Legal Focus

DRIVING LIFELONG PROSPERITY

February 2024

SPOTLIGHT ON CLIENT INTEREST

Welcome...

Welcome to the February 2024 edition of our Legal Focus. In this edition, we round up the key issues facing law firms when it comes to interest on client account, give you our top year-end tax planning tips and provide an update on the potential changes to the SRA Accounts Rules.

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INSIDE

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Client account interest – a round-up of the key issues facing law firms

Client account interest has been a topic of debate for a number of years now.

Since the 2011 SRA Accounts Rules introduced the need for a formal interest policy and allowed firms to use judgement and discretion when paying interest to clients, there has been a lot of discussion about the best approach.

Up until about 12 months ago, most of this discussion was largely theoretical, as rates had been so low that most accrued interest on the client account was unlikely to pass the *de minimis* threshold set by firms in the vast majority of cases.

For many firms, the receipt of client account interest was so incidental to normal trading that it usually slipped by unnoticed.

Things changed during the Autumn of 2022, with the government's controversial 'mini Budget' and rapidly rising inflation sending interest rates spiralling.

Since then, firms that handle large volumes of client money have enjoyed some fairly significant sums of client interest being deposited into their office account, returning us to situations similar to almost 20 years ago, when interest was a substantial (and in some cases primary) component of profit.

This has brought many of the lingering debates back to the minds of client money handling firms, and has also created some new questions that we did not see coming.

In this issue we will consider the key points.

WHAT IS A 'FAIR' RATE THAT FIRMS SHOULD PAY TO THEIR CLIENT?

Going back to basics, Rule 7 of the SRA Accounts Rules (as it currently stands at least) states that firms must account to clients for a 'fair sum of interest'.

But what is a 'fair sum'?

Those of us hoping for clarification from the SRA on this point can keep hoping as there is nothing in the way of guidance to help us decide on what is 'fair'.

Some readers might recall that there was old (now deleted) guidance suggesting that firms should set the rate of interest payable on client money at the same level that a client could themselves achieve on an instant access business deposit account at the same bank.

Although current thinking has moved on since then, it is worth bearing in mind that it is not the responsibility of the law firm to go to great effort to find the best rate possible. Firms are not expected to shop around for a more favourable rate on behalf of their clients. That is not to say they cannot of course, and achieving a better rate for the client should have the knock-on effect of more profit for the firm.

A policy of paying interest at a rate based on the headline rates on the general client account at the bank at which client money is held is unlikely to draw any challenges from the SRA. Where firms operate more than one general client account with different banks, they may choose to adopt a 'blended rate', or apply the highest rate from those accounts. In any case, that rate is likely to be lower than the rates actually being received by firms because they will usually enjoy higher rates due to the volume of money held in aggregate. There is nothing stopping firms passing on those same rates to clients, but they are not obliged to do so.

Our advice has always been that firms should have a documented interest policy, which they show to their clients at the outset of a matter, explaining issues such as:

- Their *de minimis* limit
- When interest will be paid
- The rate at which interest will be paid.

Some firms include their policy in their terms of business, so that they can easily demonstrate that the client has seen it.

WHAT IS A SUITABLE *DE MINIMIS*?

Previous versions of the Accounts Rules used to recommend the use of a *de minimis*, below which interest would not need to be paid to clients. The current rules no longer mention a *de minimis*, but it remains an important element of any interest policy.

Under the old rules a £20 *de minimis* was commonplace, but most firms are now at £50, with some moving towards £100 for certain (generally larger or corporate) clients.

HOW OFTEN SHOULD FIRMS PAY INTEREST TO THEIR CLIENT?

The other main measurement of fairness is centred around how often interest should be calculated and paid to the client, and the first thing to consider here is what the firm's interest policy states.

A well-thought-out policy should state how often interest calculations take place. In some cases, this might be periodically; for example, annual calculations on long running trust administration matters, or it might be more often where particularly large volumes of client money are held. At the very least, it should be done at the end of the matter.

Good financial hygiene is important here – not just to ensure that the calculation takes place in all cases before a matter is archived, but also that the calculation takes place reasonably promptly in order to avoid creating a potential residual balance headache on old, unarchived matters.

Do not forget, even a relatively modest amount of client money held over a long period of time can attract a large amount of interest.

MAKE SURE YOUR CLIENT BANKING ARRANGEMENTS REMAIN COMPLIANT

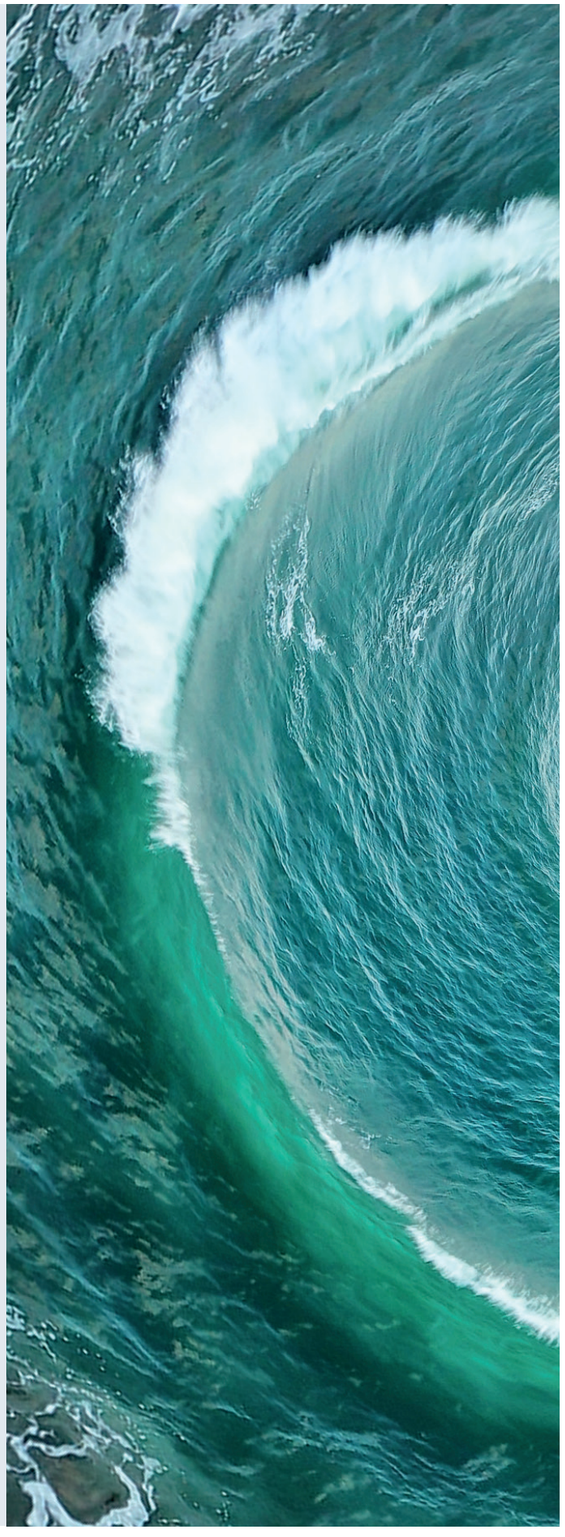
As rates of interest have been rising, we received a number of enquiries from firms asking about the ability (or not) to use more dispersed client banking arrangements in order to capture the best available deals – for example, fixed term treasury deposit accounts or placing a tranche of client money with another bank.

It is fairly common for firms to deposit a 'top slice' of client money in, for example, an overnight treasury account, as these have typically offered higher returns than a general client current account. We have seen firms locking client funds into longer-term deposit accounts that do not offer instant access, with terms ranging from weeks, to months and even whole years.

Do not forget that Rule 2.4 of the SRA Accounts Rules states that client money must be available on demand, unless you agree an alternative with your client and so, unless your client gives explicit instructions, you would be in breach of the rules if client money could not be accessed immediately.

In some cases, access terms can be broken at the expense of interest, and this should not give firms a compliance problem, but care must be taken if this is not the case.

In general, however, as we have seen rates on instant access accounts improving, the appetite for fixed-term deposit accounts has fallen.



DO NOT OVERLOOK YOUR DESIGNATED DEPOSIT ACCOUNTS

It has become much less common for firms to use client designated deposit accounts (DDAs) over the years, as the administrative burden of operating separate accounts, coupled with the difficulty of opening new accounts, has made them less attractive.

In most cases, interest earned on a DDA is paid directly into the account and that is where it normally stays, but firms are reminded that the Accounts Rules do not differentiate between this and interest earned on the general client account.

There is therefore no special treatment required for interest on any DDAs that firms still hold, and it can be included in the normal client interest calculations and allocated accordingly.

A REMINDER OF THE TAX POSITION ON INTEREST

A topic that we have mentioned in previous issues, but which is worth repeating, is the way in which the payment of tax on all interest received (including both client and non-client related interest) is treated in light of the forthcoming change to the tax basis period rules for partnerships, LLPs and sole practitioners.

Just to recap, for the tax year ending 5 April 2024, there will be a 'tax catch-up charge', for all self-employed individuals where their businesses have accounting dates which are not either 31 March or 5 April each year (i.e., they are non-coterminous with the end of the tax year), and the impact of this payment will land on 31 January 2025. For a firm with a 30 April year end, the profits assessed for the 5 April 2024 tax year will be the 12 months ended 30 April 2023 plus the 11-month period to 31 March 2023, less overlap relief.

Taxpayers can elect whether to pay the whole catch up tax charge on 31 January or to spread it, interest free, over a five-year period, which of course most firms will do to ease the cash flow pressure.

The main exception to the ability to spread the tax burden for law firms is that any element of this catch-up profit that relates to interest cannot be spread. Given the amounts of client interest may be significant for firms, this can have a big impact for firms that are not prepared.

Another important issue is that, for partnerships and LLPs, interest is taxed on a cash basis (i.e., when it is received and paid) rather than on an accruals basis. Therefore, firms need to ensure that they have credited their client ledgers with any interest due in advance of 31 March 2024 to ensure that they receive a tax deduction for it, rather than simply including an accrual for interest payable within their accounts.

VAT AND PARTIAL EXEMPTION

There has been much talk recently of the unintended, and potentially unwelcome, consequence of the surge in client interest income which arises where the earning of interest may no longer be classed as 'incidental' to the normal trading activities of the firm for VAT purposes.

Because interest is exempt from VAT, but the normal business of a law firm is not, there is the potential for VAT partial exemption rules to arise. This may affect a firm's ability to reclaim input VAT in full on their trading expenses.

In simple terms, where a proportion of a firm's total income is made up of a VAT exempt amount and the partial exemption rules apply, a corresponding proportion of its reclaimable input VAT becomes irrecoverable.

We are aware that some firms have looked to mitigate their exposure to this potential problem by, for example, applying to HMRC to adopt a 'special method' of VAT attribution, which looks to limit the apportionment of irrecoverable VAT to the proportion of time spent actively managing the interest earning function. This can be a lengthy and potentially time intensive process, and is only recommended where a firm is confident that they are captured by the rules. A further downside of the special method is that once you are in it, you cannot get out again, without renegotiating with HMRC.

It should be noted that it is highly unusual for law firms to have extensive resources allocated to anything other than VATable supplies. It is not usual, for example, to see firms expending a significant proportion of staff time on the act of actually earning interest; this is usually an incidental consequence of handling a client matter. Even where members of staff were to spend long periods of time pursuing best rates, employee costs will primarily fall outside of the scope of VAT, and so it is our view that the majority of firms should not actually have a great deal to worry about, irrespective of the overall amount of client interest earned.

An exception to this might arise where, for example, a firm engages a consultant to source the best available rates on client money and the consultant charges for their services by way of a VAT invoice. This can be dealt with quite simply by specifically blocking the reclaim of input VAT on those costs.

In any case, under the *de minimis* rules, HMRC allows the recovery of up to £7,500 of VAT per year that would otherwise be captured.

Due to the potential complexities with this, we recommend that firms consider their own position carefully and take advice where necessary, rather than assuming they are automatically captured by partial exemption requirements and making unnecessary adjustments to their reclaimable input VAT. We are of course very happy to help.

Changes to the Accounts Rules are on ice (for now)

Most readers will know that, following an SRA consultation in March 2023, we have been waiting with bated breath for several changes to the SRA Accounts Rules.

Some of the minor changes had already been approved by the LSB, while other more controversial changes around the accounting for, and reconciliation of, clients' own accounts had seemingly become stuck in limbo.

It appears now that the SRA has decided to put all Accounts Rules changes on ice. In light of recent events, most notably the closure of Axiom Ince, the SRA has stated that now is not the time to make changes to anything concerned with the protection of client money.

The SRA has left the door open to make changes in the future, but for now it seems that it is business as usual.

MAKE SURE YOU ARE PREPARED FOR YOUR YEAR-END

It is highly likely that, once the SRA has concluded their review into the current 'tricky' issues and have dealt with the fall out, their eyes will turn with even sharper focus onto the systems and controls that firms have in place to combat potential breaches of the Accounts Rules.

So, although there has been a pause on compliance amendments, it does not mean that firms can take their eye off the ball. Everyone needs to give careful thought to whether their own processes are fit for purpose.

Making sure that you have taken positive action to address recurring issues from previous SRA audits is a great place to start, and we advise all firms to consider the following points well in advance of their year-end:

- Has the COFA reviewed their Reporting Accountant's summary of findings from last year's audit and addressed their recommendations?
- Has the firm reviewed their retentions and dormant balances for instances of residual balances that need to be returned to clients or money otherwise held incorrectly on the client account?
- Have suspense ledgers been cleared down regularly?
- Is there a complete set of monthly client and office account reconciliations that are free from errors or reconciling adjustments, and have they all been reviewed, signed and dated by the COFA?
- Is there evidence in all cases that bills have been sent to clients before costs have been taken and have all costs been paid and/or properly incurred?
- Does the client matter listing include any overdrawn client ledgers or office ledger credit balances and, if so, what is the firm doing to review and deal with them?
- Is the breaches register up to date and has a proper assessment been made around whether any breaches are reportable?
- Have all clients' own accounts been reconciled during the year or, where that has not been possible, has the firm maintained a record of transactions that have originated from within the firm?

This list is not exhaustive, but these tend to be the common issues we see cropping up across firms.

Of course, good financial hygiene does not begin and end with compliance, and the importance of making sure your year-end accounts processes are running smoothly before you reach that point should not be underestimated.

The following points should put you on a positive footing:

- Make sure your opening balance adjustments have been entered to align your opening accounts system balances with the previous year-end accounts.
- Review your control accounts – including billed debtors, unbilled disbursements, PAYE/NIC, VAT and trade creditors – and make sure they reconcile to the appropriate reports.
- Review narratives on postings for consistency, accuracy and a suitable level of detail to help with year-end analysis, including reviews of allowable vs. disallowable expenditure.
- Try to be consistent with postings and make sure that the same types of transaction are posted in one place rather than spread across different nominals.
- As far as possible, update your accounting system for prepayments, accruals, depreciation etc. or make sure you have prepared schedules that can be updated in the year-end accounts.
- Make sure you have a file of all loans, finance agreements and operating lease agreements, as there is usually some degree of accounting or disclosure required for these.
- Ask your accountant for a list of all of the reports that they will need you to run at the year-end, as sometimes they cannot be produced retrospectively and can be difficult to try to recreate after the event.

Again, this list is not exhaustive and so, as a final overarching point, make sure you are in close communication with your accountant prior to the year-end because proactive planning can really make a big difference when the annual accounts and audit process rolls around again.

Top 10 year-end tax planning tips

As another tax year draws to a close, now is a good time to take stock and consider whether all allowances and reliefs have been maximised as far as possible and whether any action needs to be taken before the new tax year begins.

We have set out below our top ten tips to consider:

	Description	Relevant to:	Possible action
1	Director/shareholders of owner managed businesses should review their remuneration package in advance of the new tax year to ensure that it is as tax efficient as possible.	Director/ shareholders	Consider paying a combination of low salary, high interest and dividends. This could result in tax free income of up to £19,070 in 2024/25 (£19,570 in 2023/24) and double that for couples, if structured correctly and depending on the specific circumstances of the individual.
2	The tax free dividend allowance is set to reduce from £1,000 to £500 from 6 April 2024.	Director/ shareholders	Where possible ensure that dividend allowances have been fully utilised by 5 April 2024. Spouse planning could also be considered (if they are not already a shareholder) to double the available tax free allowances.
3	The personal allowance is reduced by £1 for every £2 of net income over £100,000, meaning that those with income of between £100,000 and £125,140 could have a marginal tax rate as high as 60%.	High earners	If your income is within this threshold, you could consider ways to reduce your taxable income, such as making pension contributions, charitable donations, deferring income into 2024/25 or transferring income producing assets to your spouse.
4	The personal savings allowance allows the first £1,000 of savings income to be paid tax free to basic rate taxpayers. This drops to £500 for higher rate taxpayers and nil for additional rate taxpayers.	Savers	If you are a director and have loaned money to the company you could consider paying a commercial rate of interest on the loan to utilise this allowance. Note, however, that the company would need to deduct basic rate tax and submit a CT61 form to HMRC. If you are a higher/additional rate taxpayer and you receive large amounts of interest, you could consider transferring savings held in your own name to your spouse.
5	If yours or your spouse's taxable income exceeds £50,000 for the tax year, this could lead to a claw back of child benefit under the high-income child benefit charge. Once taxable income reaches £60,000 the benefit will be lost in full.	Parents	Reducing, deferring or transferring taxable income as described for higher earners above could help to preserve this benefit.
6	Up to £1,260 of your personal allowance can be transferred to a spouse or civil partner if neither of you are higher rate taxpayers, by virtue of the marriage allowance.	Spouses	A transfer of allowance claim is easy to make and can be of benefit where one spouse has income of less than the personal allowance (currently frozen at £12,570), with a tax saving of up to £252 per annum.
7	Mortgage interest relief for landlords is restricted to the basic rate of tax, which can result in significant effective tax rates for some landlords, particularly higher earners.	Investment property owners	A review of your operating structure could be undertaken to see if the arrangements can be made more tax efficient. This could include incorporation, spousal transfers or use of partnerships.
8	There are various Government backed investment platforms, such as enterprise investment scheme (EIS), seed enterprise investment scheme (SEIS) and venture capital trusts (VCT), which give the incentive of income tax relief in exchange for the underlying investment carrying a varying degree of commercial risk.	Investors	If you have any surplus cash, you could look to make a tax efficient investment.
9	The capital gains tax annual exemption for all individuals is £6,000 for 2023/24 but reducing to £3,000 for 2024/25. Any unused exemption is lost.	Investors	Consideration should be given to the transfer of assets between spouses such that both utilise their annual exemptions on a subsequent disposal. Claiming/crystalising capital losses could also help to offset future gains with the reducing allowances.
10	The annual allowance for pension contributions is £60,000 for 2023/24. This is reduced, however, proportionately for individuals with adjusted income above £260,000 by £1 for every £2 above this threshold down to a minimum limit of £10,000. This reduction also only applies where your 'threshold income' (broadly taxable income) is also over £200,000.	Higher earners	You could consider utilising your pensions allowance wherever possible as well as any unused allowances from the prior three tax years.

Two other important year-end reminders

CHANGE OF TAX BASIS PERIODS

This applies to sole practitioners and partnerships (including LLPs) with an accounting date that does not fall from between 31 March to 5 April.

Previously, partners in these firms have paid tax on their profits further in arrears than those businesses whose accounting dates are coterminous with the end of the tax year, but that changes this year and for affected firms, this is going to result in a tax 'catch-up charge' on 31 January 2025.

For the tax year ending 5 April 2024, all sole practitioners or partnerships with a non-31 March to 5 April accounting year-end are going to need to apportion practice profits of a particular accounting period between those arising in one tax year and those arising in the next. For example, a firm with a 30 April year-end will have 11 months of their accounting year in one tax year (1 May to 5 April) and one month in the next (6 April to 30 April).

The apportionment process will add an extra layer of administration into the whole annual accounting and tax computation process, and many law firms are considering a change of accounting date to 31 March to ease this burden. However, care needs to be taken in order to ensure that changes in accounting date do not result in unfavourable operational or tax related consequences.

LLP MEMBERS – A REMINDER TO REVIEW YOUR SELF-EMPLOYED STATUS

As is normal for this time of year, LLPs need to review each member's position to ensure they can continue to be taxed as a self-employed individual.

By way of a reminder, three conditions need to be considered separately, and just one needs to be 'failed' for a person to be classed as self-employed. In brief, they are:

- At least 80% of remuneration is fixed or not linked to firm wide performance
- The member does not have significant influence
- The member's capital contribution is less than 25% of their remuneration.

Reality can be a little more nuanced than this of course, and we frequently advise firms on all of the issues noted here, so please do get in touch if you have any questions.

An audience with… Faye Warren

People are the essence of our Legal Team and, in this article, we get to know more about Faye Warren, Associate Director.

HOW DID YOUR CAREER WITH HAZLEWOODS START AND EVOLVE?

I joined Hazlewoods as a placement student in the Tax Team in 2009. After graduating a year later from Cardiff University with a degree in Accounting and Finance, I moved back to Gloucester and re-joined Hazlewoods in the Legal Team. I have since ACA qualified and worked my way up the ladder to become an Associate Director in May 2022.

WHAT DREW YOU TO HAZLEWOODS ORIGINALLY AND HOW HAS THE FIRM CHANGED SINCE?

Whilst looking for a summer placement, I researched lots of different accountancy practices. I initially started with the Big Four, but quickly decided they weren't for me and refocused on smaller practices. I applied to Hazlewoods because I grew up in Gloucester and wanted to stay local and had heard of Hazlewoods because of its great reputation. Since I joined, the firm has grown massively, with staff numbers more than doubling.

WHAT IS ONE THING THAT SURPRISED YOU ABOUT WORKING AT HAZLEWOODS?

How much I would enjoy it! When I first trotted along to my interview for a summer placement in the Tax Team, I never imagined that I would still be with Hazlewoods over 10 years later.

WHAT DO YOU ENJOY MOST ABOUT YOUR ROLE?

The people I work with. We are very fortunate to have lovely people working in the team and having worked at Hazlewoods for such a long time, I have made some wonderful friends and have built up great relationships with both my colleagues and clients.

WHAT DOES A TYPICAL DAY LOOK LIKE FOR YOU AND WHAT ARE YOU CURRENTLY WORKING ON?

Every day is different and there is no such thing as a 'typical day' when working in the Legal Team. The variety of work is one of the things I love most about my job. This week I have done some compliance work (accounts, tax returns etc.), but I've also prepared a valuation report for a practice, prepared slides for a presentation on a client's financial performance and put together some cashflow forecasts for a client looking to obtain finance from the bank.

HOW DO YOU SEE THE LEGAL TEAM CHANGING IN THE NEXT 10 YEARS?

The Legal Team has grown massively since I first joined it as a trainee, both in terms of staff and client numbers. Our client base isn't just local and spans the country. Over the next 10 years, I anticipate the team will continue to grow and we will see more and more clients coming on board due to the sector-specialist service we offer.

WHAT DO YOU ENJOY ABOUT THE OFFICE LOCATIONS?

I am based at our Windsor House office in the centre of Cheltenham. It's great working so centrally so I can nip into town or go out for a nice lunch!

WHAT IS THE BEST ADVICE YOU CAN GIVE TO SOMEONE JUST STARTING OUT IN THEIR CAREER?

Ask questions! There will always be someone around who knows more than you, so make use of them and never be afraid to ask if you're unsure about something. Sometimes a bit of short-term pain pays off in the long-term!

WHAT DO YOU LIKE DOING IN YOUR SPARE TIME?

My husband Lee and I have two boys – a three-year-old named Max and a one-year-old named Zac. Spending time with them is by far my favourite thing to do and they keep me very busy!!

TELL US SOMETHING WE MIGHT NOT KNOW ABOUT YOU?

I have an identical twin sister and we both had our first baby boys, Max and Harry, on the same day! We call them twin cousins!

LAW FIRM AMBITION ANNUAL CONFERENCE 2024

Law Firm Ambition will be holding their second annual in-person conference, on Tuesday 25 June from 9.00am – 6.30pm, at the Regent's Conference Centre in London.

This year's theme is 'Embedding culture and taking people with you' and will feature a host of great speakers, with the same pace and quality that has made their webinars so popular.

Find out more and RSVP:
bit.ly/lfa-conference-2024

Law Firm Ambition

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