The Law

Armstrong Watson's specialist publication for the legal profession

Winter 2012/13

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Why they're on the increase

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We take a look at the issues of ownership of property in partnerships

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Welcome to the Winter 2012/13 edition of The LAW, the specialist publication for the legal profession from the legal sector team at Armstrong Watson.

Specialists are available from all of our 14 offices to provide pro-active support and advice to lawyers in compliance and business improvement matters. This publication is designed to allow us to share our collective experience in acting for lawyers throughout the UK.

If you would like any further information on the issues raised within The LAW, or if you would like to work with us, please contact me on 07828 857830 or email me at andy.poole@armstrongwatson.co.uk

I also keep our law firm clients up to date with more immediate developments in the legal profession via Twitter. If you would like to follow me, I'm @AW_AndyPoole

One recent development is that the SRA have released a consultation Paper on the referral fee ban. We emailed that to our contacts shortly after its release; if you would like to discuss the implications for your firm, please do contact me.

Andy Poole

Andy Poole
Legal Sector Director

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In this edition:

Company Demergers

Nigel Holmes, Tax Director, explores company demergers, what they are, the reasons for doing them and the potential benefits and tax pitfalls.

nigel.holmes@armstrongwatson.co.uk

Partnership Property or Partners' Property?

Keith Johnston, Tax Director, discusses the issues associated with the ownership of property in professional partnerships.

keith.johnston@armstrongwatson.co.uk

About Turn on WIP Valuation?

Andy Poole, Legal Sector Director, looks into possible upcoming changes to WIP valuation for law firms.

andy.poole@armstrongwatson.co.uk

Listed Buildings and VAT

Val Vince, VAT Consultant, updates her article due to changes which occured after the last issue went to press.

val.vince@armstrongwatson.co.uk

Workplace Pensions Reform

Nathan Glaister, Financial Planning Consultant talks about the considerations you need to make as an employer.

nathan.glaister@armstrongwatson.co.uk

Increased Appetite for Law Firm Mergers

Richard Andrew, Legal Sector Manager discusses the increasing number of law firm mergers.

richard.andrew@armstrongwatson.co.uk

Company Demergers

By Nigel Holmes, Tax Director

A demerger is where an existing company is divided into more than one company. Companies may wish to demerge for many reasons such as:

- Shareholders wishing to go their separate ways but with different parts of the company
- To split trading activities from non-trading activities – often to improve the capital gains tax and inheritance tax position of the shareholders in respect of the trading element
- In anticipation of a sale of part of the business

"There are numerous tax traps that can catch a demerger if not structured correctly including corporation tax, income tax, capital gains tax, stamp duty and stamp duty land tax."

A well constructed demerger plan, carried out for genuine commercial reasons, should result in most of these traps being avoided by seeking advance clearance from HM Revenue and Customs (HMRC). This clearance application sets out the reasons for the demerger and provides HMRC with sufficient information that the demerger is not being carried out for tax avoidance reasons.

The method used to carry out the demerger will vary depending upon whether or not the company to be demerged is a trading company or not, and the purposes for the demerger. If the company is a trading company and the reason for the demerger is not in anticipation of a sale then the demerger can be carried out by using distributions (dividends). Otherwise, an alternative format will be required.

"The most popular method used, if a distribution demerger is not an option, is a liquidation demerger."

This involves the liquidation of the company and the liquidator distributing its assets to new companies. It is possible to avoid liquidating the existing company, if this is preferred, by inserting a new holding company prior to the demerger, and liquidating that new company instead.

As an alternative to a liquidation demerger, a reduction in share capital demerger could be used. This type of demerger is becoming more commonplace since the implementation of the Companies Act 2006 and is effective when the liquidation route is likely to give rise to a substantial stamp duty land tax charge. Whatever method chosen, specialist tax advice is required and a good corporate lawyer will be needed. In the event of a liquidation demerger, a licenced insolvency practitioner will also be required.

This represents an overview of a very complex area and each case will be different. We would be happy to discuss specific circumstances, and provide a tailored solution, if you are advising a client on a demerger.

Partnership Property or Partners' Property?

Keith Johnston, Tax Director

The ownership of property in either a professional partnership or a family business can lead to both legal confusions and tax issues if great care is not taken. The purpose of this article is to consider the legal issues and tax considerations when advising either partnerships or individual partners.

Where land is owned by a partnership, the legal position can be confusing – the title deeds will show that legal ownership remains in the names of individual partners but a declaration of trust transfers beneficial ownership to the partnership.

> "Partners in a business may consider that they hold a distinct share of partnership property, but in reality they are merely entitled to either repayment of capital on retirement or a distribution of funds on dissolution."

The Partnership Agreement is therefore crucial to determining what this figure is and how it is calculated. Three brief examples will illustrate some of the possible problems and pitfalls:

- A sole trader has property on his balance sheet at its historic cost. He takes a family member into the business and they share trading profits equally. There is no partnership agreement or any other document recording the ownership of the property. The new partner could claim 50% of the capital profit on sale or revaluation of the property.

- In the second example the issue is identified when the family member is made a partner. Rather than preparing a formal legal document, a note is placed on the partnership balance sheet stating that the property in question does not belong to the partnership but rather by the individual. However, after several years (and several changes of accountants) this note has been overlooked and we are in the same position as the first example.

- A father and son have been in partnership together for many years. The business premises are on the balance sheet despite the deeds stating that they belong to father solely. The partnership accountant advises that this is advantageous for Inheritance Tax purposes – see below for more on this subject. However, the client's Will which was prepared before the son came into partnership, treats the property as being personal property rather than partnership property. There is a risk that the wrong child will inherit part of the property if it remains a partnership asset, and an Inheritance Tax liability will arise if it ceases to be a partnership asset.

“The purpose of these examples is to emphasise the importance of lawyers and accountants working together so that the possible pitfalls can be avoided.”

Turning to the tax issues, how a property is held can make the difference between Inheritance Tax (IHT) relief being due at 50% and 100%:

- If an asset is held personally but used by a trading partnership, Business Property Relief (BPR) is only due at 50%.
- If the property is treated as a partnership asset then the value of the partner’s capital account could qualify for 100% BPR.

This is a simplified summary of what is a hugely complicated subject area. For example if the assets concerned are agricultural land and buildings they may qualify for 100% Agricultural Property Relief (APR) regardless of whether they are held personally or as partnership assets. However APR is restricted to the agricultural value of an asset so care needs to be taken where land or buildings may have development value.

BPR is not due if a business is deemed to consist “wholly or mainly of holding investments” and this has been the subject of several tax tribunals in recent years. BPR is due on the business as a whole rather than on specific assets, thus:

- If the business is mainly a trading entity with a handful of investment assets, then BPR can be claimed on the value of the whole business.
- If the business is deemed to mainly consist of holding investments, then no BPR is due, even on those assets which are clearly used for business purposes.

This issue was brought into focus by the Balfour Case (also known as Brander) in 2010 when 100% BPR was successfully claimed on a large estate in Scotland which included a number of cottages and other rental properties as well as farmland and other trading assets. Space precludes me from going into greater detail but the success of the Executors in Balfour has encouraged other businesses to introduce property onto their partnership balance sheets in order to improve their IHT position.

“However, a failure to properly document the transaction and consider all the consequences, may lead to confusion and family disputes in years to come. At which point any IHT saving will have been long forgotten by all parties.”

If you’d like to speak to our tax team about any of the issues covered in this article, we’d be happy to arrange a personal meeting. Please contact your local Armstrong Watson office on 0808 144 5575 or email help@armstrongwatson.co.uk

About Turn on WIP Valuation?

Andy Poole, Legal Sector Director

The accounting standards board has recently issued revised 'exposure drafts', outlining their intention to replace all currently existing accounting standards with a new single 'Financial Reporting Standard' (FRS) applicable to the UK for accounting periods commencing on or after 1 January 2015.

You might say at this point "ok, accounting standards aren't really my thing; in fact, they're pretty boring and I'll move on to the next article", but hold on there might be a bit of a shock in store for law firms. You may recall that work in progress (WIP) was valued at cost when it was first introduced around 15 years ago. That created a one-off increase in paper-profits for law firms that until that point hadn't recognised any WIP in their accounts at all. In turn, that created an additional tax liability that was spread over 10 years.

That changed for accounting periods ending on or after 22 June 2005, when "UITF40" was introduced. Law firms were then required to value their WIP, not at cost excluding partner-time; but at sales value including partner-time. This change also uplifted profits and tax payments, this time spread over 3 to 6 tax years. It also caused issues on valuation calculations and policies, with no single clear route being adopted by a majority of firms; there are still many inconsistencies today.

The potentially bad news is that, some people have commented that we could be set for yet another change.

"The key question throughout all of this, is not necessarily how you value the WIP on your balance sheet, but at which stage do you take that WIP to become recognised as revenue in your profit and loss account."

At present Application Note G to FRS5, the basis for UITF40, says that you should recognise revenue when, and to the extent that, you obtain a 'right to consideration' in exchange for your performance. Essentially this means that law firms recognise revenue (and therefore WIP) in line with performance of their duties. This in most cases excludes contingent WIP which is usually recognised when the contingency is removed.

The proposed new standard is more in line with international accounting standards, which has been anticipated as we undergo an international convergence project.

- Paragraph 23.3 of the draft FRS refers to revenue being the fair value of the consideration 'received or receivable'.

- Paragraph 23.15 of the draft FRS refers to a 'specific act' and a 'significant act' and suggests that an entity should postpone recognising revenue until the significant act is executed.

"Some commentators have argued that these subtle differences may mean that we have an 'about-turn' on WIP recognition; taking us back to valuing WIP at cost as the default position. This could mean that law firm revenue would be recognised at a later stage, thus causing a one-off reduction in profits and tax bills."

Most lawyers will probably say that this couldn't come at a worse time with all of the changes in the profession at the moment. However, our benchmarking shows that a lack of cash is more of a problem for most firms at the moment rather than a lack of profits. The reduced tax bills could be welcomed.

"A question could be, since HMRC allowed the tax payments to spread over a number of years, would they expect the tax reductions also to be spread?"

You could say that this would bring us back to where we were before UITF40 and that there should therefore be a certain equilibrium. However, what is the position for partners that retired since June 2005? They are likely to have had their capital accounts uplifted by the acceleration in profits caused by valuing WIP at sales price in 2005/06. They may have been required to pay an extra tax bill, but they have still retired in most cases with the net uplift added to their payout.

The continuing partners are the ones that would have their capital accounts reduced now if the proposed changes do take effect as outlined above. Essentially, the changes will have had the result of continuing partners transferring part of their capital to the recently retired partners. You could say that this is a goodwill payment, and there are many arguments over whether goodwill should or shouldn't be paid on retirement which I won't go into here. I can see that, if the changes do come into force, future retiring partners may now demand a goodwill payment in recompense, but would the future generation be willing to pay that?

Of course, this is purely conjecture at this stage. When the new standards are finalised and guidance notes released it may be that a different tack is taken. I only hope that the standard setters do take these issues into account otherwise there will be yet more confusion to come and we may move even further away from a uniform UK Generally Accepted Accounting Practice.

I will keep you informed of any updates on this through The LAW, our regular e-shots, and via my Twitter account @AW_AndyPoole – watch this space!

Extension to Zero-Rating of Alterations to Listed Buildings - an Update

Val Vince, VAT Consultant

Shortly after the last edition of The LAW was made available, the government made a change to the rules relating to the zero-rating of alterations to listed building.

You will recall that in the last issue we advised that where contracts had been entered into prior to 21 March 2012, zero-rating could apply to the eligible work until April 2013.

That date has now been changed, allowing zero-rating of eligible work on a contract entered into prior to 21 March 2012 to apply up to September 2015.

Workplace Pensions Reform 2012

Nathan Glaister, Financial Planning Consultant

In the last issue of The LAW I wrote about new pension legislation which came into effect on 1 October. This introduced mandatory auto enrolment into a workplace pension by employers on behalf of their employees, virtually without exception.

It is likely that many employers will need help, support and guidance with regard to the changes in order to consider:

1. The contribution basis for employee pensions
2. Whether any existing schemes are adequate to meet the strict qualifying criteria
3. If a new scheme is required, whether NEST, an alternative scheme, or both are most suitable for employers and employees

"To allow you time to reach the most suitable solution to ensure that you meet the minimum requirements of the new legislation, it is important to start to review the situation for both your business and your employees as soon as possible."

Armstrong Watson can provide a comprehensive Auto Enrolment workforce assessment report for you or your business clients, explaining in detail what you need to do to comply, when you need to do it and what the potential cost implications may be.

Increasing Appetite for Law Firm Mergers

Richard Andrew, Legal Sector Manager

After a period of declining numbers of law firm mergers during the recent recession, we're finding that mergers are now firmly back on the agenda for law firms.

"We've had a number of approaches from law firms either looking to buy, sell or merge and we're busy putting people together as appropriate."

There appears to be a trend of reasons cited for this growing interest including tough trading conditions; compliance regime changes; banning referral fees; removing family legal aid from scope; general retirements/succession planning; professional indemnity insurance costs; avoidance of PII run-off cover; building scale to increase efficiencies; and defence against or opportunities from the Legal Services Act.

We currently have firms looking to:

- Acquire crime legal aid practices throughout the North of England
- Acquire any work-type sole-practitioner/two partner firms in Yorkshire
- Sell their practices to larger firms – mostly small practices in the North West with an exposure to Personal Injury
- Sell their North East general practice

What ever your reason for looking to buy, sell or merge, we can help to find a good match for you and look after your interests throughout the process. Contact me for a confidential no obligation discussion.

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