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Legal Focus

Guiding you to lifelong prosperity

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DRIVING LIFELONG PROSPERITY

Issue number 36

Welcome to the latest edition of Legal Focus

There is a huge amount of activity in the legal sector at present, and we hope that you will find what follows useful.

Our team is going from strength to strength with us adding nine new retained practices in the last twelve months and more project work of one sort or another than ever before.

Please do get in touch with your feedback on any of the content.

Pension planning under the new Government

Following the Government's Emergency post Election Budget in June 2010, consultation periods have now been completed in two important areas of pension planning.

Tax relief on Contributions

For the last two years, "anti-forestalling" has restricted the higher rate tax relief available for higher earners (those with taxable income over £130,000 per annum) on contributions in excess of £20,000, unless an existing regular subscription was in place at 21 April 2009. Contributions over these levels have tax relief restricted to an effective rate of 20%.

From 6 April 2011, the concept of higher earners has come to an end, replaced by a contribution limit of £50,000 for everyone, with **no relief at all** for excess contributions. Care needs to be taken with employer contributions, as where the pension input period ends in 2011/12 contributions are, in effect, already restricted to £50,000. With careful planning, it may be possible for contributions of up to £255,000 to be made, if the scheme's input period ends in 2010/11.

The ability to carry-forward unused relief has returned. Up to three earlier years' unused contributions may be aggregated, but only where pension scheme membership already existed (i.e. not available for new schemes).

The Lifetime Allowance (maximum pension pot in plain English), currently £1,800,000, is to reduce to £1,500,000 from 6 April 2012, and seems unlikely to be increased in line with inflation on a regular basis. This means that, although higher contributions may be made, greater care needs to be taken to ensure that future growth does not result in an excessive fund value at a later date.

In summary, we welcome the new contribution limits, as they cater well for the contribution expectations of most family business owners and executives, but prevent the extremes of tax mitigation enjoyed by certain 'mega earners' in recent years.

Removal of Annuity Compulsion

On 9 December 2010 the Treasury announced a new retirement framework that sees the arrival of what they called 'Capped and Flexible drawdown', replacing the previous unsecured pension and alternatively secured pension, both more commonly known as income drawdown. The new rules apply from 6 April 2011.

Most importantly, drawdowns may continue beyond age 75 and, as a result, annuity purchase may be delayed indefinitely. Instead, the fund remaining after a spouse's and dependants' pensions have been paid may be passed to beneficiaries, subject to a special tax charge of 55%. If there are no beneficiaries, the fund may be donated to charity tax-free.

Whilst this rate seems very high, it is often far preferable to the loss of one's fund through annuity purchase and, if compared to the combination of income tax and inheritance tax on pension income "received but not spent" the effect is not dissimilar.

Capped Drawdown will operate in a similar way to current drawdown, other than a new maximum level (roughly 20% lower) and more frequent reviews (every three years instead of five).

Flexible Drawdown will allow unlimited income to be drawn, subject to a minimum income requirement of £20,000 per annum. This will include state pensions, final salary pensions and pension annuities and will apply to each individual i.e. no allowance for couples.

In summary, the changes represent genuine progress for retirement income planning. The high tax charge on death will prevent use of pensions to avoid inheritance tax, but the open-ended choice of whether to purchase an annuity is very welcome.

Annuity purchase will still be the best route for lots of people as drawdown, by its nature, is not without risk. For people with little or no other income, an annuity gives certainty, while drawdown will always remain prone to variations in interest rates, economic growth, life expectancy and taxation policy. In contrast, once an annuity has been purchased, it is generally fixed for life.

However, for more wealthy, adventurous or sophisticated individuals, drawdown offers an opportunity to draw income while still experiencing investment growth or, perhaps, increasing interest rates in the future. Whilst these advantages are uncertain, the ability to pass on the fund on death may be the main attraction for many people.

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Practice structure - have you reviewed yours recently?

We now have no less than 18 different types of structure in our retained legal practice client base, all driven by a combination of commercial and tax efficiency. The latter has received increased attention since personal allowances started being eroded and 50% tax started being charged. We have been surprised at how solicitors have reacted to this. Most are not known for their appetite for less conventional forms of tax planning, but that statement is now in the past tense for many.

We are currently receiving more new enquiries for structure planning than anything else, including strategy measures pre Alternative Business Structures going live on 6 October. We have six such projects on the go at the moment, and this is now quite normal.

The fact is that choosing the right overall structure can very substantially reduce a practice's partners' overall exposure to tax and national insurance. With all mainstream national insurance rates having increased by a further 1% on 6 April 2011, the percentage of your income that goes to the Revenue is only going one way, unless you act and do something about it.

Many structure choices involve the use of one or more limited companies somewhere in the overall organisation. There has been some sporadic press coverage of late, warning of increased Revenue attention for service companies and corporate partners. This is a fairly natural position, as the Revenue are now aware of various structures that are put in place purely to avoid tax. The key here is a combination of careful implementation and commerciality. We have always advocated the importance of both, and have been working with differing practice structures for well over fifteen years now, with no issues arising.

We are always pleased to review the structure of a practice, and our experience here allows us to see the best way forward very quickly.

Client account interest - trading or investment income?

One recent legal ruling which has caught our eye is in respect of the matter of Barnetts (a firm of solicitors) v HMRC.

The case concerned the tax treatment of interest earned by Barnetts on short term funds held on general client account. Barnetts argued that the interest should be treated as trading income, while HMRC argued that it should be treated as savings income.

The distinction between the two treatments is a subtle but important point; in this case affecting the way in which trading losses could be offset against interest earned (although we note that this case refers back several years when the question of interest earned was much more relevant). In this instance, the solicitor had originally submitted a partnership tax return which offset current year trading losses against interest for the year, but this was subsequently amended to offset trading losses in earlier years against the current year interest; a treatment that would only be possible if interest earned were to be classed as trading income. This amended treatment resulted in substantial tax savings for the firm's partners.

Barnetts' argument was that the majority of the firm's work was derived from volume conveyancing, performed on a production line basis by relatively unqualified staff. The clients of the firm were mainly mortgage providers lending money to individuals that did not instruct solicitors of their own, and these clients are usually quite aggressive in tendering for the lowest quote among firms offering similar services. As such, the fee charged by the firm would not usually cover the cost of actually performing the work and it is therefore the interest earned on the transactions that allows the firm to make a profit on its volume conveyancing business.

It should be noted that there was no issue of SAR compliance here – the firm was applying the prescribed SRA interest calculation tables to determine how much (if any) interest was payable to clients.

The argument also focused on historical treatment of interest earned on client accounts by tour operators and on investments by insurance companies who view interest earned as an integral part of their trade to meet future trading liabilities (which was really what was being argued in the case with Barnetts).

HMRC argued that, among other important features, client interest should not be classed as trading income as it is earned on money belonging to others - that is, the relationship is of trustee and beneficiary, rather than debtor and creditor, and legal precedent had viewed trading income as 'the fruit' of capital employed by a business. Since client money does not belong to the solicitor, it cannot be classed as capital introduced.

Ultimately, the courts found in favour of the solicitor on the grounds that the fee structure had been specifically structured at the client's insistence (in this case the lending institutions) so that fees were lower than the cost of providing the service, with the understanding that interest earned on the client account (so far as they complied with the Solicitors' Accounts Rules) comprised part of the firm's reward. An alternative treatment, whereby the firm charged a higher fee to the client to ensure a profit, while accounting for and paying over every penny of interest due on the client account, would give the same result, except for the fact that the income of the solicitor would clearly all be automatically classed as trading income.

In summary, the interest in this matter was viewed as an integral part of the firm's income rather than 'a casual bonus for the solicitor' and was taxed in an appropriate fashion, resulting in quite significant benefits to the practice.

This is not a 'one size fits all' rule for all practices, and the set of circumstances leading to the ruling is fairly unique to the sector in which this firm operated. However, it does present at least the opportunity for firms to consider the treatment of interest received.

The changing regulatory framework - October 2011 and beyond

As many of you will already know, October 2011 marks a new chapter in the regulatory framework for legal practices, as the SRA is set to unveil a fully revised Code of Conduct.

Code of Conduct and Outcomes Focused Regulation:

Seemingly as a reaction to the gradual liberalisation of the legal sector and shifting consumer demand towards a more cost effective and accessible service, the SRA is adopting a method of 'Outcome Focused Regulation' (OFR). In plain English, this is the SRA moving away from a strict rules-based approach, and instead wanting to be seen as supportive of innovation rather than being prescriptive.

The initial milestones of the OFR approach will hopefully be in place by 6 October 2011, with the publication of a new handbook detailing all of the regulatory requirements, as well as including the updated Code of Conduct.

In summary, the handbook will consist of the following:

- 10 mandatory principles,
- Code of Conduct,
- Accounts Rules,
- Authorisation and Practising Requirements
- Client Protection Principles
- Disciplinary and Cost Recovery Rules
- Specialist Services
- Guidance

At the same time, the SRA will adopt a new risk-based approach to its authorisation, supervision and enforcement policies and we should also see the licensing of the first Alternative Business Structures (ABS).

The aim of the new OFR seems to be that the SRA will largely leave firms that can be seen to be acting ethically and professionally to their own devices, while firms that are deemed to be higher risk will be monitored much more closely and may be subject to sanctions and tighter reporting requirements. Firms will be required to take responsibility for identifying and managing the risk of not delivering the required principals and outcomes, act ethically and professionally, exercising judgement on how to deliver good outcomes and engaging positively with the SRA when difficult issues emerge.

Put simply, the SRA wants to allow ethical firms to get on and focus on developing the business without being unduly tied up by restrictions and rules.

The SRA will be considering the intention behind any breaches of the Code (including breaches of the Solicitors' Accounts Rules) rather than just looking at the breach itself. Practically speaking, this means that firms should not be too concerned about a few breaches on their Accountant's Report as long as it can be shown that steps have been taken to prevent future breaches.

You can read about the proposed changes to the Solicitors' Accounts Rules in our last Legal Focus as we covered them in detail then (you can find a copy on our website). We won't cover them again here, but, in line with the spirit of the new OFR, there is a greater emphasis on leaving interpretation of the Rules to the discretion of the solicitor (and the Reporting Accountant).

In practice, the SRA will assess a firm's risk profile through additional information gathering. It is not presently clear what form this will take, but we understand that the SRA is considering obtaining financial information and other operational information as part of the annual registration process. This could include business plans, forecasts, accounting information and self-certified reports on internal controls. Lexcel accreditation is likely to become increasingly relevant here and we understand that the SRA is keen for as many firms as possible to attain Lexcel status (as are PI insurers).

We do know that the annual registration process will be more rigorous and evidence based, and the practising certificate application procedures are likely to be tightened, with increased CRB checks. The SRA will be putting a greater focus on financial stability and management, and firms experiencing financial difficulties can expect increased attention from them.

Licensing authorities

One of the most interesting, but potentially uncertain changes that will be implemented over the course of the next twelve months will be around licensing requirements.

Currently, various bodies, such as ILEX for example, are applying to the Legal Services Board to become licensing authorities. It may no longer be the case that the SRA is the only regulator for firms of solicitors.

In the case of ILEX, who we understand are looking to be a licensing authority for probate cases, this would allow firms that deal exclusively in this type of matter to choose ILEX to be their regulatory authority if the SRA rules were to become too restrictive.

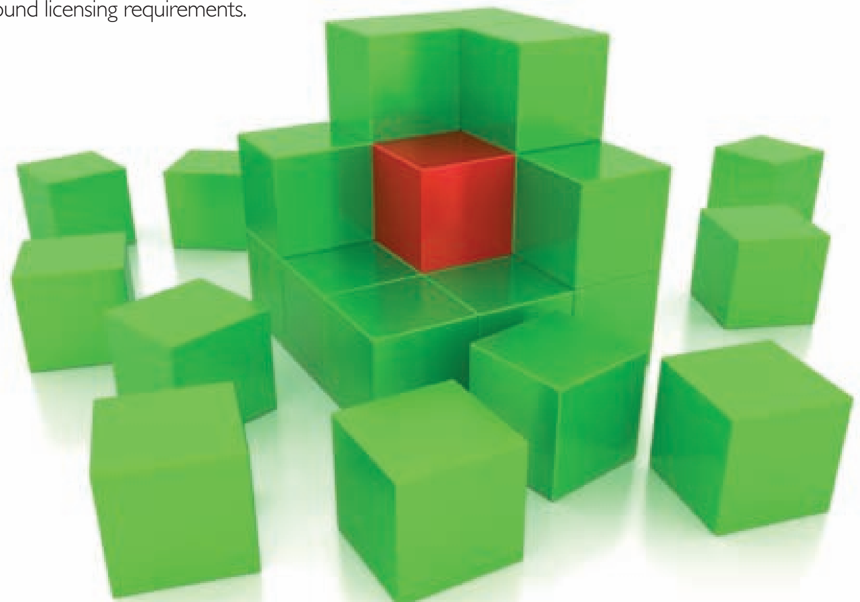
It is perhaps too early to understand the likely long term impact that this change will have on law firms, and this is an area that we will be watching with close interest over the coming months.

Alternative Business Structures

6 October 2011 will see the licensing of the first ABS (Alternative Business Structure).
On the face of it, the ability for solicitors to set up in practice with non solicitors should be revolutionary in the legal offering to consumers. However, the reality is likely to be much more gradual.

Jon Cartwright sat as a panel member at a recent LMS seminar where we debated ABS's and their likely popularity/take up, and the number of practical hurdles are tremendous.

Not unexpectedly, most firms seem to be keeping their cards close to their chest at the moment as they wait to see how the regulatory framework will develop.



Summary of October 2010 practice note

In March 2009, Rule 7 of the Solicitors Code of Conduct was amended to set out the requirements for information that practices must provide on letterheads, websites and emails. Despite this, it seems many practices are still unclear on what is needed. The Law Society issued a practice note at the end of last year, and we thought it might be useful to summarise the main requirements.

	Company	LLP	Unincorporated Partnership	Sole Practitioner
Information on letters, websites and emails	A statement that the firm is regulated by the SRA The registered name and number of the firm The address of the company's registered office	A statement that the firm is regulated by the SRA The registered name and number of the firm	A statement that the firm is regulated by the SRA The name and number under which the firm is recognised by the SRA	A statement that the firm is regulated by the SRA The name and number under which the firm is recognised by the SRA
Letterheads and fax headings	The company's corporate name The registered number from Companies House Either a list of directors, or a statement that a list of directors is available for inspection at the registered office	Either a list of members, or a statement that a list of members is available for inspection at the registered office	For ≤ 20 partners, include a list of the partners For > 20 partners, include either a list of the partners or a statement that a list available for inspection at the premises	From 1 January 2010, sole practitioners must include their name on their firm's letterhead and fax headings

In addition:

- The firm's practising address and all other details that would normally appear on the firm's letterhead should be included in all early stage email communications to third parties.
- Branch offices must also include the firm's SRA recognised name and registration number on correspondence.
- The practice note gives further guidance on who can be presented as a partner, LLP member or director, and also what information should be included in respect of non-UK lawyers.
- If the owners of the firm include non-solicitors, then letterheads and fax headings must identify any solicitor as a solicitor.

2010 LMS Benchmarking Survey

This is now written, proofed, and at the Law Society's printers. We believe it is an essential read for all practices. The report costs £75 for LMS members and £150 for non-members. If you are one of the 200 practices that took part, you will receive a free copy, and also a bespoke report specifically for your practice.

To order your copy, and to find out more about LMS, please visit www.lawmanagementsection.org.uk

Family additions

Both Trish Kinahan and Jon Cartwright have new additions to their families. Trish gave birth to her first child, Isabelle on 16 December, whilst Jon had the easier job of watching his baby daughter Katy arrive on 26 October. Trish returned to work on 4 April.

Residual client balances - are you doing enough?

It has been over two years since the amended rules 15 and 22 of The Solicitors' Accounts Rules 1998 were introduced to address the issue of dealing with residual client balances. An improvement from the pre-14 July 2008 situation, the amendments permit the donation to charity of balances less than £50 without the need for prior authorisation from the Solicitors Regulation Authority.

This flexibility means that solicitors are no longer required to wait six years before applying to donate small balances. Practices have also been encouraged to deal with balances of less than £50 that existed pre July 2008 using the new 22(2A) rule.

Solicitors must now keep a central register of all attempts made to return residual balances, but there is much ambiguity surrounding what constitutes a 'reasonable attempt' to return funds. Firms are also unsure what avenues are available and who should bear the costs incurred when tracking down clients and returning funds.

New threshold, same duty

The new rules do not give carte blanche for firms to purge their client matter listings and freely donate all balances less than £50. On the contrary, the amended rules remind solicitors of their duty to take all possible steps to return client funds promptly at the close of a matter, and there is now a specific obligation for the solicitor to return client money promptly at the close of a matter, and report annually to the client if funds continue to be held on their behalf.

Old balances of less than £50 must be thoroughly investigated before the solicitor can be satisfied that a self certified donation is appropriate.

Indeed, the same rigor must be applied to a balance less than £50 as to one over £50. It is advisable that the solicitor retains detailed evidence of all attempts made to return client funds in the form of a central register, although in practice, this need not be anything more complicated than an A to Z lever arch file containing copies of letters sent, telephone calls made and any other attempts made to return the funds to their rightful owner.

What 'reasonable' steps should be taken?

The SRA's Rule 22(1)(h) Application Form hints as to what the SRA deem to be a 'reasonable' attempt to return client money. The first step should be to write to and/or telephone all known contacts on the client file, including third parties such as family, employers, and bankers, to enquire as to the client's whereabouts. An internet search should also be performed.

The SRA also recommends checking the electoral roll and making use of the letter forwarding service of the Department for Work and Pensions. Usually, for smaller balances of less than £50, utilising all of these resources would satisfy the 'reasonableness' test. If the search still proves fruitless then a self certified donation can be made to an indemnified charity.

For larger residual balances the SRA suggests two further steps to be taken: placing a newspaper advert and / or instructing an enquiry agent. The SRA is very keen to stress that the onus is on the solicitor to weigh up the cost of extensive investigation against the value of the balance held. Nevertheless, before an application to donate funds over £50 is approved, the SRA might request evidence of the outcome of the searches and some detail of the attempts made.

The SRA has stated that "generally, the greater the attempts made before application, the quicker the application can be dealt with." A more extensive investigation could therefore save time in the long run.

Who will bear the cost?

All of this checking will come at a cost, but are you able to deduct these from the monies being held?

The short answer is yes. In its 'General Advice for Applicants', the SRA accepts that where 'out of pocket' expenses have been incurred, the solicitor would normally be required to donate the balance over and above these expenses to charity. However, it then goes on to say that the solicitor would be prudent to retain all invoices and documents relating to these expenses in the central register, to provide a clear audit trail to the sum ultimately donated.

The SRA does not have any legal authority to authorise the repayment of out-of-pocket expenses. If you manage to trace the client, you need to agree deduction for the expenses with your client.

What a solicitor must not do is simply raise an invoice for time and services to match the client residual balance in order to clear the client ledger, as this may be viewed as 'sweeping up'.

Avoidance in the first instance

Clearly, the best approach is to prevent residual client balances occurring in the first place. The SRA has outlined 'preventative measures' in a practice note on unclaimed client funds issued on 8 September 2010, and is keen to promote good practice and sound internal control systems. One such measure is to pre-empt the issue by agreeing with the client as to how any potential residual balances are to be dealt with at the outset of the matter in the client care letter. Clearly, this needs to be worded carefully and not hidden in small print on the back page. Neither should it be a clause which conflicts with the requirements of the Solicitors Code of Conduct, nor should it be a caveat to the solicitor's duty to return client funds.

The benefits of having strong systems and controls in place are clear. Fee earners should be instructed to maintain up to date contact details on client files, while practice management database records should be regularly reviewed for out of date client information.

There should also be a clear procedure with respect to the closing and archiving of matters, which incorporates the swift return of residual client balances. Most practice management systems do not allow a matter to be 'archived' unless the client ledger is cleared first, and you should be reviewing client listings for old matters that might need attention.

In terms of the cashier function, checks should be made as part of each month end procedure for any unpresented client account cheques over a month old. Such cheques may represent previous failed attempts to return client funds and the sooner the reason for non clearance is determined, the sooner action can be taken.

Where to begin?

Some practices have client matter listings containing residual balances that have been there for years. Tackling all of these in one go may prove to be difficult, and so a wiser target might be to investigate and resolve a set number of balances each month. The benefits of clearing out these old balances will be immediately clear, and not just in terms of accounting for client money, as having an up to date and accurate client database can be advantageous to other functions within the practice, such as marketing.

Medical records and reports can be disbursements

Fees paid for medical records and medico-legal reports by solicitors acting for clients in personal injury and medical negligence claims can be treated as disbursements and thus outside the scope of VAT, following the recent Tribunal decision in Barratt, Goff and Tomlinson.

Background

The Appellants, a firm of solicitors who specialise in personal injury claims would, as the first stage in the claim process, go through a "pre-action protocol" which involves obtaining medical records from the relevant hospital / GP. Once in possession of the medical records, the Appellants instruct a medical expert to examine the client and prepare a medical report, which will provide sufficient prognosis to enable the parties to proceed to negotiate a settlement, or for the action to move to trial.

HM Revenue & Customs argued that the obtaining of medical records and reports was fundamental to the discharge of the solicitor's service to his client, in that their purpose was to advance the case as a whole, and thus the associated costs were part of the overall value of the supply of legal services. The Appellants, supported by an intervention from the Law Society, maintained that the cost of obtaining the records and reports, which was done as agent for the client (if the client changed solicitors, they could take the report with them), was a separate activity from the subsequent use of that information in pursuing the claim.

The Tribunal agreed with the Appellants, finding that the cost was incurred as agent of their client and could therefore be treated by the Appellants as a disbursement when calculating the VAT on their services.

At this stage, it is not known if HMRC will appeal this decision.

Comment

This decision will only affect those cases where no VAT is incurred on obtaining the records or report – typically this will only be where access to records is provided under the terms of a statutory requirement, or a medical report is prepared by a medical expert who is not VAT-registered. In these cases, VAT will no longer need to be added by the solicitor when passing on the cost to his client. Where the medical expert is VAT-registered, VAT will still need to be charged by the solicitor.

Where a firm has incorrectly added VAT when recharging such costs in the past, it may apply to HMRC for a refund, although HMRC will insist that the refund is passed to the client to prevent the firm being "unjustly enriched" by retaining the repayment.

If you are unsure whether this ruling will affect you, please feel free to contact our resident VAT experts, Adam Lloyd and Julian Millinchamp, for more information on adam.lloyd@hazlewoods.co.uk or julian.millinchamp@hazlewoods.co.uk

Amount of VAT bad debt relief available when VAT element of invoice not paid

The recent First Tier Tribunal decision in Simpson & Marwick (TC00662) sounds a warning note for solicitors who act on behalf of insurance companies, as well as providing a general reminder on how the VAT bad debt relief rules operate when the net value of an invoice is settled but the VAT element of the total invoice value remains unpaid. These rules are relevant both to suppliers who are claiming relief and customers who are required to repay input tax on unpaid amounts.

In Simpson & Marwick, the Appellant billed the insurance company for the net amount of its fees and the policy holder for the VAT element, but when the policy holder failed to pay the latter, the firm claimed bad debt relief on the full amount of outstanding VAT.

The Tribunal considered that where, for example, the Appellant invoiced the insurance company for £100 and the policy holder for £17.50, the consideration was the aggregate of the fees plus the VAT thereon (i.e. £117.50), but only £17.50 was written off - a fraction of 7/47 of the whole consideration. It followed that the Appellant was limited to claiming only that same proportion of the VAT (i.e. an amount of £2.61 in the example) as bad debt relief under VATA 1994 s 36.

This a short but important reminder that, while we might view the firm's original treatment as the common sense approach for dealing with a case of VAT bad debt relief, this might not be the view shared by HMRC.

In short, if in doubt, please check first.

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Our legal team are happy to discuss matters arising from this newsletter, as well as any other issues relating to your business or personal financial affairs.

The services we provide include:

- Audit under the Solicitors' Accounts Rules
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- Practice strategy planning
- Income recognition advice
- Partnership mergers/acquisitions
- Taxation - compliance and planning
- Practice structure planning, including LLP conversion, limited company incorporation and combinations
- Practice finance and performance reviews
- Improving fee earner and non fee earner efficiency
- Benchmarking against similar practices
- VAT and Stamp Duty
- Partnership changes
- Remuneration planning
- Goodwill valuations
- Expert witness work
- Business plans (including financial forecasts)
- Raising finance
- Advice on practice administration software
- Financial services
- Trusts and estates

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This newsletter has been prepared as a guide to topics of current financial and business interest. We strongly recommend you take professional advice before making decisions on matters discussed here. No responsibility for any loss to any person acting as a result of this material can be accepted by us.

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