Legal Focus

DRIVING LIFELONG PROSPERITY

Autumn 2017

SPOTLIGHT ON PARTNERSHIP PROFIT SHARING

Welcome...

to the autumn edition of Legal Focus. In this edition, we look at the new rules for profit sharing arrangements in LLPs, applying VAT correctly to online searches and, with the introduction of GDPR, what you must to do to receive our next Focus.

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INSIDE

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GDPR, ARE YOU PREPARED FOR THE CHANGES?

On 14 September 2017, the Government published its Data Protection Bill. This bill will take account of the EU's General Data Protection Regulation (GDPR), which comes into effect on 25 May 2018 and reaffirms that GDPR will apply post-Brexit. GDPR has been widely touted as the biggest overhaul of data protection legislation for 20 years.

DOES IT APPLY TO ME?

Whether you are a sole practitioner, company or partnership; data controller or data processor; a business or an employer; dealing with third party suppliers and contractors, if you handle personal data, you should already be thinking about and preparing for GDPR. Understandably, the prospect of fines up to €20 million or 4% of global turnover, for the most serious data breaches, sounds very daunting.

WHAT DO I NEED TO DO?

You can find out how GDPR will affect your practice from the Information Commissioner's Office (ICO) website, which provides:

- an overview of GDPR, with a helpful 12-step checklist and other guidance;
- details of webinars and workshops (often free to attend); and
- the ICO newsletter and blog, which provide regular updates.

It is not a matter of one size fits all. Checking regularly against the definitions and exemptions in the legislation, and keeping up-to-date with the latest guidance, may mean you can confirm or discount some actions immediately.

You will need to be able to demonstrate that you are meeting the GDPR principles, which can be summarised as:

Processing of personal data must be lawful, fair and transparent.	
Data must be:	Collected for specified, explicit and legitimate purposes;
	Adequate, relevant and limited to the purposes it is being used for;
	Accurate and kept up-to-date;
	Kept for no longer than necessary;
	Kept safe and secure.
Data controllers shall be responsible for, and be able to demonstrate, compliance with these principles.	

Having raised awareness of GDPR with key decision makers, you will need to consider and document, for example:

- what kinds of personal data you collect and use;
- how and when you obtain and use this data;
- where the data is held (whether in paper or electronic form);
- who has access to the data and who you share it with outside your organisation; and
- how long you should keep the data for.

You may already have some of this information as part of your compliance with existing data protection legislation.

Carrying out this assessment will also help you judge whether you can:

- demonstrate the relevant lawful basis for processing personal data;
- meet the rights of individuals under GDPR;
- check whether you have GDPR-compliant consent where you need it;
- put the right procedures in place around data breach identification, reporting and investigation;
- confirm that the contracts you have with others (not just IT providers) take GDPR compliance into account. GDPR requires that personal data is kept secure to protect it from 'unauthorised or unlawful processing and against accidental loss, destruction or damage, using appropriate technical or organisational measures'.

One approach is to consider what you would need to provide the ICO if they visited your practice. See Appendix 1 in the ICO's 'Guide to Data Protection Audits'.

WHAT OTHER REGULATION SHOULD I BEAR IN MIND?

You will need to refer to the Data Protection Bill as well. The Government has described this bill as 'a complete data protection system, so as well as governing general data covered by GDPR, it covers all other general data, law enforcement data and national security data. Furthermore, the Bill exercises a number of agreed modifications to the GDPR to make it work for the benefit of the UK in areas such as academic research, financial services and child protection.'

If you send direct marketing, consider the 'Privacy & Electronic Communications Regulations' (PECR), which sits alongside the DPA and is under review. The UK Government has signed up to the new e-Privacy Regulation too.

For further information and helpful guidance, please visit the ICO website www.ico.org.uk.

New rules for partnership profit sharing arrangements – Are they always fair?

In the 2016 Budget the Government announced proposals to review the way partnership profits and losses are allocated between partners for tax purposes. HMRC have long suspected practices of manipulating the allocations in order to gain a tax advantage (albeit a perceived one in reality). Following consultation, HMRC have produced draft legislation to be included in the Finance Bill 2018. This article illustrates the proposed changes and effect on taxable profits. We hope that losses are something our readers seldom encounter (although the principles are the same).

Whilst the Government does not wish to restrict the ability to allocate profits on a commercial basis, the proposed new rules remove any flexibility regarding how the tax-adjusted profits may be shared between partners. The current legislation simply states that a partner's profit share follows 'the firm's profit-sharing arrangements.' If the draft legislation is passed as it stands, the tax-adjusted profits will be shared in a strict ratio, based on the allocation of the commercial profits (i.e. the accounting profits), as stipulated in the partnership agreement.

EXAMPLE

The members' agreement for ABC LLP states that Anne receives a fixed profit share of £30,000, and the remainder is shared 30% to Bob and 70% to Carol. For the current year, the commercial profit (as reported in the accounts) is £100,000, so the profit allocations are as follows:

Anne	£30,000
Bob	£21,000
Carol	£49,000
Total	**£100,000**

After making the normal tax adjustments (disallowing non-tax deductible expenditure, deducting capital allowances etc.), the tax-adjusted profit is £120,000. Anne receives a fixed share and none of the tax adjustments, so, based on the current rules, the profit allocations for tax purposes will be:

Anne	£30,000
Bob	£27,000 (30% of the balance)
Carol	£63,000 (70% of the balance)
Total	**£120,000**

In this common scenario, the net tax adjustments result in an additional profit (for tax purposes only) of £20,000, which is shared between Bob and Carol in the ratio that they share the balance of commercial profits.

The proposed new rules dictate that the tax-adjusted profit of £120,000 is shared in the effective ratio that the members share the profit commercially, which would result in the following:

Anne	£36,000 (30%)
Bob	£25,200 (21%)
Carol	£58,800 (49%)
Total	**£120,000**

Now Anne is taxed on £6,000 of the net tax adjustments, with a corresponding reduction of £1,800 for Bob and £4,200 for Carol. Overall, the same amount of profit is being taxed, but Anne will be acutely aware that, under these new rules, her tax liability is higher but the profit share she actually receives is not.

The above scenario is commonplace, with a large number of practices offering fixed share partners a profit allocation that is unrelated to the practice's tax adjustments, so that they pay tax on what they receive (akin to a salary). Other practices may adjust for the disallowed costs that are directly attributable to the fixed share partners (akin to a salary plus benefit in kind).

For many legal practices with large amounts of entertaining expenses disallowed each year, taxable profit will be higher than commercial profit. In this case, the fixed share partners will be forced to share in all tax adjustments, with a corresponding reduction for the equity partners. The exception might be where there has been a large investment in equipment, where a large capital allowances claim might result in taxable profit being lower than commercial profits (and so the winners and losers will be reversed).

We expect that, more often than not, fixed share partners will lose out as a result of this change, and equity partners will gain. If these new rules are approved, all practices will need to reconsider their profit sharing arrangements. One school of thought is that it is right for fixed share partners to share in a proportion of the tax adjustments, in which case the outcome may be that no action is required.

As with many areas of tax, a change to one aspect can have consequences elsewhere. Where the practice operates as an LLP, fixed share members rely on their capital contribution to the LLP to determine a self-employed tax status. If their profit share is increased to compensate for their higher tax liabilities, then a larger contribution may be required.

LLP members taxed as employees through the payroll are unaffected by these proposals. HMRC confirmed via the 'Salaried Member' rules that these members do not share in the practice's tax adjustments.

The new rules will take effect for accounting periods beginning after the Finance Bill receives Royal Assent, so it is likely that the first tax year in which partners will be taxed on this new basis will be 2018/19, although this will depend on the practice's accounting date. Practices will be wise to start considering this now, particularly given the implications for profit share negotiations, and the calculation of tax reserves and drawings.

How much can I pay into my pension?

If you are thinking of making pension contributions this tax year, the amount of tax relief available to you will depend on three factors:

- Your annual contribution allowance;
- The amount of unused contribution allowance you have from the previous three tax years; and
- Your pensionable income in the current tax year.

THE ANNUAL CONTRIBUTION ALLOWANCE

In general, the total allowable contributions are limited to £40,000 per annum. However, for higher earners, the allowance is reduced or tapered by up to £30,000.

Since 6 April 2016, if your taxable income is more than £150,000 and your 'threshold income' (taxable income less gross pension contributions) exceeds £110,000, then the allowance is reduced by £1 for every £2 in excess of the threshold. The maximum reduction is £30,000, resulting in an annual contribution allowance of £10,000.

CARRY-FORWARD ALLOWANCES

If you are a high earner with a tapered annual allowance for 2016/17 and/or 2017/18, any unused allowances from the previous three tax years can be carried forward at the full annual allowance level, plus anything unused from the tapered allowance.

Unused allowances must be applied in strict order, with the current tax year allowance (2017/18), and then any available allowance from the oldest of the previous three tax years first, i.e. 2014/15, then 2015/16, and lastly 2016/17.

PENSIONABLE INCOME

It is possible to obtain tax relief on personal contributions up to the level of your gross pensionable income for the tax year in which a contribution is made. This is essentially earned income which is taxable.

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For more information, please contact **Gary Cook** on **01242 680000** or gary.cook@hazlewoods.co.uk

BENCHMARKING SURVEY – ARE YOU BUCKING THE TREND?

Hazlewoods Legal Team is preparing the Law Society's LMS Financial Benchmarking Survey once again this year. Now in its 17th year, the survey is widely recognised as the annual financial health check for small to medium sized practices. It includes valuable information on key performance areas such as:

- Fee income
- Employment costs and other key variable overheads
- Profitability
- Working capital

In addition to a free copy of the survey, everyone that takes part receives a personalised report, comparing their performance against all other participants in the survey.

The survey is open to all firms, and it is quick and easy to complete. Participation is completely anonymous, and your data is not shared with any other organisations or individuals.

To take part, please download the questionnaire at:
http://communities.lawsociety.org.uk/law-management/fbs/

Closing date 30 November 2017.

VAT AND ONLINE PROPERTY SEARCHES – ARE YOU GETTING IT RIGHT

Following a recent Tribunal decision, the North-West law firm Brabners faces a £68,000 VAT bill for electronic local authority property searches procured from an agency, after the tribunal ruled that they should not have been treated as disbursements, notwithstanding that Brabners was supported by the Law Society in presenting its case.

The Law Society's position has long been set out in its practice note on VAT and Disbursements. The Society believed that, provided the report or search result was given to the client, that was sufficient for the disbursement treatment to apply, even if the solicitor then used the report or search result to assist in providing advice to their client. The Law Society considered that the act of obtaining the search results and the subsequent use of them by the solicitor to prepare a report were 'conceptually different'.

On the other hand, HMRC's view is that fees for local authority searches are subject to VAT when you charge them to your client. However, historically by concession, they are prepared to allow solicitors to treat postal search fees as disbursements, so that VAT will not be payable. Crucially to this argument, HMRC did not extend this concession to electronic search fees.

In the Brabners case, HMRC and the Law Society disagreed over who required the search. HMRC's view was that if the information from the report or the search was used by the solicitor to provide advice, then the service had been provided to them and not to their client, and therefore the disbursement treatment was not available.

In an earlier case (Barratt, Goff & Tomlinson), the Tribunal had agreed with the Law Society viewpoint, but in the Brabners case the Judge rejected the Law Society's argument, stating that he could not 'readily identify the *concept* that was said to be different.' He concluded that when Brabners obtained search results, and prepared a separate report on them, it was using that information 'as part and parcel of its overall service.'

The Judge drew a distinction between the medical records that were the subject matter of the Barratt case, and the search reports in the instant case, on the basis that the client could be viewed as the 'owner' of the medical records, and the solicitor could only obtain access to those records with his client's consent.

WHAT NEXT?

The Law Society have said that they are considering the implications of this decision for its practice note on VAT and Disbursements. At the time of writing, we don't know if there will be an appeal to the Upper Tribunal. Strictly speaking, First Tier Tribunal decisions have no bearing in law, and do not generally set legal precedent. However, given the significance of this issue, we would be surprised if it did not open the door to further attacks from HMRC.

In the meantime, you have to protect your position. It would be prudent to treat these types of transactions in accordance with HMRC's view of the correct approach, which is that the VAT liability of the recharge to the customer will follow the VAT liability of your overall supply to the customer, and thus almost inevitably will be subject to standard-rate VAT. This will only impact on transactions where VAT has not already been charged on the original cost. There should not be any cost to the practice, as it is the client that will suffer the additional VAT.

Based on the Tribunal's analysis of the position, it is hard to conceive of any situation where you could pass on the cost of an electronic search as a VAT-free disbursement to your client. Indeed the Judge did comment specifically that *"In my view, wherever searches are obtained, the payment is part of the overall consideration which the client pays for the service supplied by the solicitor."*

For more information, and to check that you are treating property search fees correctly, please contact our in-house VAT experts, Julian Millinchamp and Andy Connolly.

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