Winter 2014

Legal Focus

Guiding you to lifelong prosperity

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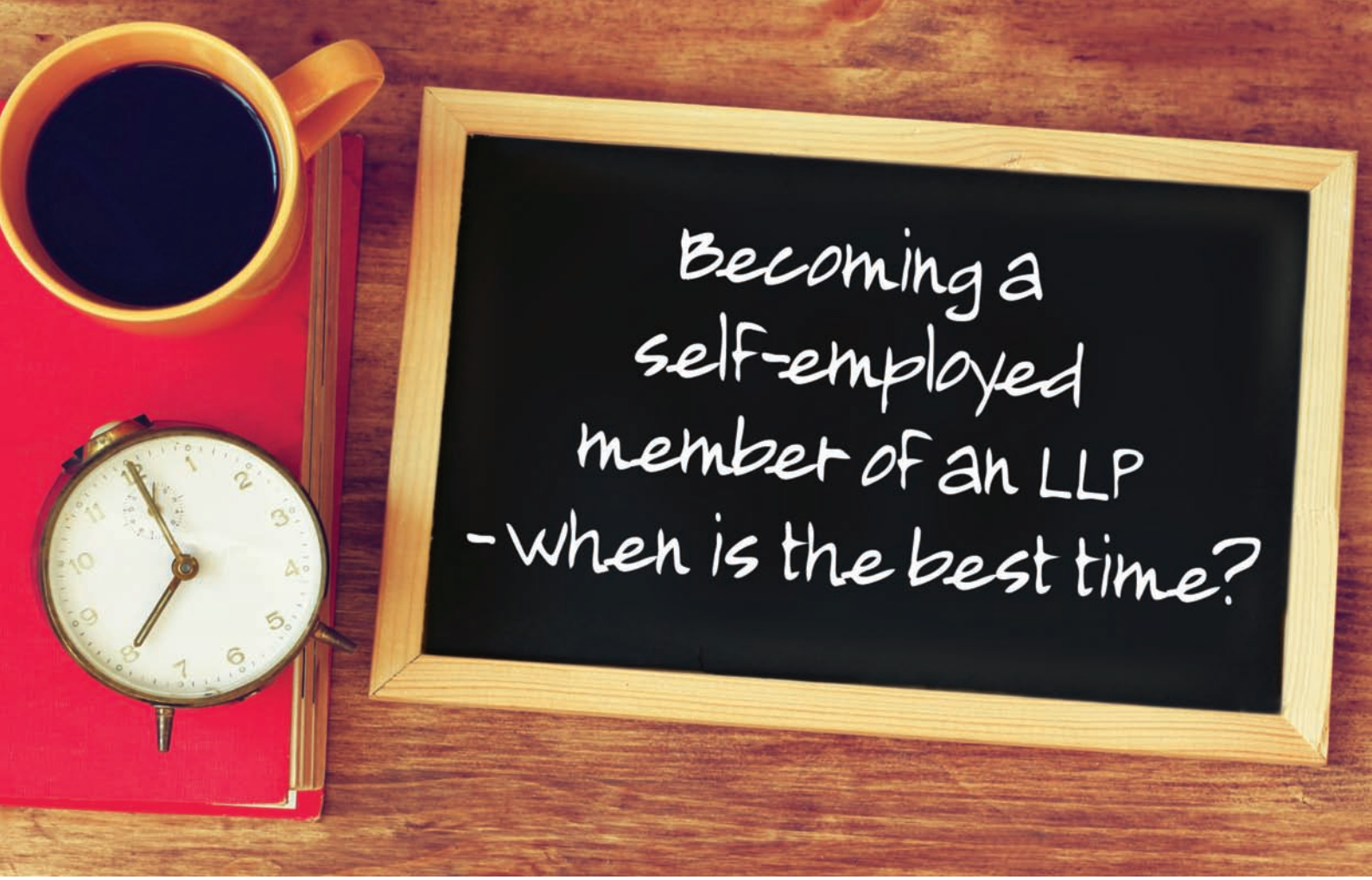
HAZLEWOODS

DRIVING LIFELONG PROSPERITY



In the past, becoming a self-employed LLP member has often meant complex calculations of the new member's taxable profit share for the first few years, and dealing with the creation of "overlap profits". The new rules that came into affect on 6 April 2014 for fixed share members of LLPs have added more complexity, and all may not be as it seems.

Background

By way of a reminder, the introduction of new rules prompted firms to decide what action to take for their fixed share members to be able to remain self-employed for tax purposes.

> "Of the three choices available (variable profit shares, increased influence and injection of capital), in our experience by far the most popular route for remaining self-employed has been the making of a capital contribution."

Condition C of the new rules requires the fixed share member to have made a capital contribution equating to 25% or more of the amount they reasonably expect to be paid by the LLP during the tax year in question.

The position is relatively straightforward for existing members at 6 April 2014 who had made the required contribution by that date (or by 5 July 2014 in certain cases). However, there are some pitfalls to watch out for in other situations.

Existing self-employed members making additional contributions

Where an existing member made the required contribution at 6 April 2014 (or by 5 July, where applicable) based on their expectation on 6 April of their profit share for the coming tax year, they continue to be taxed on a self-employed basis. If there should be an increase in their expected profit share part way through the tax year, which was not expected at 6 April, and therefore not taken into account in the assessment made on that date, it is necessary to reassess the level of their capital contribution, and additional capital will need to be contributed to remain self-employed for tax purposes. For example:

> Robert, a long-standing LLP member, receives an annual profit share of £80,000. At 6 April 2014 there was no expectation that his profit share would change during the year to 5 April 2015, and so he made a capital contribution of £20,000 to remain self-employed. On 22 December 2014, following a particularly lucrative client win, the board decide to reward Robert with an increased profit share of £90,000, effective from 6 January 2015. This change in Robert's circumstances means that he now expects to receive £82,500 (£80,000 x 9/12 plus £90,000 x 3/12) in the year to 5 April 2015, so his capital contribution needs to be increased if he wishes to remain self-employed for the rest of the tax year.

Robert needs to increase his capital contribution to £20,625 (£82,500 x 25%) by 6 January 2015, or he will be taxed as an employee from that date. There is no grace period for introducing the additional capital.

In addition, as his capital contribution is reassessed on 6 April each year, in order to remain self-employed throughout the 2015/16 tax year Robert will need to increase his contribution to £22,500 (£90,000 x 25%) by 6 April 2015, assuming no change is expected to his £90,000 profit share. For simplicity, Robert may decide to increase his contribution to £22,500 from 6 January 2015, cash flow permitting.

Existing members taxed as employees

Where existing LLP members have made no capital contribution by the required date, or where the contribution is less than 25% of their profit share, they are taxed as an employee from 6 April 2014. If the member subsequently increases their capital contribution in order to become self-employed, a special rule applies a fraction to the individual's contribution, thereby potentially reducing its value when applying the

25% test. The fraction is calculated as the number of days from the date of the additional contribution to the end of the tax year divided by the number of days in the tax year. This is best illustrated using an example:

> Linda has been a member of an LLP for many years, receiving an annual profit share of £100,000. At 6 April 2014 she had made a capital contribution to the LLP of just £5,000, so she was taxed as an employee from 6 April 2014. On 1 December 2014 she contributes a further £20,000 to the LLP in an attempt to become self-employed, but her contribution is deemed to be £8,630 (£25,000 total contributions x 126 days / 365 days) for the purpose of the test. As she is deemed to have only contributed 8.63% of her profit share for the tax year, she remains employed for tax purposes.

In order to become self-employed, Linda would need to have contributed at least £67,421 (£25,000 x 365 days / 126 days less the £5,000 already contributed). The later in the tax year the contribution is made, the greater it needs to be. If Linda had made the contribution on 1 January 2015 it would need to be £91,053 for her to become self-employed. The logic behind this measure is pretty questionable, but it seems HMRC require a 25% contribution to have been in place for the full tax year, and a contribution made part way through the year must be pro-rated.

The test is recalculated at the start of each tax year, with no pro-rating of contributions, so Linda might prefer to wait until the start of the new tax year before making the further £20,000 contribution. That is unless she can afford to make the exceptionally large contribution and wait until the start of the new tax year to then withdraw the excess.

New members

As explained above, the test to calculate whether a member's capital contribution is sufficient is based on their profit share for the tax year. For a new member joining part way through a tax year it would, on first glance, appear that a reduced capital contribution can be made initially, as a full year's profit share will not be received in the first tax year. However, the fraction calculated above is also applied to the contribution in this situation. There is a detailed calculation involved, but the overall effect of this is that the member must effectively contribute at least 25% of their annual profit share, regardless of the date on which they join the LLP, which is arguably a reasonable outcome.

Summary

Applying the 25% test at 6 April 2014 and at the start of subsequent tax years should not present too many difficulties, but at all other times care needs to be taken to ensure the correct amount of capital is contributed to secure self-employed status.

New **LLP SORP** issued

On 15 July 2014 the Consultative Committee of Accountancy Bodies (CCAB) published a new version of its Statement of Recommended Practice (SORP) on Accounting for Limited Liability Partnerships (LLPs).

The new SORP, which is effective for accounting periods commencing on or after 1 January 2015, has been updated to remove all references to old UK Generally Accepted Accounting Practice (UK GAAP) and takes account of the introduction of Financial Reporting Standard 102 – The Financial Reporting Standard applicable in the UK and Republic of Ireland. It applies to all LLPs incorporated in the UK that prepare their accounts under either FRS102 or the FRSSE. It does not apply to LLPs that have adopted International Financial Reporting Standards (IFRS).

That's a lot of acronyms - what does this mean for LLPs?

Well first of all, FRS102 is a brand new accounting standard, which replaces all of the current FRSs and SSAPs.

It is a single standard with 35 sections, covering the various different items previously dealt with in separate standards, and is a mere 342 pages long, compared to the 3,000 or so pages of current UK GAAP! Most large and medium-sized UK entities will need to apply FRS102 when they prepare their accounts in future.

FRS102 will introduce a number of changes to financial statements, including:

- Requiring more intangible assets to be recognised separately from goodwill when there is a business combination. These could include values on things like brands and client lists.
- A presumption that the useful life of goodwill and intangible assets (the write off period) is no more than five years, unless a reliable estimate can be made.
- Changes to the formats (and titles) of the Profit & Loss Account and Balance Sheet, such as introducing a Statement of Financial Position, a Statement of Comprehensive Income and a Statement of Changes in Equity.
- Changes to the accounting treatments available on reconstructions and mergers.

In short, the new SORP explains how FRS102 will impact on an LLP's accounts. As a result, there are changes to the presentation and disclosures required for members' remuneration on the face of the P&L Account (or Statement of Comprehensive Income), considerable changes to the classification of items appearing on the LLP's cash flow statement, and changes to the treatment of members' retirement benefits.

The SORP also gives guidance on the use of merger accounting on conversion from partnership to LLP and in the event of business combinations or group reconstruction, and requires additional disclosures of remuneration to key management personnel, including employees.

Capital Allowances - reporting change

All practices involved in commercial property conveyancing need to be aware of recent changes in tax legislation relating to the claiming of capital allowances on fixtures, and its potential impact on how they should advise clients. Previously, capital allowances were generally the domain of accountants and tax advisers.

Failure to ensure that the new form CPSE 1 is answered correctly in respect of capital allowances could have a significant impact on the viability of commercial property transactions, and leave clients out of pocket, possibly leading to negligence claims.

> "When advising on property purchases, solicitors should now ensure that the full capital allowances history of the property is obtained prior to the purchase agreement being signed."

What are capital allowances?

Capital allowances provide tax relief to the owner of a property, and can be claimed on 'integral features', which include things like electrical and lighting systems, cold water systems, ventilation systems, lifts and escalators. The amounts can often be significant.

For capital allowances purposes, integral features fall within the definition of 'fixtures', which means 'plant or machinery that is so installed or otherwise fixed in or to a building or other description of land as to become, in law, part of that building or other land'. Readers should be aware that this is not the same as the legal definition.

What has changed?

The rationale behind the new rules is to ensure that expenditure on fixtures is only written off once against taxable profits over its economic life. Therefore, when a commercial property is sold, the purchaser's position regarding the capital allowances that are available needs detailed consideration at the time of the transaction, as the availability will be dependent on what (if any) allowances have previously been claimed by the immediate, and also previous, owners.

From April 2012, a 'fixed value requirement' has been introduced. Therefore, a purchaser is only able to claim capital allowances on fixtures within the property if he and the seller have signed a joint election to agree a value for such fixtures on which the seller has previously made a claim. This is documented through something called a 'Section 198 election' (freehold) or 'Section 199 election' (leasehold), which must be made within two years of the completion date. Although there is a two year window, to ensure this requirement is not missed, it would clearly be wise for the election to be made at the time of the transaction. There is no requirement that the fixtures disposal value used must be market value, but it cannot exceed the original cost.

Alternatively, an independent determination can be obtained from a Tax Tribunal if the two parties are unable to arrive at an agreed value. Any application to the tribunal must be within two years of the transaction.

Failure to do one of the above - either make a joint election or make an application to a tax tribunal – not only impacts on the immediate purchaser but also any subsequent purchasers, as the inability to claim capital allowances may reduce the value of a property.

It is also worth noting that if the vendor has never claimed allowances on fixtures, and makes a statement to that effect, the purchaser can still make a capital allowances claim on the acquired fixtures.

However, from April 2014, a 'pooling requirement' has been introduced. Therefore, in addition to the fixed value requirement, 'mandatory pooling' will be required, which means a buyer will only be permitted to claim capital allowances if the seller has 'pooled' all qualifying expenditure that they have incurred, in their tax return.

To sum up the impact of the new rules, if the seller has claimed capital allowances on fixtures, the purchaser will need to confirm that the seller has allocated the expenditure to a pool and then agree a disposal value for the expenditure by way of a Section 198/199 election or by application to the Tax Tribunal. If these steps are not taken, the purchaser is prevented from claiming capital allowances. It is therefore important that necessary procedures are taken prior to signing, otherwise capital allowances will be lost forever on the fixtures acquired as part of the building.

Consequently, when involved in the acquisition or sale of a commercial property, careful consideration of the capital allowances position should be undertaken. Solicitors may therefore need to take a more proactive role in the capital allowances process.

VAT - a reminder of why tax law is so lengthy

For VAT purposes, the supply of solicitor's services will be subject to the normal rules for charging VAT at the time of supply of services. The time of supply is normally when the supply is completed. This is called the "Basic Tax Point". VAT has to be accounted for in the VAT quarter in which the tax point falls.

However, this tax point can be overridden by an "Actual Tax Point", as per the following:

- The time when a payment is received or a VAT invoice issued, whichever is the earlier, if it is before the Basic Tax Point.
- The time at which an invoice is issued if it is within 14 days of the date of the supply. However, if the invoice is issued 15 days or more after the completion of the service, then the actual tax point will be the basic tax point.

> "In the legal sector, we all know that sometimes it can be difficult, or even impossible, for solicitors to decide on a fee before a service is provided, because of the nature of their work."

In those situations, the supply may be treated as taking place at the time when the solicitor issues a VAT invoice in respect of it, provided that the invoice is issued no later than three months after the date of performance of the services. However, if the invoice is issued more than three months after the service was completed then the tax point will revert back to the basic tax point.

Single Supply?

The majority of the supplies made by solicitors are 'single supplies', i.e. a single service is delivered. Here, each supply will have its own basic tax point. This will still be the case where the solicitor is making supplies to an individual on a regular basis or where the supplies will span a number of years and billing occurs on a periodic basis. The issue of a periodic invoice will create an actual tax point and VAT will need to be accounted for in the VAT period in which the actual tax point falls.

Continuous supply?

However, there are certain supplies of services (such as acting as trustees or where the solicitor is retained and remunerated as a 'permanent legal adviser' or acting as the client's legal office) that will be inherently continuous in nature and as such, there will be no basic tax point. An actual tax point is created whenever an invoice is issued or payment is received, whichever is the earlier. Firms that are involved in making a continuous supply can issue what is called a 'request for payment' instead of a periodic VAT invoice. A request for payment does not create an actual tax point.

Money held on behalf of clients, and disbursements

Although solicitors are subject to the normal tax point rules as they apply for advance payments, monies received from a client into the firm's client bank account do not create an actual tax point for VAT purposes. A tax point is only created when monies are transferred from the client bank account to its office bank account.

Similarly, monies received from client that represent reimbursement of expenses paid on the client's behalf (such as Stamp Duty and Land Registry fees) do not create a tax point for VAT purposes.

Place of supply

The place of supply will determine where VAT is accountable. Additionally, the place of supply for services will be determined by whether the supply is a Business to Business supply (B2B) or a Business to Customer supply (B2C).

If the supply qualifies as a B2B supply then the place of supply will be where the customer is located, and VAT will be accountable in that country. On the other hand, if the supply qualifies as a B2C supply then the supply is deemed to take place where the supplier belongs. Hence, VAT will be accountable in the country where the supplier belongs.

It has to be mentioned that where the supply is a B2B supply and the client is VAT registered and located in a different EC Member state then VAT will have to be accounted for by the client in its Member State via reverse charge. The supplier will need to zero rate their supplies and add the wording "reverse charge" on their sales invoice.

However, there are certain services where the place of supply is not influenced by whether the supply is B2B or B2C, but rather by specific VAT rules. These are as follows.

Supply of services relating to Land

If the supply of services is related to land or property, the place of supply of those services is where the land itself is located, rather than where the supplier or their customers belong. This will include services such as conveyancing, surveying or valuation of properties. However, the services must be directly related to land. If not, then the supply would follow the normal place of supply rules for services.

An example of a service that is not directly related to land is services provided in drawing up a will that contains land as an asset.

Services provided to clients resident outside the EU

There is a special VAT provision in regards to the place of supply rules for 'lawyer services' where the recipient of those services is a non business customer belonging outside the EU. In this case, the supply is deemed to be made in the country where the recipient belongs and will fall outside the scope of UK VAT.

Easy isn't it?

Of course, if anybody has any questions, we are always happy to help.

Residual Balances Rules
have changed

As expected, version 12 of the Handbook includes confirmation of the increase in the limit for donating residual client balances without prior SRA authorisation. The changes are effective from 31 October 2014, and apply retrospectively, i.e. to existing and new balances.

> "For those of you who are unaware, prior to these changes the limit for donating residual balances to charity without first having to obtain written permission from the SRA was £50. The new rules have increased this to £500."

The limit applies to individual balances, not aggregate amounts, and any balances above £500 will still need to be approved by the SRA.

Other than the increase in the threshold, there are no changes to the underlying rules around what practices should do to try and return the balances to the clients, and the records that need to be kept when balances are donated.

SRA and Accountant's Reports - the current position

Many readers will be aware that, following a somewhat unusual consultation, the SRA have now backtracked on their planned intention to remove the need for Independent Accountants to report on their compliance with the SRA Accounts Rules. The need for Accountant's Reports will remain in place for all practices apart from those who:

a) receive all of their fee income from the Legal Services Commission; and/or b) can claim exemption as the amount of money passing through their client accounts is below the de-minimis limits.

Item b) above is the same exemption that existed previously, so the only change is a).

In addition, practices who receive an unqualified Report from their Accountants will no longer need to file them with the SRA.

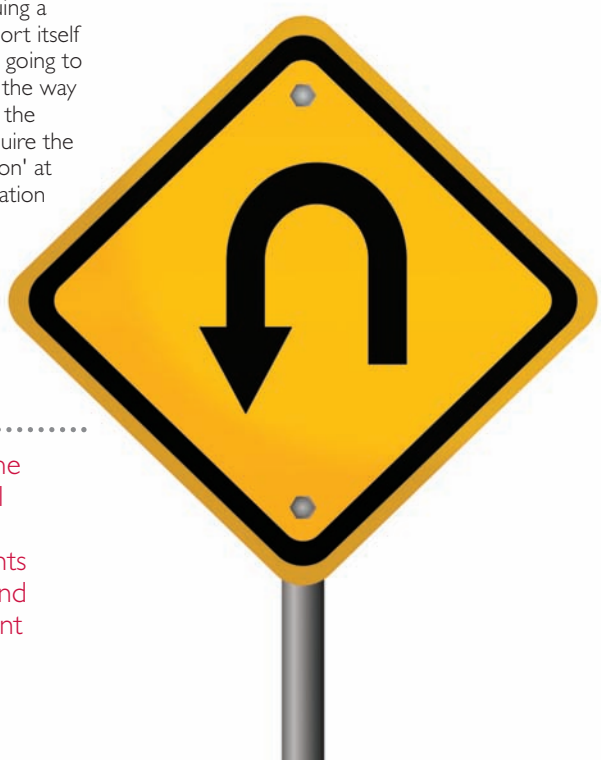
Whilst we understand that the SRA have a desire to reduce their own administration burden, the move to only requiring qualified Reports to be filed with them is somewhat surprising, as the SRA are only too well aware of the fact that far more Reports ought to be qualified than presently are. In fact, out of the 10,000 or so Reports filed with the SRA each year, only about half are qualified. If you ask any Reporting Accountant that does a lot of this kind of work, non-qualified Reports are very much the exception (only about 3% of ours are), so it could be said that many non-qualified Reports are in some ways the ones the SRA should be focusing on.

So what is coming next?

First of all, the SRA are planning on issuing a modified form of the Accountant's Report itself during the first quarter of 2015. This is going to take a risk based approach, with less in the way of prescriptive tick boxes compared to the current Report format. It also may require the Reporting Accountant to sign an 'opinion' at the end. There is going to be a consultation process shortly.

Secondly, the SRA are going to issue revised SRA Accounts Rules during 2016, which again are likely to be less prescriptive and more risk based.

> "The SRA have clearly taken the many responses to their initial consultation seriously, and in particular listened to comments about not only the strength and importance of the independent reporting process but also about modernising the Accounts Rules, and trying not to place yet more burden on those filling the position of COFA in practices."



LMS 2014 Financial Benchmarking Report

- results out soon

Many readers will know that we produce the Law Society's annual benchmarking report. The 2014 report has now closed, and we are almost there in drafting it. It should be available on line from early December, and the results make really interesting reading.

New Team Members

Over the last few months we have been delighted to welcome several new members to our ever-expanding team.

Mathew Barlow and Emma Whittaker (far right) have joined us as trainee accountants, Adele Beadle (far left) specialises in performing SRA Accounts Rules audits, and Amanda Chamberlain (second left) helps to keep everything running smoothly on the admin front.

This now gives us over 25 dedicated members in our Legal Team and about 130 retained practice clients.

We are very 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 SRA Accounts Rules
- Accounting
- Practice strategy planning
- 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)
- New practice start-ups
- Raising finance
- Advice on practice administration software
- Financial services
- Trusts and estates

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