Making the transition from employee to partner

Making partner is an accomplishment many employees dream of their entire career. You work for years as a salaried employee and now have the opportunity to own a piece of equity in the business you've worked so hard to build. Whether you are a lawyer, accountant, consultant or any other profession that has a career goal of becoming a partner, there are several practical wealth management and financial considerations to keep in mind during the transition.

Defining the model: Equity reserves or partnership?

Does the business fund equity reserves using bank debt, partner capital or distributions of profit? Or maybe a combination of all three? Is the partnership model based on a seniority system, a merit-based approach, or some combination of both? Are you required to contribute capital in proportion to your respective percentage of profit entitlement, or is the partnership model one that uses fixed shares, in which partners aren't normally required to contribute significant amounts of capital?

These are very important considerations that can impact your personal cash flow and debt needs, as well as future financial planning goals.

Funding your capital purchase

There are a variety of ways to fund your initial equity stake. Lump-sum cash payments, personal loans or a loan arranged by the business are common solutions. Lump-sum cash payments are a straightforward solution, however not everyone may have the amount of cash required at their immediate disposal. In those situations, debt may be necessary. While personal debt may be possible, the firm may have access to preferential interest rates with outside financial institutions specifically for partners. Consider any program the firm has already established.

Partner capital loans can be a tax-efficient solution, since you're able to claim deductions on the interest paid as investment interest (it's typically deducted from partnership income annually to arrive at net taxable income). Keep in mind, if you choose to finance your capital investment, you'll have scheduled monthly or quarterly principal and interest debt payments. You may also have to make additional capital contributions annually if your interest in the firm increases, potentially causing another strain on cash flow.

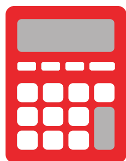
Managing a fluctuating income

Since partners are not salaried employees, your income will be based on profits. In good years, your take-home income increases, but in lean years it can decrease. It could also be sporadic throughout the year, due to lower monthly or biweekly draws and larger, periodic profit distributions. You must ensure you have considered this in your personal budget. Lines of credit are a good resource for getting through lean months in between distributions.

Planning for income and self-employment taxes

As a salaried employee, you have taxes automatically withheld from earnings. But now, as an equity partner, you're considered self-employed and therefore required to make estimated tax payments while also paying your full self-employment tax (with a corresponding deduction of about 50% for the self-employment tax on your return).

To comfortably fund these payments, you should set aside money to pay quarterly estimates and/or year-end payments. If your business operates in multiple states, you'll likely owe taxes in all of them. You'll need to determine whether you should participate in state composite returns or file your own non-resident state returns instead.



It's also important to consider the business' tax year and how it coincides with your personal tax year. Partners could potentially see a delay in reporting firm income in the initial year of becoming a partner, with a big tax bill due in April.

Equity partner tax situations become significantly more complicated so, it's important to consult with a trusted CPA or other qualified tax professional on these matters.

Additional health, welfare and fringe benefit plan deductions

As a partner, you may be entitled to a deduction on your individual income tax return for the cost and expenses related to your health, welfare, and fringe benefit plans (since those costs are technically includable in partner income). This differs from the employee standard of automatically excluding these costs and expenses from taxable income.

Changing pension policies

Benefits accrued under a firm pension as an employee may come to an end upon making partner. The formula for determining pension benefits for a partner under a partner pension plan could be different from the employee formula. There may also be a separate vesting schedule based on years of partner service. Some companies also offer non-qualified retirement benefits to partners, which provides supplemental retirement benefits in excess of qualified plan benefits available to general employees.

Note that non-qualified benefits may be subject to claims from company creditors.

Liability for partnership debts

Many firms today have moved toward an LLP versus a general partnership as their entity structure. As an LLP partner, you may think you are wholly protected by the LLP, making traditional asset protection unnecessary. But unfortunately, an LLP partner may still be liable for actions that aren't covered by partnership assets or your professional indemnity insurance. Additional asset protection may be needed.

Updating your Last Will

Young partners may not have accumulated significant wealth at the time they make partner, leaving a Last Will seemingly unnecessary. But it's important to note that some partnership agreements require that each partner has a valid will and, in some cases, specific language in their estate documents regarding their partnership interest. Partnership agreements may specify that executors must accept the accounts published by the company.

Additional insurance needs

It's important that new partners thoroughly review all insurance options. With life insurance, you'll want to ensure you have appropriate coverage to replace lost income to your family in the event of your death. Base coverage from the firm may be insufficient and supplemental policies should be considered.

Long-term disability coverage should also be reviewed, as most policies only pay a percentage of income (and that benefit is taxable, reducing the amount even further). If you become disabled, that percentage of current income may not be enough to cover current expenses (e.g., mortgage, debt payments, tuition, additional healthcare costs, etc.).

Umbrella coverage is another important consideration, as is property, casualty, and long-term care (depending on your age).

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Leaving a partnership

The above outlines important planning points to consider when entering a partnership, but it's equally important to educate yourself on the potential implications of leaving a partnership.

If you were to exit, how would the capital you contributed during your tenure be returned? What are the effects on outstanding capital loans? The partnership agreement should address the repayment of your capital contribution. In some cases, the terms within the agreement provide for repayment in installments over a period of time, which could have cash flow implications if you are no longer receiving income.

The considerations outlined above show the implications your partner ownership will have on your overall financial plan and wealth management needs. Establishing a strong advisory team to help navigate these new cash flow, income, estate, and insurance planning considerations during your transition is more important than ever.

For more information, please contact your Key Private Bank Advisor.

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