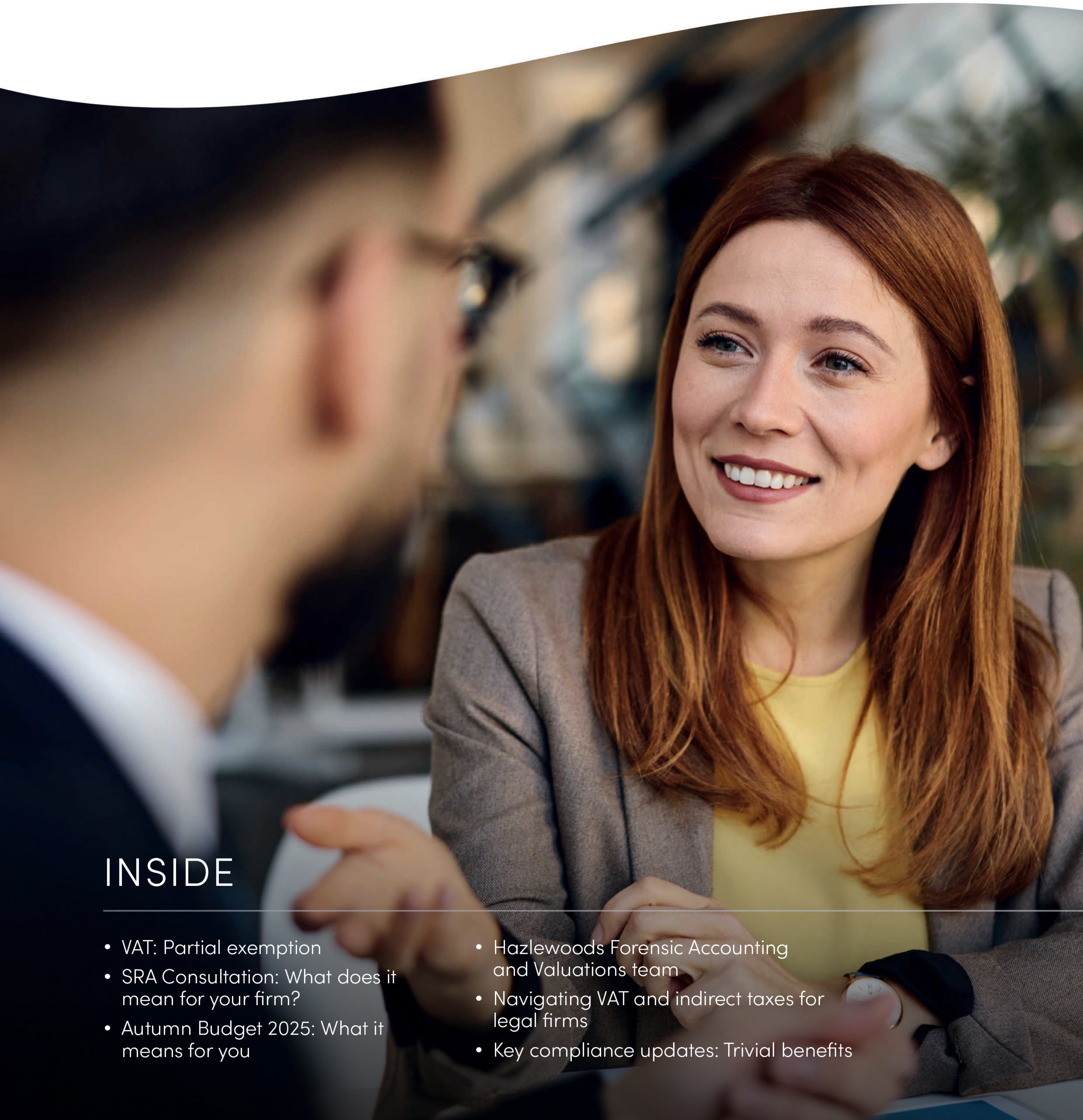
WINTER 2025/26

Hazlewoods

Legal Focus



INSIDE

VAT: Partial Exemption

Speculation in the Legal sector has grown over the last 12 months in relation to whether law firms need to apply for partial exemption when calculating the amount of input VAT that they can reclaim as a result of the increase in interest income received on client monies.

Patricia Kinahan, Legal Partner sets out some practical context around this speculation and explores options that firms can consider to help mitigate any concerns that they may have.

What has changed?

To avoid the need to apply partial exemption to the claim for input VAT, a firm needs to demonstrate that interest is an incidental source of income.

HMRC's officers manual on partial exemption states that a supply is incidental if it 'arises merely as a minor consequence of normal business activity'.

HMRC then goes on to reference the European Court of Justice (ECJ) decision in *Régie Dauphinoise*, where the Advocate General considered what constituted an "incidental transaction". In that case, a property management firm held client funds in its own account and in its own name and used the retained interest as part of its established business model.

The ECJ held in *Régie Dauphinoise* that in order to be "incidental", a transaction would "*... have a certain link with the taxable persons other activity but do not form a direct part thereof...*". The ECJ then determined that the interest income the taxpayer earned on these monies was not incidental because the receipt of the interest was a "direct, permanent and necessary extension" of the main taxable activity.

By contrast, law firms are subject to strict regulation under Solicitors Regulation Authority (SRA) rules for dealing with client money and the operation of client accounts.

Interest income is highly dependent on external factors - particularly prevailing interest rates and is often modest, irregular, or non-existent, because the money is held for such a short space of time in the first place. In many firms, only some departments or matter types lead to such deposits, and the timing of deposits is often uncertain.

The case of Régie Dauphinoise was in 1996 when interest rates were at 5.94% at the end of that year. Interest rates remained at a high level until they started falling as a result of the financial crisis when they fell to 0.25% in August 2006.

Over a period of 10 years from 1996 to 2006, law firms were receiving a significant amount of interest from client monies, but during that time HMRC accepted that interest income was incidental.

Over that period and since then, the underlying activities of law firms have not changed. Interest has not been and is still a direct, permanent and necessary extension of the main activities of law firms.

All that has changed in the last five years, in particular post Covid, is a significant rise in inflation as well as a war on talent that has pushed the cost of employing staff up significantly. Law firms have seen profit margins reduce as a result of the economic climate that they operate within. The level of client interest in comparison to total profits appears more acute that it was perhaps 20 years ago.

In my opinion, nothing has changed in the fundamental approach law firms take to the way that they operate their businesses in order to make a profit. What has changed is interest rates have increased and HMRC are looking at ways to collect more income.

My view is therefore in line with HMRC's current published guidance on partial exemption, i.e. that such income is an incidental consequence of the provision of legal services.

Having worked in the legal sector for over 30 years, we have successfully defended a challenge from HMRC on this particular point for a very large law firm. Using the facts of that case we were able to demonstrate that the income was incidental.

The recent Ministry of Justice (MOJ) consultation on client interest could be seen as additional evidence that interest is not a direct, permanent and necessary extension of their main taxable activity if they have to pay over a substantial proportion of that interest to the MOJ before they even look to pay part of it to clients.

What can you do?

It is understandable that there is concern amongst law firms about what is the right course of action to take, especially when advisors to the sectors take different views. Ultimately, if there is an issue, it can only be solved for the sector as a whole by taking a case to the First-Tier Tribunal which Brabners did many years ago, which clarified the position in relation to the reclaiming of VAT on disbursements.

However, that case may take some time and firms may feel that they want to protect themselves as much as possible in the meantime. There are several options that firms can take to mitigate the position for themselves going forward if they are concerned.

Create a VAT group

Often law firm will have a service company that supplies services, mainly people. These entities will charge VAT on their supplies, which increases the level of input VAT for the law firm itself and so increases the exposure. By the law firm and its service company being in the same VAT group this exposure is minimised, as no VAT needs to be charged on invoices from one entity to another.

Create a separate entity for client monies

It is possible for a law firm to create a separate entity to receive the interest on client monies. This would work on the same principles of Third Party Managed Accounts. That entity would not be in the same VAT group as the law firm itself and its service company. However, there are SRA and FCA issues to consider when looking at this option.

Register and apply partial exemption.

This may seem a bizarre option in light of my comments already in this article. However, if you are concerned, then you can apply and make partial exemption adjustments as required. However before the end of four years, which is the normal period for making an error or mistake claim, you apply to HMRC to correct the partial exemption adjustments made on the basis that you do not believe that it applies. This will force HMRC to make an enquiry into your business and assess the position.

If the fact of the case support the position that it is incidental, then HRMC would need to refund all of the input VAT that has been restricted during that period. It is also possible that within that timeframe a case may have been heard to the First-Tier Tribunal and the outcome decided. If HMRC are unsuccessful then you can make the claim earlier than the four year window. If HMRC are successful, you have already secured your position so will not be exposed to penalties and interest.

In relation to penalties and interest, I am aware of suggestions being made that firms should be putting in a provision into their accounts for the potential exposure to date. Accounting standards only allow a provision to be included where a liability is probable.

Therefore, if a provision has been made, that would suggest that the law firm believes that it has a liability and therefore does it have the responsibility to make partial exemption adjustments and pay that liability across?

Certainly, if at a later date HMRC challenge the position and they are successful, you have to imagine that the level of penalties for firms that have included a provision in their accounts is going to be higher than for those firms who have not, on the basis that they have been deliberate with choosing not to disclose their liability to HMRC until they are forced to.

Special method treatment

If partial exemption does apply, HMRC has stated that time-apportionment methods are no longer acceptable, as the standard method (based on income) provides a fair result. Even where special methods have been agreed in the past, HMRC is likely to challenge their ongoing use.

This marks a practical shift for many law firms, who had invested time and resource in applying for and agreeing bespoke methodologies.

Larger law firms with significant input VAT exposure may be able to rely on the standard method override (SMO) where the standard method produces a result that is not fair and reasonable.

The SMO is set out in Regulation 107A of the VAT Regulations 1995. It requires a business to adjust its input tax recovery if:

- The amount of VAT recoverable under the standard method differs by more than £50,000 from the amount that would be recoverable using a method that better reflects actual use; or
- The amount of VAT recoverable under the standard method differs by more than 50% (up or down) from the amount that reflects actual use, and the difference exceeds £25,000.

These tests are applied annually, typically at the end of the partial exemption tax year. If either test is met, the business must adjust its input VAT recovery to reflect the actual use of inputs in making taxable and exempt supplies, even if it does not have an approved special method. It would therefore be worthwhile for law firms to keep detailed timesheets for all individuals that are involved with the processing of activities around client monies and other work in order to demonstrate that the time apportioned method better reflects actual use.

Where do we go from here?

At this point in time HMRC published guidance has not changed or a Tribunal decision published and therefore it is not unreasonable for firms to rely on this in the absence of anything definitive. It is important that law firms do look at the guidance carefully to ensure that they are fully compliant and not just assume that they are.

Ultimately the issue can only be dealt with definitively if there is a case at First-Tier Tribunal.

SRA Consultation: What does it mean for your firm?

On 11 December, the SRA released its latest consultation following a webinar of the same name, "Protecting client money: next steps and what it means for your firm".

The SRA are clearly concerned that not all required Accountant's Reports are being obtained, and that not all qualified reports are being submitted. This was evidenced when the SRA carried out their spot checks on 596 firms last year where 25 had not obtained an Accountant's Report (despite not being exempt), and another 31 filed their report late.

The consultation considers the following:

- Whether all non-exempt firms should be required to submit an Accountant's Report
- Whether firms should make an annual declaration of compliance
- Whether reporting accountant's should submit Accountant's Reports directly to the SRA. The obligation has always been with the law firms themselves, although in practice, at Hazlewoods, we have always submitted Accountant's Reports on behalf of our clients
- Whether there should be fixed financial penalties for late submissions or incomplete declarations
- They are also proposing to issue updated guidance for reporting accountants. For example, obtaining letters from banks confirming the accounts open in the firm's name and balances held

We also know that following Axiom Ince, the SRA have expressed concerns about individuals holding multiple compliance roles. The next element of the consultation will therefore propose the following:

- That unilateral decision makers in firms cannot hold COLP and COFA roles
- There will be risk thresholds for separating the roles, being turnover over £600,000 and client money over £500,000
- Sole owner-manager firms below the turnover threshold, but above the client money threshold (above) cannot be the COFA, but can still be the COLP

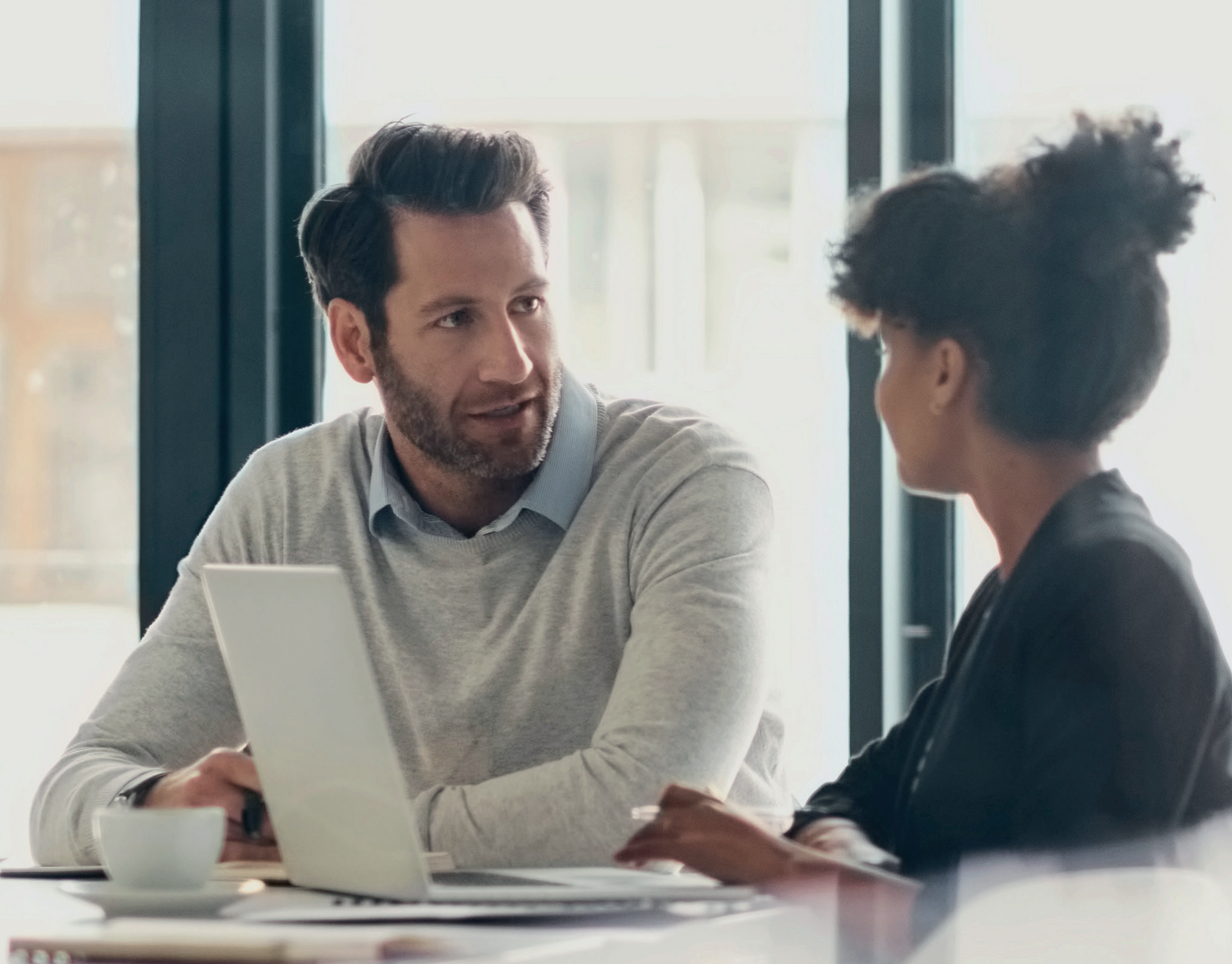
The online questionnaire can be found at **www.sra.org.uk/client-money** and the deadline is 20 February 2026.

On 7 January the Ministry of Justice then launched their long-awaited consultation into their proposed Interest on Lawyers Client Accounts (ILCA) scheme following the roundtable discussions held in August last year.

This would affect all law firms with client accounts pursuant to activities undertaken by providers in England and Wales, regardless of who their regulator is. The proposal is that 75% (although they later mention 75-100%) of interest on pooled (general) client accounts is remitted to government, and 50% on individual (designated deposit) client accounts. It will even cover Third Party Managed Accounts (TPMAs).

You have until 9 February to respond and whilst the document released states that 94% of 604 law firms surveyed by the MOJ said losing client interest would have little/no impact on their firm, that is not our experience from conversations with law firms. We would therefore strongly encourage everyone to respond.

Interest on Lawyers' Client Accounts Scheme can be found by scanning the QR code.



Law Society Financial Benchmarking Survey is on its way

Many readers will know that Hazlewoods has written the Law Society's Leadership and Management Section (LMS) annual financial benchmarking report, and we have done so for the last 17 years.

We are excited to share that the latest results have been compiled and this year's report is due to be released on 5 March 2026. Ian Johnson, Partner in our Legal Team, will be presenting the results at a Law Society seminar on that day and everybody is welcome to register.

The event is a hybrid seminar, with limited in person spaces for LMS members at the Law Society, as well as online spaces for everybody else.

We will provide further details of how to access the report at this time too.

At Hazlewoods, our deep experience and understanding of the legal sector have enabled us to develop and refine the report over the years that we have been involved and it is unique in the level of detailed financial information and metrics that it collects to enable firms to properly benchmark their performance against their peers. Unlike other surveys of its type, we have a wide range of participants across all sizes of firm and so it is properly representative of the whole legal sector.

We are always happy to discuss the results with firms, so please do contact one of our team members if you would like to talk further.

Registration is free and can be accessed via the QR code opposite:

Autumn Budget 2025: What it means for you

The Chancellor's Autumn Budget, delivered on 26 November 2025, was widely anticipated as a "tax-raising" statement. While some feared measures did not materialise, the implications for law firms remain significant. Below we outline the key changes and what they could mean for your practice.

No new tax on LLPs - A relied for the sector

One of the most notable outcomes is what didn't happen: the government has decided against introducing employer-style National Insurance Contributions on members of Limited Liability Partnerships (LLPs). This proposal had been heavily trailed and would have added a substantial cost burden to many firms. The decision will be welcomed across the profession.

Economic crime levy - Sharp increases for larger firms

While LLPs escaped additional taxation, the Economic Crime (Anti-Money Laundering) Levy will rise steeply for firms with UK revenues above £500 million. From April 2026, firms in this band could see their levy increase by up to 1,400%, with the largest firms paying £1 million annually. Medium-sized firms will also see incremental rises. These changes come with little lead time, so affected firms should review budgets and cash flow now.

Personal tax changes – Impact on partners

Although headline income tax rates remain unchanged, freezes on thresholds until 2031 mean more partners will drift into higher tax bands over time. In addition:

- Dividend tax rates will rise by 2% from April 2026.
- Property and savings income will follow suit from April 2027.

For firms operating through corporate structures or with partners extracting profits via dividends, this will increase the overall tax burden. For higher-rate taxpayers, the cost of extracting profits from a company will become almost 10% more expensive than from an LLP, making disincorporation a likely consideration for some firms.

No new tax on LLPs - A relied for the sector

The Budget introduces a 2% tax increase on savings interest income, including client account interest. For many firms, this represents a significant additional tax cost, unless the MOJ's ILCA proposal is successful. This measure will reduce after-tax receipts for partners and could lead to upward pressure on fee rates and reduced investment in people and technology.

Salary sacrifice pension cap

From April 2029, only the first £2,000 of salary sacrifice pension contributions will be exempt from employer and employee NICs. This measure will particularly affect senior fee-earners and partners who rely on enhanced pension arrangements as part of their remuneration package. Firms should revisit reward strategies and consider alternative benefits planning.

Employee Ownership Trust (EOT) – Reduced relief

The Budget restricts Capital Gains Tax relief on sales to Employee Ownership Trusts from 100% to 50%. While still attractive in some circumstances, this change reduces the appeal of EOTs as a succession planning tool and may lead to increased interest in private equity or external investment.

Other measures

- ISA Changes: The annual cash ISA limit will fall to £12,000 from April 2027, encouraging investment in equities.
- High-Value Property Charge: Homes valued over £2m will attract an annual surcharge from 2028.
- Rental Income Tax: Income tax on rental property will rise by 2% from April 2027, impacting many partners with property portfolios.

Compliance and regulatory pressures

The Budget confirmed increased funding for the justice system and reiterated commitments to tackling economic crime. HMRC will gain statutory powers to reward whistleblowers, and consultations are expected on restricting non-compete clauses in employment contracts. These developments underline the need for robust compliance frameworks and proactive risk management within law firms.

What should law firms do now?

- Review financial forecasts to account for levy increases and tax changes.
- Revisit remuneration structures, particularly for partners and senior staff.
- Strengthen compliance systems ahead of enhanced anti-money laundering measures.
- Plan for long-term fiscal drag, as frozen thresholds will erode real income over time.
- Consider succession planning options in light of reduced EOT relief.

At Hazlewoods, we work closely with law firms to navigate these challenges and identify opportunities for strategic planning. If you would like to discuss how the Autumn Budget 2025 impacts your firm, please get in touch with our Legal team.

Hazlewoods Forensic Accounting

Chrissy Wilkinson, Partner and Charlotte Okninski, Director, have joined Hazlewoods Forensic Accounting and Valuations team, expanding the offerings for clients across the UK. With nearly 40 years combined experience, these two senior appointments bring a wealth of experience, with particular expertise in Sale and Purchase Agreement (SPA) advisory, SPA dispute resolution, expert determination and valuations to the team.

SPA advisory and dispute resolution

Chrissy specialises in accounting related disputes and enquiries with a particular interest in M&A disputes. Sale and Purchase Agreements (SPAs) often involve complex financial mechanisms that can lead to disputes post-completion. As forensic accountants we provide expert support, acting as the independent expert determiner, expert witness, or a party adviser, to help resolve these issues efficiently and fairly. Drawing from the knowledge and experience of SPA mechanics derived from assisting in 100s of successful deals and applying a deep understanding of accounting standards, our SPA advisory services help clients achieve fair resolutions, minimise risk and protect value in transactions.

Key trends shaping SPA disputes in today's market are:

1. The rise of completion account disputes in a volatile economy

During times of economic uncertainty, completion accounts are increasingly preferred over locked box mechanisms. Completion accounts allow adjustments to be made to the purchase price post completion, however unclear accounting hierarchies or poor drafting of definitions can lead to ambiguity and hence post-completion disagreements.

2. Earn-out mechanisms under pressure

Whilst earn-outs remain popular for bridging valuation gaps between parties, allowing for part of the purchase consideration to be deferred and be dependent upon results achieved post completion, disputes over subjective performance metrics and GAAP interpretations are increasing. The mechanisms can be complex and may trigger accounting consequences not considered at the time of drafting the SPA.

3. Increased risk as a result of accelerated deal timelines

Rushed transactions and compressed timelines, driven by market pressures or because both parties are eager to lock in headline terms, often mean incomplete due diligence, vague definitions and broad warranties. The rush can be costly, and risks that are missed pre deal, often resurface later as disputed items.

4. ESG & regulatory complexity

ESG is now a core due diligence area, influencing deal terms and risk allocation. New ESG obligations and regulatory changes are increasingly shaping warranties, indemnities, and valuation mechanisms in SPAs. Buyers demand warranties covering ESG compliance or emerging regulations and breaches of ESG warranties can lead to significant claims, as non-compliance may trigger regulatory penalties or reputational harm.

Expert Determination

Chrissy and Charlotte have extensive experience of expert determination as a mechanism for resolving disputes under SPAs, particularly those involving technical accounting issues such as completion accounts and earn-out calculations. As the independent expert, we interpret the accounting provisions of the SPA and apply them to the financial data.

The expert determination procedure is agreed between the independent expert and the parties. To ensure an efficient process, it important to ensure the timetable for submissions and their review are reasonable and achievable by all involved. In addition to the flexibility of the process, allowing for parties to tailor the procedure and timetable to their specific needs, some of the key advantages of a well structured expert determination are:

- Confidential process – resolution in private protecting a company's reputation and sensitive information
- Quicker and more cost-effective compared to litigation or arbitration
- Outcome determined by an independent expert with specialist knowledge (whom the parties can choose)
- Determination report provides the reasons for the decision of each dispute item (if required)
- Final and binding on the parties, and therefore provides certainty of the outcome

and Valuations team

Valuations

Charlotte specialises in share and business valuations. An objective, evidence-based assessment of the value of the business can be crucial in resolving the following types of dispute:

- Equitable division of assets – in matrimonial cases, the court needs an accurate valuation of any shareholdings to ensure a fair division of marital assets.
- Shareholder and partnership disputes – when owners disagree, valuations help them to determine the appropriate price at which to buy/sell the relevant shares.
- Post-transaction and contractual disputes – courts rely on valuations to assess claims relating to breaches of warranties or misrepresentations in deals.
- Damages and compensation – in commercial litigation, valuations quantify financial loss or damages relating from wrongful acts, such as breach of contract or negligence.
- Insolvency and bankruptcy proceedings – valuations establish the value of assets for liquidation or restructuring, ensuring creditors and stakeholders are treated fairly.

Key challenges for valuations today

Valuation has become central to resolving high-stakes disputes — divorce, shareholder oppression, post-deal claims, and damages compensation. Courts increasingly demand robust, transparent methodologies, and are sceptical of speculative projections or opaque adjustments. The following challenges are present for valuations today:

1. Dating and the use of hindsight
Establishing the date of the valuation is critical in all cases. Some cases require an assessment of the value at multiple historical dates depending on the nature of the case.

Care must be given to avoid the use of hindsight. The valuation opinion should be based on the facts known or knowable at the valuation date.

2. Identifying the basis of value required
"Value" is a measure of the worth or benefit that an asset provides to a particular person or in a specific context. It is vital to establish what type of value is required. For example, courts often request a "market value" or a "fair market value", which may differ to the value a current shareholder or a potential investor may enjoy.

3. Data quality and availability
Privately owned companies, particularly those that are smaller in size, often lack the robust forecasts required to perform certain valuation techniques (e.g. discounted cash flow). In addition, market data used for benchmarking appropriate multiples or discount rate inputs can be outdated.

On occasion, the valuer may receive conflicting information from the parties and needs to deal with such with their duty to the court in mind, for example, considering the different conclusions that could be drawn from different data sets.

4. Economic volatility
Persistent inflation, higher interest rates and volatile risk premia are making discount rate inputs and growth rates more volatile. This can also impact market multiples as markets respond to pricing shocks in the short term.

5. Integration of ESG and new risk factors
Valuations must now factor in elements like ESG compliance, supply chain resistance and regulatory risk, broadening traditional financial models.

6. Scrutiny over discounts
The application of discounts for lack of control or marketability can have a significant impact on the final valuation. The discount for lack of marketability ("DLOM"), in particular, has been the subject of scrutiny in many high-profile cases and remain best considered on a case-by-case basis.

At its most straight forward, it is presented as an arbitrary or illustrative discount to the valuation, which lacks robust support. At its most complex it can involve considering empirical data such as restricted stock studies or pre-initial public offering studies or using option pricing models. There is no 'one-size fits all' approach, any DLOM should be considered on a case-by-case basis and supported with appropriate evidence.

Summary

Chrissy and Charlotte would be delighted to discuss any queries you might have in relation to the above, or any other forensic accounting or valuation matters.

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Navigating VAT and indirect taxes for legal firms

VAT and indirect taxes can feel like a maze, especially for legal practices where the rules are complex and constantly changing. It's not just about staying compliant; it's about making sure you're not missing opportunities to recover VAT or plan more effectively. A small misstep can lead to costly errors, penalties, and missed benefits.

At Hazlewoods, we don't just know the legislation, we understand how it impacts law firms in the real world. Our team combines technical expertise with practical insight to help you stay compliant and make the most of every opportunity.

Why VAT matters

Tax rules evolve quickly, and the implications for your firm can be significant. With the right planning, you can protect your business, avoid unnecessary costs, and ensure you're benefiting where you're entitled.

Key areas of consideration

- **Disbursements vs. Recharges** – Correct classification of third-party costs is critical to avoid VAT errors.
- **International Transactions** – Reverse charge and place of supply rules often apply when handling cross-border matters.
- **Litigation and Settlements** – Understanding whether payments represent compensation or a taxable supply can prevent disputes.
- **Partial Exemption** – Firms offering both taxable and exempt services (e.g., financial or insurance-related work) face complex recovery calculations.
- **Deal Fees and Advisory Services** – VAT treatment on cross-border M&A and restructuring requires careful consideration.
- **Professional Services for Exempt Businesses** – Recovery restrictions apply when advising sectors such as healthcare, education, or finance.
- **Multiple Entities or International Branches** – VAT grouping and registration obligations can impact compliance and cash flow.
- **Property Transactions** – The interplay between VAT, SDLT, and the option to tax is a common area of risk.

How we can help

We take the time to understand your firm, your clients, and your goals. Whether it's reviewing your current processes or advising on complex transactions, our specialists provide clear, practical guidance so you can navigate VAT legislation with confidence.

Bernardo Almeida
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Key compliance updates: Trivial benefits

Law firms often provide small perks to staff but we frequently see where not following the rules results in additional filing requirements and unexpected tax liabilities.

Understanding the £50 trivial benefit threshold

HMRC permits employers to offer certain minor benefits without triggering tax or National Insurance, provided all conditions are met:

- **Cost per benefit:** £50 or less (including VAT).
- **Form:** Must not be cash or a cash voucher. Non-cash gift cards are acceptable if they cannot be exchanged for cash.
- **Purpose:** Cannot be a reward for work or performance, nor part of a contractual entitlement.
- **Arrangement:** Must not be provided under salary sacrifice.

If any condition is breached, the entire value becomes taxable – not just the excess over £50.

Implications of exceeding £50

The £50 limit is absolute. Spend £50.01 and the whole amount is taxable. This means:

- The benefit must be reported on a P11D or processed through payroll.
- Employers may incur Class 1A National Insurance on the full value.
- For group benefits (e.g., team lunches), HMRC allows an average cost per person, which must not exceed £50.

Annual limits on trivial benefits

- **Employees:** No annual cap, provided each benefit meets the £50 rule.
- **Directors of close companies:** Limited to £300 per tax year, including benefits to family or household members. Beyond this, the excess becomes taxable – typically up to six gifts of £50 each.

Common pitfalls

- Regular or expected gifts (e.g., monthly vouchers) fail the exemption.
- Gifts linked to performance or contractual obligations are taxable.
- Salary sacrifice arrangements disqualify the exemption entirely.

Next steps for law firms

Review your policies on staff perks and client entertaining. Ensure costs are monitored and documented to avoid breaching thresholds. Where in doubt, seek professional advice – small oversights can lead to significant compliance issues.

Hazlewoods

Law firm breakfast and learn event

Please scan the QR code to register to attend

Tuesday 10 February 2025 | 8.30am – 11.30am | Tewkesbury Park

Join us for breakfast, networking and presentations on the key issues facing the legal sector, with practical takeaways from our Hazlewoods Legal specialists.

The key topics we will cover include:

- An update on all things SRA and financial compliance, including insights into the impact of the latest budget announcements for the legal sector and our thoughts on the MOJ consultation on client account interest
- A review of current market conditions, including financial benchmarking and strategic considerations for law firms

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