The Law

Armstrong Watson's specialist publication for the legal profession

Winter 2014/15

An interview with... Martyn Caplan of Lawyers Inc

RTI- A report from the coalface

We explore practical advice and share experience so far...

LLP Members – an update following our lectures for MBL seminars

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Welcome to

the Winter 2014/15 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 15 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.

I am delighted to announce that The Law Society has exclusively endorsed Armstrong Watson for the provision of accountancy services to law firms in the North of England.

Watch this space for further information on what that means for our solicitor clients.

One of the articles in this edition has been written by Mark Ranson, a restructuring expert within our corporate recovery team. Mark has joined me in jointly writing a financial stability toolkit on behalf of the Law Society. At the time of writing, we're hoping that the toolkit will be published in early 2015, so by the time you read this you may be able to use Google to find it, and then obtain your copy.

Andy Poole

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In this edition:

A good liquidator?

Mark Ranson looks at the potential positive outcomes of meeting with a liquidator and explores when it can achieve good results.

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LLP Members – an update following our lectures for MBL seminars

Graham Poles advises on this complex area and how it impacts upon those working in professional practices.

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Auto-Enrolment Update – from an operational point of view at the coal face

Brian Stenhouse gives practical advice for those who have to implement auto enrolment and shares his experience so far.

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An interview with... Martyn Caplan of Lawyers Inc.

Andy Poole talks with Martyn Caplan of Lawyers Inc. about an alternative solution to the many issues the legal sector is facing today.

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A Good Liquidator?

Mark Ranson, Restructuring Partner

Members of the legal profession may well claim that they have seen too much of liquidators and other insolvency appointment takers over the last few years, whether it be in respect of their clients or (more rarely) other legal firms. This article acts as a reminder of the times when it is positive to meet a liquidator, and the opportunities for readers to consider involving one in order to achieve some very pleasing results.

Members' Voluntary Liquidation (MVL) is the liquidation of solvent companies. It completes the financial affairs of a limited company, ensures all creditors have been settled in full and enables the distribution of surplus funds to shareholders. The distribution of funds to shareholders is a return of capital, rather than of income, and is therefore subject to the favourable capital gains tax regime in the UK. It is particularly effective when the conditions for Entrepreneurs Relief can be met, resulting in a 10% rate of tax on the value of the gain.

Uses of MVL

- Distribution of surplus funds following completion of trading
- Distribution of cash receipts following sale of business and assets
- Distribution of property from company's remaining assets to shareholders
- Reorganisation of group structures to remove surplus companies
- Preservation of Substantial Shareholders Exemption (SSE)

Readers will frequently be involved in the sale of the business and assets (or certain assets) of a company. The key for your client is to extract the funds from that sale out of the company in the most cost and tax efficient manner possible. Planning the extraction of the funds post sale in parallel with the sale of the assets provides opportunities to manage the follow on process to shareholder advantage – so questions should be asked at the sale stage.

Liquidators of a MVL can distribute assets in specie as well as distributing cash. The most frequent use of this power is distributing property from within a company to its shareholders. Helpfully there is an exemption from the payment of Stamp Duty Land Tax (SDLT) when it is a distribution in specie by a liquidator of a MVL – saving £40,000 on the transfer of a £1 million property.

Many groups grow and accumulate subsidiaries which, over time, become redundant. MVL is a means of cost effectively removing surplus group members.

Substantial Shareholders Exemption (SSE) is a valuable relief from capital gains in a corporate group which avoids the crystallisation of a capital gain on the sale of a group subsidiary. For an ongoing group it can be very useful in helping to retain value within the group. However the criteria to retain SSE are detailed and include a requirement to qualify as a trading group both before, and immediately after, a sale. Where a group sells its major operating subsidiary for substantial value it will probably not meet the strict test criteria, so this would run the risk of a major tax liability crystallising. But, in a little known exemption to the rules, a MVL at the right time post sale can ensure that the SSE reliefs are preserved. In a recent case the preservation of SSE saved several million for a group, and therefore materially increased the return for its shareholders.

There is a further variation on a MVL called a S110 MVL. This involves the MVL of a company so that a company or group can be reorganised in order to split the company, or a group of companies, into two separate companies or groups. Subject to strict criteria and clearances, the reorganisation can avoid crystallising various taxes at the point of reorganisation.

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Uses of S110 MVL
- Splitting a company, or group, for risk management purposes (Demerger)
- Splitting a company, or group, for shareholder separation purposes (Partition)

In a demerger the company or group is separated into two, or more, other companies or groups. The shareholders of the company subject to MVL retain the same percentage shareholdings in each of the resulting entities.

Common examples of using this type of MVL are:

- where shareholders wish to split a riskier activity (e.g. haulage) from a less risky activity (e.g. property investment)
- or where shareholders wish to split an activity qualifying for (Inheritance Tax reliefs) Business Property Relief or Agricultural Property Relief from a non-qualifying activity in order to avoid the whole entity not qualifying

A Partition is used where there is, in effect, a commercial divorce – with each set of shareholders taking some portion of the assets away to an independent commercial future.

Conclusion

Used correctly, and in conjunction with taxation specialists, MVL can be a powerful means of reorganising companies or groups of companies. The key is spotting the opportunity early so that the right options can be taken to facilitate the best outcome for shareholders.

Mark Ranson is a Restructuring Partner at Armstrong Watson with significant experience of working with shareholders and tax specialists in delivering high value or complex MVLs.

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LLP Members – an update following our lectures for MBL Seminars

Graham Poles, Tax Partner

Over the past year I have travelled across the country giving a series of lectures for MBL Seminars on the Finance Act changes that affected the taxation status of members within professional practices. The issue of the status of salaried members was without doubt the main talking point. The reason for this was fairly simple – the changes to the rules are anything but simple.

The changes came into force on 6 April 2014 and only affect LLPs. One of the first questions I was asked was whether the rules would be expanded to affect partnerships? My answer was always the same - I can't provide any guarantees, but I can see real difficulties with such a change.

Partners in a traditional partnership have a significantly different legal position to members of an LLP, particularly when it comes to financial risk. That is one of the main factors in many of the tribunal cases on self-employed status.

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So the new rules only apply to members of an LLP and to be regarded as an employee you need to pass three tests, which have been set by legislation. The tests are, in my opinion, counter intuitive in that you need to fail to be regarded as self-employed and therefore a member of the LLP.

The first test, condition A, looks at how the member is remunerated for the personal services they provide to the LLP. This means that corporate members and investors in an LLP are not caught by these rules.

The condition then looks for the "disguised salary" i.e. that part of the member's remuneration that is fixed, or if it varies if it does not vary in line with profits. This does not mean that members who receive a fixed drawing each month are caught as HMRC accepts that this is likely to be adjusted at the end of the year by their share of the profit. However, for members who receive a guaranteed drawing during the year that is unlikely to be affected by the year end profit but who received a profit share on top, this variable element will need to be greater than 25% of their fixed drawing for them to fail this test.

This condition is applied at the start of the year and looks forward, so you needed to assess the likelihood of the profit being greater than 25% at the start of the year using projections etc. Once an assessment is made, the status of the individual doesn't get re-assessed until the arrangement on sharing profits is changed, albeit HMRC feels this is likely to be on a yearly basis – I don't see these agreements changing that regularly in practice.

Condition B relates to the management of the LLP. To fail this condition you need to show that the individual had significant influence over the LLP. This is a very subjective test that is probably easier to satisfy for LLPs of ten or fewer members, although the legislation makes no distinction on size.

In larger LLPs it is likely, according to HMRC, that only the management board or similar would wield such influence over the firm that they could fail this test.

Condition C simply requires the member to have capital exposed to risk of greater 25% of their "disguised salary".

This arithmetic test is much more straight-forward to fail, however there is a question mark over some LLPs that do not need the additional capital. If the additional capital is not required, or the LLP loans the capital to the member to introduce it, then the member may not be deemed to have failed this test. HMRC have targeted anti-avoidance in this area, so whilst this may appear to be the easiest test for any member to fail, care is still required.

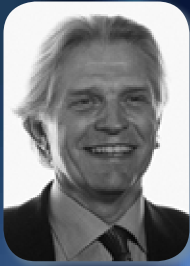
The conditions can be complex to apply since every LLP agreement has subtle differences. If a member satisfies all three tests, then the implications are far reaching.

For those members who do satisfy all three tests, they will be regarded as employees:

- any payments made to them will need to go through the payroll;
- they will cease to have self-employed status and their tax return should reflect that change; and
- if they receive any benefits for the LLP then there will be a requirement to complete P11Ds in relation to these benefits.

There is no doubt that the rules reach far and wide into the taxation of LLP members.

Their complex and often subjective nature makes application difficult. HMRC have already started to focus PAYE visits on such members, so I would recommend that any LLP that hasn't considered the changes does so, and documents their review as soon as possible.



Auto-Enrolment Update – from an operational point of view at the coal face

By Brian Stenhouse, Director of Payroll

The new Pension Reform 'Auto-Enrolment' (AE) process is now gathering momentum. Here at the Armstrong Watson Payroll Bureau, we staged around 70 clients this year using a wide variety of different Pension Providers, and I think that it is true to say that the experience has been 'challenging'. We have a further 70 to stage this year and around 800 in 2016.

The Pension Regulator's report published in October 2014 stated that there had been an increase in 'Enforcement Activity' with some 163 Compliance Notices issued and 3 Fixed Penalty Notices issued.

To date, 33,000 employers have complied with the AE legislation, enrolling 4.7 million workers, however, over the next three years over 1.25 million employers will be required to comply. Unless employers act in good time in advance of their staging dates, it is very likely that 'Enforcement Activity' will continue to increase, together with an increasing number of penalties.

Companies that have missed their staging date have had to 'retro-fit' the AE process back to their staging date and in some cases have had to fund the employee contributions in order to avoid heavy fines. So, what action should employers take to ensure the smooth introduction of Auto-Enrolment and avoid penalties, and what are some of the issues to look out for? The important thing is to start early, at least a year before your staging date, and be aware of some of the issues that may confront you.

Often overlooked is the need to amend contracts of employment. These will need to include details of the AE process you will be using and whether or not, for example, you will have employee postponement for new starters.

Employees will need to be notified that you will be introducing AE, and if you are intending to postpone, this has to be communicated to them.

You are able to postpone for up to 3 months, but remember, your staging date remains the same and any employee may demand to be enrolled at any time after the staging date so you will have to have a suitable pension scheme in place by your staging date.

Assuming you do not have an existing AE compliant pension scheme, you are going to need to select a pension provider. We have found that many overlook the fact that it is essential that the payroll process and the AE process are integrated if it is to work properly. The data that drives AE is held in the payroll, and the assessment of workers is carried out on the payroll data once all input has been completed for each pay run. A file then has to be generated in the payroll containing the data in the correct format for the pension provider and sent to the provider. Some pension providers require more than one file to be submitted each pay run. Payroll schedules need to be reviewed to allow time for this to happen and to pay employees on time. Files are usually in .csv format and these can be unreliable, leading to delays in sorting data errors out. There are no data or processing standards, so each pension provider's process and file formats will differ. Some pension providers only have a manual process which can take some time to process.

Another area to check out, is what employee communication does the pension provider produce. Employers need to communicate assessment details to each employee and details of how they can opt out/in etc. Some pension providers will provide all the necessary communications, whereas others provide very little. Some providers will only send communications if they have the employee's email address; if there are no email addresses, the employer will have to post out the communications. If the pension provider does offer to post out the communications, there will usually be an additional fee.

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The assessment and enrolment process is carried out for each pay run and enrolled employees will have 30 days in which to opt out if they wish.

This can mean that more than one pension deduction can happen (especially with weekly payrolls) before an employee opts out. These deductions then have to be refunded. Some pension providers will accept all deductions during the opt-out period, and then refund the employer if the employee opts out for them to refund the employee.

Some, however, will not accept the deductions made during the opt-out window, so the deductions are 'withheld' by the employer. This can lead to some very large headaches in trying to reconcile the pension deductions and refunds, especially if the company has a high turnover of staff and/or a weekly payroll.

A few pension providers, mainly the larger established companies, insist that you use their own software to carry out employee assessments and AE management. This will mean that you will have a completely separate software system to operate in addition to the payroll. Moving data back to the payroll (enrolments, opt outs, opt ins, refunds) will then be a manual process.

Some companies advocate the use of 'Middleware'. This is a software product that sits between the payroll software and the pension provider software or website.

Providers of Middleware claim that it will manage the whole AE process ... but beware ... the AE process is complex and not all products are quite as straightforward as you may think and may or may not interface with your payroll software or pension provider software.

In any event, the whole process is further complicated with multi software interfaces.
The above is in addition to the complexities of understanding the actual process, and terminology such as the definitions of pensionable pay, qualifying earnings (these are not the same thing) and pay reference periods and pay periods (again, not the same thing).

As we move forward, and more people start to understand the complexities of the process, systems will be created to automate the process. Already, the group 'Friends of Auto-Enrolment', set up by CIPP, have created a data standard (PAPDIS) which we hope pension providers and payroll software developers will start to use. There are several new products being developed that will hopefully automate and make the whole process more seamless using the latest technology such as XML, API's and Data Integration Platforms (DIP). And the more forward thinking pension providers are working on more automated systems.

Certainly, if the Auto-Enrolment process is to be successful, these new systems will have to be operational in time for the tsunami of SME's staging in 2016 and beyond...............

Auto-enrolment for the self-employed - Editors note

Further to Brian's article on Auto Enrolment (AE) above, owners of law firms may be interested to note that:

Self employed individuals are outside of the AE rules. However, the definition of 'self employed' is another matter that is rather more complicated. The key is determining if the individuals are 'workers' and the rules state a 'worker' is anyone who –

1. Works under a contract of employment
2. Has a contract to perform work or services personally and is not undertaking the work as part of their own business.

A contract can be implied and doesn't necessarily have to be signed.

There may also be issues regarding directors. If a company has just one director and no employees, then they will be excluded from AE.

However, if the company then takes on an employee for example, and they both work under a contract of employment, then both will be workers and included in AE.

Further detail can be found at:

http://www.thepensionsregulator.gov.uk/doc-library/automatic-enrolment-detailed-guidance.aspx#s11496

http://www.thepensionsregulator.gov.uk/docs/detailed-guidance-1.pdf

Andy Poole
Legal Sector Partner

An interview with ... Martyn Caplan of Lawyers Inc.

Armstrong Watson works with many other supporters of the legal profession.

In this edition, Andy Poole our Legal Sector Partner talks with Martyn Caplan of Lawyers Inc. about an alternative solution to the many issues the legal sector is facing today.

How do you see the current issues in the legal sector impacting UK lawyers?

There are many issues which are having a direct effect upon the survival of law firms which include:

- The failure to provide for succession
- A substantial increase in the annual indemnity premium, or no insurance being available
- The daily battle with the bank overdraft
- Secondary lenders not providing loans
- The banks or insurance companies requiring personal guarantees
- The departure of lawyers prejudicing cash flow
- Salaried partners not wanting equity
- A profitable department relocating
- Failing to find a suitable merger partner
- The daily demands of being the COLP and/or COFA
- The expense of investing in new IT systems and software
- The inability to raise capital to restructure a practice
- The reduction of client account interest
- Reduction of fees for personal injury cases
- Concentrating on a client's future rather than the firms

Two of the major issues are succession and indemnity insurance.

'Crucially many small and medium sized law firms have failed to plan adequately for succession.'

Increasingly junior lawyers understand that taking equity carries a number of substantial risks from the moment the partnership deed is executed, and the perpetual model is gradually being eroded.

If salaried partners do not take equity, and a merger partner cannot be found, the ultimate result is that the practice will have to dissolve. The dissolution in many cases could result in the bankruptcy of partners as often there will be insufficient assets to pay the run-off premium, primary and secondary loans, redundancy payments, third party creditors, and lease obligations. Junior equity partners are saddled with the extra concern that failure of a firm to pay the run-off may result in their inability to practice.

Increased indemnity premiums, or the inability to obtain insurance is also resulting in the dissolution of law firms. Due to a reluctance to make the necessary financial investment law firms are failing to introduce systems to reduce risk such as case management systems, specialised software, and reviewing files on a regular basis. Law firms are increasingly reluctant to make the necessary financial investment, and provide adequate supervision.

Why are we currently seeing the rise of 'virtual' or 'dispersed' law firms?

Over the past few years law firm partners have become subjected to working long hours, billing targets, lengthy commutes, management duties, office politics and the lack of autonomy. Their years of training to practice law have been overtaken by regulation and financial pressure.

Modern technology now enables lawyers to be independent and to work for a law firm under a contract for services whereby salaries are replaced by a percentage of invoiced fees. In exchange for a percentage of the invoiced fees the law firm provides an umbrella where the banking and professional indemnity insurance are provided in addition to all of the required administrative functions including accounts, software, precedents, and dictation facilities.

Entrepreneurial lawyers who have the ability to generate their own clients are becoming attracted to this virtual law firm model which gives a lawyer freedom, flexibility and autonomy.

Lawyers Inc. have gone one step further by creating a flexible business model which not only accommodates individual lawyers, but whole departments, and entire firms, by the creation of what the SRA have termed as a 'Pod'.

The SRA have described this as a Pod because although the lawyers of the former firm continue to work together at their existing offices, providing services to their clients, sharing gross fees as governed by an internal agreement; they are not in partnership with each other and have no liability for run-off cover, secretarial and accounts department fees, or a bank overdraft.

How do you work with specialist accountants for the legal profession?

In order to consider whether our business model is suitable for a law firm, the first stage is for specialist accountants for the legal profession to be instructed to prepare projected accounts for the firm. The accounts will need to demonstrate to a bank that the income that will be produced for the equity partners over the next couple of years will substantially exceed the income generated by their current firm.

The bank will then have the confidence to provide funding repayable over a number of years to assist the dissolution of the law firm. Accountants such as Armstrong Watson have in-depth knowledge of how to deal with work in progress, run-off insurance, the SRA regulations, and appropriate tax legislation.