SUMMER 2025

Hazlewoods

Legal Focus

INSIDE

Practice Structures – One size does not fit all

Structure

15 years ago, a large number of our law firm clients fell into two categories: partnerships or sole practitioners. At that time, 70% of all firms in the UK were unincorporated. This has changed drastically, and now nearly three-quarters of law firms are incorporated.

Structure	July 2010	May 2025
Sole Practitioner	37%	16%
Partnership	33%	11%
Company	17%	57%
LLP	12%	16%

Interestingly, the proportion of LLPs has not changed significantly, with the majority of unincorporated firms becoming limited companies. Unsurprisingly, tax efficiency remains a key consideration when advising firms on structure.

There have been many benefits to operating as a limited company in recent years:

- In 2016/17, shareholders could receive a dividend of £5,000 per annum tax-free. This was reduced to £2,000 in 2018/19 and is now only £500 per annum.
- In 2015, a unified corporation tax rate of 20% was introduced, which reduced to 19% in 2019. It remained at this level until 2023/24, when a tiered system was reintroduced: small firms (with profits under £50,000) pay 19%, while firms with profits over £250,000 pay 25%.
- Entrepreneurs' Relief, introduced in 2008, allowed a 10% Capital Gains Tax (CGT) rate on qualifying business disposals, including goodwill. This enabled owners to live off the sale proceeds alongside a modest income from the business, thereby minimising personal tax liabilities. In December 2014, Entrepreneurs' Relief was blocked on goodwill sold to a company connected with the vendor. In 2025/26, the renamed Business Asset Disposal Relief (BADR) increased from 10% to 14% and is set to increase further to 18% from 6 April 2026.

Over the years, the lifetime allowance for BADR has ranged between £10 million and the current level of £1 million.

There are also practical considerations:

- Obtaining funding is generally easier for a limited company, as banks tend to have a better understanding of them than LLPs. However, banks have recently become more reluctant to lend to individuals seeking to buy shares in a limited company, prompting the need for alternative structures to support succession planning.
- It is easier to separate ownership from management in a limited company, which can facilitate ownership by family members or third parties (subject to SRA approval). This may explain why many sole practitioners have incorporated, as it allows them to involve a spouse or children in profit distribution in a tax-efficient manner. However, this can lead to complications if a shareholder is unwilling to sell their shares when the firm wishes them to exit, for example due to retirement or a dispute.
- Partnerships and LLPs offer greater flexibility regarding partner entry and exit, and remuneration structuring. In contrast, limited companies require the buying and selling of shares, necessitating a firm valuation agreed upon by all parties. Differentiating remuneration among company owners based on seniority or responsibilities can also be complex, often requiring different share classes.

However, where company profits are used to repay debt, reinvest in the business, or where shareholders do not need to draw profits, the higher dividend tax rates can be avoided.

Congratulations on becoming a partner

When you join a partnership or LLP as a partner, you cease to be an employee and are classed as self-employed. Below are some key considerations to help you understand how your income is taxed, along with tips to help you make the most of your new status.

Income

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

The **partnership's taxable profit** usually differs from the **accounting profit**, as some expenses are disallowed for tax purposes. These include depreciation, client entertaining, and any personal expenses paid by the partnership, such as motor costs.

Drawings

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

The key distinction is that you are taxed on your entire profit share, regardless of whether you have received it in cash or left part in the business to support working capital or future growth. This also applies if your drawings exceed your profit share.

Partners and directors move into a different tax regime. Instead of being taxed regularly through PAYE, tax is now paid twice a year via self-assessment. It is essential to make provision for these tax bills in advance, typically through regular saving. Some firms retain part of your profit allocation and pay tax liabilities on behalf of the owners. In such cases, the retained funds may form part of the firm's working capital.

If you are responsible for saving and paying your tax personally, many banks offer savings accounts with attractive interest rates for regular savers - so it is worth shopping around.

Paying tax

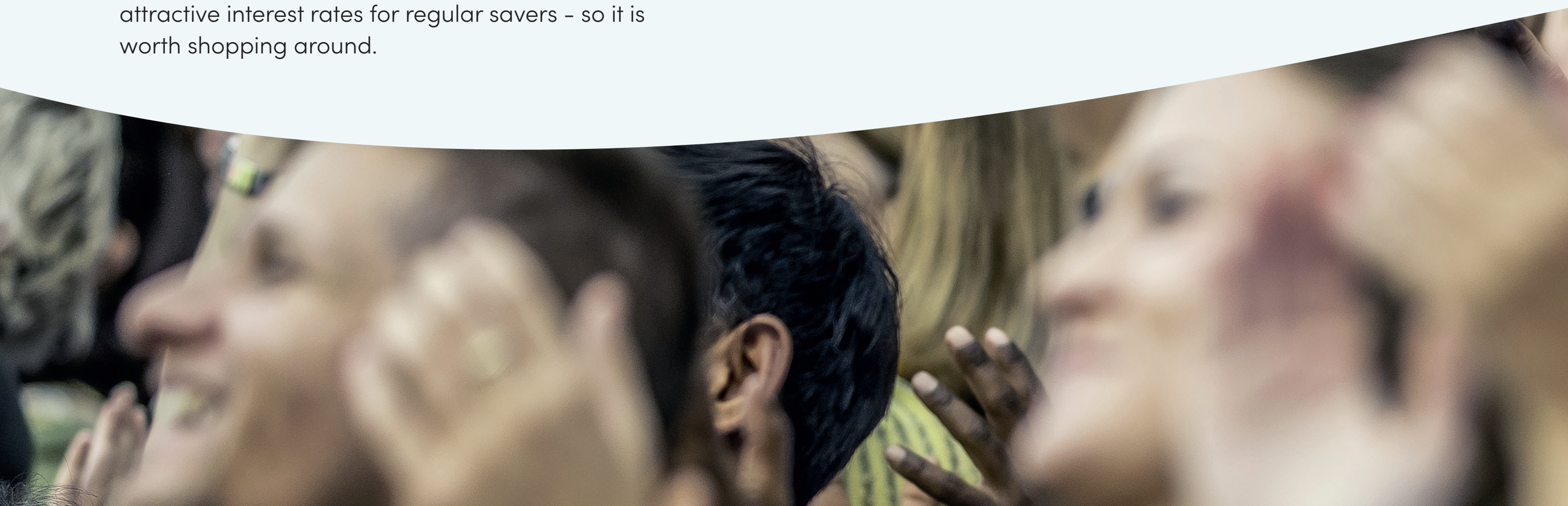
All individuals now pay tax on their profit share for the year ending 5 April (or more practically, 31 March), regardless of the business's accounting year-end. If your accounting year does not align with the tax year, you may need to estimate your taxable profit for part of the year.

For example, if your accounting year ends on 31 December 2025, you must include the final nine months of that year and estimate the first three months of 2026 on your tax return. This return is due by 31 January 2027. As the accounts for the year ending 31 December 2026 may not be finalised by then, this adds a layer of complexity.

Your tax liability is paid in three instalments:

- **1 January 2026** – First payment on account (50% of your 2024/25 tax liability)
- **31 July 2026** – Second payment on account (same as above)
- **31 January 2027** – Balancing payment or repayment based on your 2025/26 tax return

In your first year of self-employment, you are unlikely to make payments on account (unless you had other taxable income previously). Instead, you will pay the full tax for 2025/26 on 31 January 2027.



Allowable expenses

As a partner, if you incur business expenses personally and are not reimbursed by your firm, you may be able to deduct these from your taxable profits:

- **Motor running costs** – You can claim the business proportion of costs such as servicing, repairs, fuel, insurance, and interest on finance.
- **Capital funding** – If you borrow money to invest capital into the LLP or partnership, the interest paid is deductible.
- **Working from home** – You can claim for business use of your home telephone, broadband, and a proportion of household bills (e.g. electricity, gas, water, mortgage interest or rent). This is known as a 'use of home as office' claim.
- **Other expenses** – Computers, bicycles, professional books and journals, subscriptions, stationery, and training courses may also qualify for tax relief.

Donations

Any gifts to registered charities reduce your tax liability by extending your basic rate band. For example, a donation of £800 is grossed up to £1,000 on your tax return, extending your basic rate band by that amount. If you are a higher-rate taxpayer, this could reduce your tax bill by at least £200.

Pensions

As an employee, you were likely part of a workplace pension scheme. Upon becoming a partner or director, this typically ends, along with employer contributions. It is now your responsibility to ensure pension contributions continue.

Partners can only make personal pension contributions from their own earnings. Tax relief is awarded at your highest rate of income tax. Your pension provider usually claims basic rate relief from HMRC, and higher or additional rate relief must be claimed via your tax return.

Personal contributions are limited to your 'net relevant earnings', which include PAYE income and trading profits. Dividends do not count, so directors who take most of their income as dividends may have limited scope for personal contributions. In such cases, employer contributions made directly from the company are often more tax-efficient and deductible for corporation tax purposes.

Conclusion

This article provides a brief overview of the key issues to consider when becoming a self-employed partner or company shareholder for the first time. We encourage you to speak with the team to explore these matters further and ensure you take full advantage of the opportunities available to you.

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