule doesn't specifically give any timescale for these, but moving away from the current 14 days could be detrimental to cash flow. Also, what changes will be required to comply with the new requirement to raise a bill in advance of taking money for paid disbursements?



CONSULTANTS – SHIFTING THE RISK

"EMPLOYED OR SELF-EMPLOYED? THAT IS THE QUESTION."

The question may not be as old as Shakespeare (or indeed ever posed by him), but it is one that businesses have been agonising over for many years.

Where a new worker is taken on, it is the firm's responsibility to assess whether they are an employee or genuinely self-employed. Incorrectly treating an individual as self-employed can be very expensive, as HMRC can seek to collect the PAYE tax and National Insurance from the firm, possibly going back a number of years.

Where the nature of a worker's status is not certain, it may be tempting to play it safe and treat them as an employee. This can result in employer's National Insurance contributions being paid unnecessarily, and the worker will likely resist if they strongly believe they are a self-employed contractor.

Historically, the risk to the firm of getting it wrong could be avoided by engaging the worker through their own limited company. In that situation, the worker could still be deemed an employee of the firm, but the liability for underpaid PAYE duties lays with the limited company.

The rules changed for public sector bodies engaging workers through limited companies in April 2017. Public bodies are now responsible for the status assessment, thereby shifting the risk back to the engager.

In the Budget 2018 it was announced that this change is being extended to medium and large businesses in the private sector with effect from April 2020, but will not apply to small businesses (typically those with turnover of less than £10.2million). There will be a further consultation on the detail of this change before draft legislation is published.

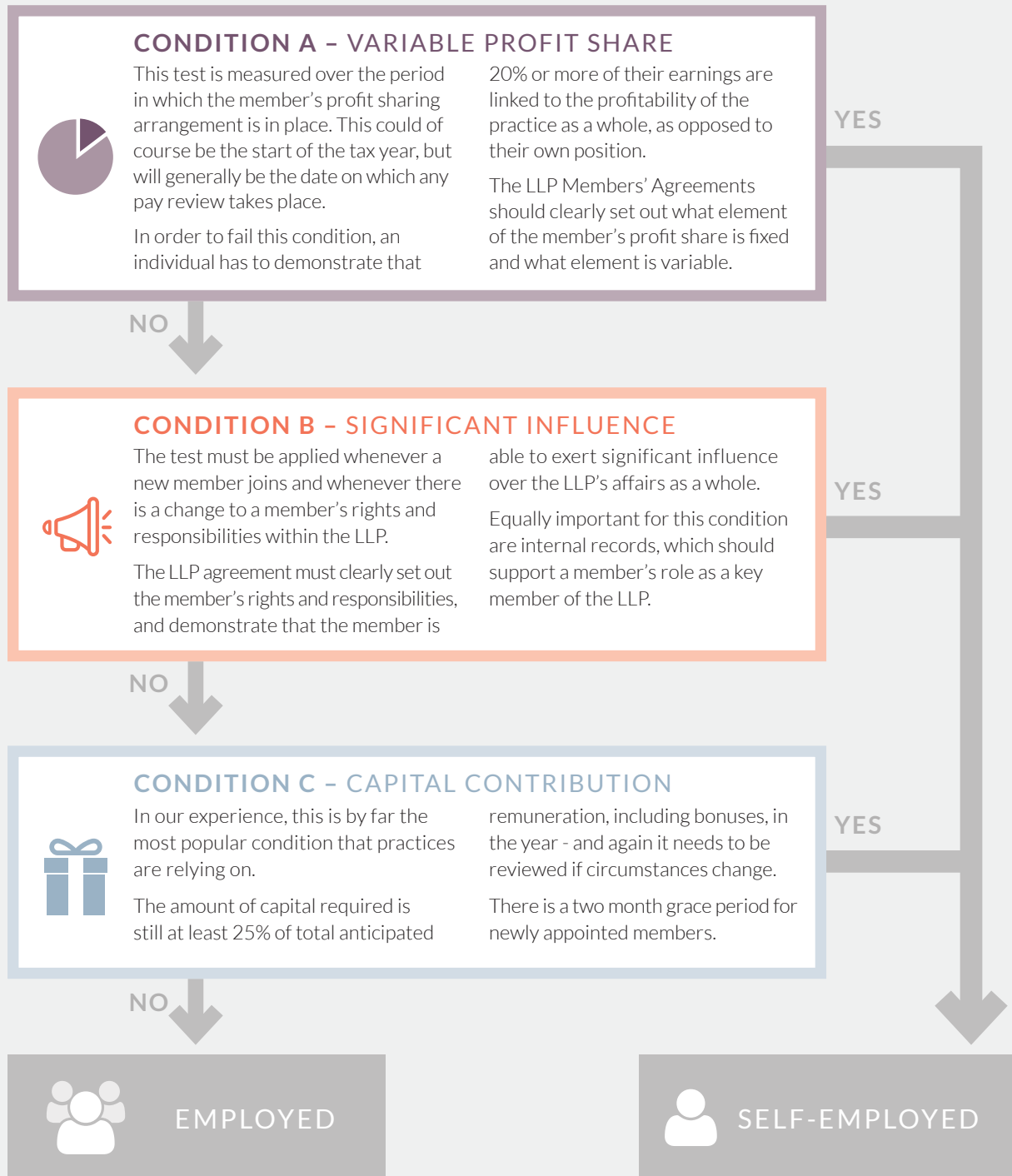
The result is that, with the exception of small practices, from April 2020 the risk of getting the status assessment wrong will lie with the firm.

Firms may wish to consider reviewing their consultancy contracts now, in anticipation of the new rules, and we can help with this review. Any worker engaged through a limited company who could be viewed as an employee may need to be added to the payroll, unless the nature of the engagement can be changed.

LLP MEMBERS – ANOTHER YEAR, ANOTHER STATUS REVIEW

With the start of the new tax year fast approaching, it is time to review each member's status to ensure they can be taxed as a self-employed individual.

As always, each of the conditions must be looked at separately, and just one needs to be failed for a person to be self-employed:





TOP TIPS FOR TAX PLANNING

As another tax year draws to a close, now is a good time to take stock and consider whether all allowances and reliefs have been maximised as far as possible, and whether any action needs to be taken before 5 April 2019.

Below are some of our top tips to consider in advance of the new tax year.

- **Personal allowance** – for higher earners with net income of between £100,000 and £123,700, the personal allowance is reduced by £1 for every £2, resulting in an effective tax rate of 60%. If your income is close to the threshold, it may be worth considering possible ways to reduce your taxable income e.g. by making pension contributions, charitable donations, deferring income into 2019/20 or transferring income producing assets to your spouse, to reinstate your personal allowance.
- **High income child benefit charge** – taxable income exceeding £50,000 for the year could lead to a claw back of child benefit, with the benefit lost in full once taxable income reaches £60,000. Reducing, deferring or transferring taxable income as described above could help to preserve this benefit.
- **Capital gains** – The capital gains tax annual exemption for 2018/19 is £11,700. Some simple planning to utilise your allowance as far as possible could include considering a transfer of assets between spouses, where appropriate. If the annual allowance has already been used, consideration could be given to deferring disposals into the new tax year, with the allowance increasing to £12,000 for 2019/20.
- **Residence nil rate band (RNRB)** – the RNRB is an additional inheritance tax nil rate band which is available on death when a residence is passed to a direct descendant. The RNRB increases by £25,000 to £150,000 from April 2019 and double that for a couple. The allowance is tapered away, however, for estates valued over £2 million. We would recommend a review of your Will to ensure this and any other inheritance tax reliefs will be available, as well as considering planning to reduce your estate value if appropriate.
- **Mortgage interest relief** – as the phasing in of the rules continue, 75% of interest costs will be restricted to the basic rate of tax for landlords from April 2019, which could lead to a significant increase in effective tax rates for some. A review of your operating structure would be advisable, and opportunities to minimise the impact of the new rules could be explored, including spousal transfers, use of partnerships or incorporation.
- **Remuneration for owner managed businesses** – director/ shareholders should review their remuneration package in advance of the new tax year. A combination of low salary, high interest and high dividends could result in tax-free income of up to £19,850 in 2018/19 and £20,500 in 2019/20 (and double that for couples), depending on the specific facts and circumstances of the individual.
- **Tax efficient investments** – if you have any surplus cash, you could look to make a tax efficient investment. There are various options, which typically offer income tax relief at 30% (and up to 50%), with tax free capital gains on disposal. It may also be possible to carry back an investment made in 2017/18 to 2016/17 to accelerate tax relief. Certain conditions must be met to obtain the available tax reliefs, which would need to be carefully considered.
- **Pension contributions** – The pension allowance for 2018/19 is £40,000, except when income is above £150,000, in which case the pension allowance is reduced by £1 for every £2 of income above this limit. So, if income is £210,000 or more, the allowance will be reduced to the minimum level of £10,000. You can however benefit from unused allowances brought forward from the previous three tax years, but if they are not used then they will be lost. Unused allowances for the 2015/16 tax year will be lost if they are not utilised by 5 April 2019.

Please also note that where a taxpayer has flexibly accessed their pension savings, the annual pension allowance is automatically reduced to £4,000 and any unused allowances brought forward are likely to be lost.

There is potentially a significant tax saving for 2018/19 if you were to consider making a pension contribution. However, you need to take action before 5 April 2019.

The abolition of the abolition of Class 2 NIC

The Government's plan to abolish Class 2 National Insurance Contributions (NIC) has been scrapped.

The plan announced last year to scrap Class 2 NIC was intended to simplify the tax system for the self-employed. Following a backlash from affected parties the Government delayed its plans, whilst it "explored the issues" and addressed any unintended consequences.

After consideration, the Government has announced that it will now not proceed with the abolition during the current parliament. The explanation given is that a significant number of self-employed individuals on the lowest profits would have seen their contributions increase, in order to maintain the

same level of state pension entitlement. It would also have introduced greater complexity to the tax system, undermining the original objective of simplifying the position.

The self-employed, which includes partners and those LLP members who are treated as self-employed, will therefore continue to pay Class 2 NIC (currently at a rate of £2.95 per week).

Since 6 April 2015, Class 2 NIC has been collected through self-assessment and is paid on 31 January following the end of the tax year. This is collected along with Class 4 NIC, which is based on profits but which does not count towards benefit entitlements.

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