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the Law

Winter 2015/16

Armstrong Watson's specialist publication for the legal profession

Tax is sometimes taxing...
An overview of the new dividend rules and how they may affect you

Latest changes to SRA Accounts Rules
We examine the impact of the latest changes

Pensions - times are a changing
We look at new opportunites and examine how its possible to sustain an income in retirement

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A track record of providing solutions to the legal profession

Welcome

to the Winter 2015/16 edition of The LAW, the specialist publication for the legal profession from the legal sector team at Armstrong Watson.

Merger activity certainly seems to be hotting up in the legal sector. Right now we're engaged in nine separate active mergers of law firms. That's in addition to the long list of firms looking for a merger. We've not seen that level of activity for quite some time. Given the legal aid and personal injury changes, it's onl y going to increase.

The book that we've written for the Law Society on Financial Stability in law firms has now been released and you can obtain your copy at http://ow.ly/LhhNM.

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.

Please contact me if you would like to discuss how we can help you, or if you would like any further information on anything referred to in this publication.

Andy Poole

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In this edition:

Tax is sometimes taxing...

Steven Holmes provides an overview of the new dividend rules and looks at how these may affect you

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Get ready for the latest changes in SRA rules

Mark Baines examines the latest changes in SRA rules to impact most law firms

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Partnership Property: How do you own yours?

Susan Winter highlights important issues of property ownership with a focus on tax considerations.

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Pensions – The times they are a changing

Toni Carver looks into the introduction of major pension reforms and how to sustain an income in retirement and tax planning opportunities.

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An interview with...Jeunesse Edwards, Strategic Engagement Director at Augusta Ventures LLP

Jeunesse Edwards discusses the challenges the litigation market faces from new legislation and regulations.

Tax is sometimes taxing - an overview of the new dividend rules

Steven Holmes, Tax Consultant

On 8 July 2015 George Osbourne delivered the first budget of the new parliament and with this a huge change in how dividends are taxed. The move was quite unexpected and will have serious implications, for you (if you are incorporated) and your clients.

For a long while, company owners and accountants have been used to a situation whereby shareholders were remunerated by way of a low salary and received the remainder of their income by way of a dividend. Although the dividend was not an allowable expense for corporation tax purposes, the low rates of income tax meant that people saved a lot of money and therefore it is now a very common structure for law firms and businesses at large.

The government has countered this approach by introducing legislation to tax dividends at a higher level from 6 April 2016. Although specific legislation hasn't been released we can use reasonable estimates based on the government's guidance. They have effectively increased the level of tax on dividends by 7.5% across the board. Therefore basic rate dividends have been increased from an effective rate of 0% to 7.5%; higher rate dividends from an effective rate of 25% to 32.5%; and additional rate dividends from 30.6% to 38.1%.

It isn't quite as bad as it seems as there have been three introductions within the rules that slightly help the taxpayer. Firstly, the government has abolished the 'notional tax credit' on dividends. This was a tax credit that no one paid and no one received, however it counted towards your taxable income. Secondly, the government has introduced a £5,000 tax free dividend allowance. Thirdly the rate of corporation tax has been set to gradually reduce to 18% on 1 April 2020.

The next thing you need to consider is how this affects you and your clients; is there anything that can be done to mitigate the cost? Although not a huge amount, you and your clients should be speaking to an accountant to make sure that you fully understand the rules; it is important to be well informed about your business. Secondly, you should consider bringing some dividends forward so they are possibly taxed at the lower rates pre 5 April 2016. Lastly, even though it sounds daft ... people could consider taking a lower amount of dividends; a lot of people take an arbitrary amount that is tax efficient, with careful planning it might be sensible to lower this and perhaps move towards a capital exit instead.

Other points to consider:

- If you were considering incorporation, this will need to be revisited for the impact on your annual tax saving and any possible sale of goodwill and amortisation thereof
- The impact on your private investments and any dividend stream you receive
- The impact on any trusts, although no information has yet been publicised on this

In conclusion, the new dividend rules are going to negatively affect a lot of people, but the amount each person is affected may vary widely. You should speak to Armstrong Watson as soon as possible to make sure you are doing what you can to mitigate tax and to ensure you have a full grasp of the rules and their impact going forward.

Our fact sheet which provides further details on the new rules can be found at http://ow.ly/UvqQm

Get ready for the latest changes to the SRA Accounts Rules

Mark Baines, Legal Sector Manager

After initially saying it was thinking of removing the requirement for law firms to submit an accountant's report, the SRA has issued its new requirements, which make a number of changes for firms with periods ending on or after 1 November 2015.

While not removing the requirement for all firms to file a report, there are new exemptions available for those firms that hold relatively small amounts of client money - where the average client account balance is £10,000 or less and the maximum client account balance is no more than £250,000. Those figures are based on the total of all client accounts, including designated deposit accounts.

The main changes impacting most firms relate to the removal of Rule 39 and its list of prescriptive tests which the reporting accountant must carry out in order to complete the accountants report. In its place is an extension to Rule 38 requiring the accountant to use his/her professional judgement in adopting a suitable work programme. This has the potential to increase costs as more risk is passed to the reporting accountant.

While there is still a requirement to submit a qualified report to the SRA, the issues resulting in a qualification should only be those breaches which are material and likely to put client money at risk. The guidance notes which the SRA have issued define material breaches as those "likely to arise as a result of an intention to break the rules and/or as a result of a significant weakness in the firm's systems and controls such that there has been a systematic breakdown of controls designed to prevent breaches".

This means that going forward there are likely to be far fewer qualified reports, and as a result those that are qualified and therefore submitted to the SRA are likely to receive much more scrutiny. We may be moving from a regime where it was better to have breaches reported to a new regime where it is better not to have them reported.

In the SRA's opinion one or more of the following is likely to be material and/or represent a significant weakness in the firm's systems and controls and thus lead to a definite qualification:

- A significant and/or un-replaced shortfall on a client account, unless caused by bank error and rectified in a timely manner
- Evidence of the wilful disregard for the safety of client funds by such action as the deliberate overriding of the SRA Accounts Rules 2011 and/or Accounting Guidelines
- Actual or suspected fraud or dishonesty by the managers or employees of the firm that may impact upon the safety of client funds
- Material breaches that have not been reported by the COFA to the SRA
- No or inadequate accounting records
- Significant failure to provide documentation requested by the reporting accountant
- Bank reconciliations not carried out in accordance with Rule 29.12
- Client account used as a banking facility

Helpfully the SRA have provided a table detailing the type of areas the reporting accountant could concentrate on and, even more helpfully, detailing the behaviours indicative of best practice as well as those behaviours indicative of below adequate processes and controls. That section of the guidance notes is well worth a read by all COFAs that want to maximise their firm's chances of having a clean accountant's report.

It should be noted that while the emphasis of the accountant's report has changed from qualifying reports for every breach other than the most trivial to qualifying only when breaches put client money at risk or represent a systemic failure in controls, the SRA Accounts Rules (SRAAR) still have to be complied with in their entirety.

So what does this mean for those firms that will still require an annual SRAAR report? You'll still get a visit from your accountant but the focus of the work they carry out is likely to shift from the rigid transactional testing to documenting the firm's accounting procedures and controls, and testing compliance therewith. This could involve following a client matter from start to finish to ensure that the firm's procedures as documented in its handbook are effectively adhered to, and that there is adequate documentation at each stage that approval has been given by the appropriate person. Hand in hand with this will be a review of the COFA's work in respect of ensuring that file reviews are carried out and documented and the breach register is adequate and up to date.

It is possible that the need to obtain copies of paid cheques will reduce, provided the firm's authorisation procedures are adequate, and that bank audit letter will not be required.

Where procedures are deemed to be inadequate the firm runs the risk of having their report qualified on that basis, but this will also likely result in the accountant being required to carry out further detailed testing to satisfy themselves of the extent of any failing, which may result in increased costs.

In summary, the best thing to do to prepare for the new regime is to ensure that your office procedures manual is up to date and that you adhere to it; and that there is adequate documentation that the COFA has fulfilled their role. Also talk to your accountant to see how they expect to tackle the new rules so that you can prepare accordingly and minimise the risk of a qualified report and the resultant additional scrutiny of the SRA.

Further changes are planned to remove the detailed rules and replace them with systems and controls more akin to outcomes focused regulation. We'll keep you up to date with the changes, so watch this space.

If you'd like to talk through the changes in more detail and how they could affect your firm, please contact me at mark.baines@armstrongwatson.co.uk

Partnership Property: How do you own yours?

Susan Winter, Senior Tax Consultant

For years the question of property ownership within professional partnerships has raised many issues. The purpose of this article is to highlight some of those issues with a focus on the tax considerations of property ownership.

These days many firms lease their premises but for well established firms, who purchased their business premises many years ago, it is not uncommon for them to own the freehold to the property. The property will be either owned by the partnership, and its value included on the balance sheet of the accounts, or it will be held outside of the partnership but owned by the partners or a mix of the partners and retired partners.

In the former the legal position can be confusing – the title deeds will show that legal ownership is in the name of the individual partners but a declaration of trust transfers beneficial ownership to the partnership. The partners who made the original property purchase may think that they are entitled to a distinct share in the property however this may not be the case; a well drafted partnership agreement is crucial in determining the entitlement of the partners, either on retirement or dissolution of the partnership.

Where there are retirements from a partnership, the outgoing partners effectively dispose of their interest in the property on the balance sheet and new partners acquire it. This will lead to Capital Gains Tax (CGT) and Stamp Duty Land Tax (SDLT) issues which will need to be addressed.

It is not only retirements that give rise to CGT issues; where there is a change in profit sharing ratios either after or at the same time as a revaluation of the assets in the partnership, there is a disposal of an interest in the property to other partners. This is often overlooked and where a partnership owns property the gains could be substantial.

Retiring partners may qualify for the Entrepreneurs Relief (ER) rate of CGT of 10% but there are a number of other conditions which would need to be met. If partnership or profit sharing changes are imminent, it is essential to seek professional advice before the event to ensure all potential tax issues are considered and dealt with accordingly.

Having a separate property partnership would protect the interest of the original partners, who purchased the property, while giving the trading partnership a leasehold interest in the property. The lease would need to be at full market value so there is clarity between the two.

Businesses may increase or decrease in size over time and surplus office space may become available. Partnerships renting out space in their property would include the rent received in the partnership accounts but it should be accounted for separately on the partnership tax return and taxed as property income. This would not be subject to National Insurance in the way that trading profits are, but there may be a restriction in the ER available on the disposal of the parts of the property rented out.

Moving on to Inheritance Tax (IHT) - how the property is held can be the difference between relief being due at 50% or 100%:

- If an asset is held personally and 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 property would be included in the partners' capital accounts and BPR would be due at 100%

BPR is not due however, if the business consists 'wholly or mainly of holding investments'. Where BPR is concerned, the business would need to be considered as a whole because BPR is given on the value of the business, not on a particular asset.

If the partnership mainly consists of a trade but has a few investment assets then BPR is likely to be given so, a firm of solicitors who transfer their business premises in to the business should still qualify for BPR. On the other hand, if the partnership assets are mainly investments, for example, a property investment company, then BPR is likely to be denied on the whole of the business , even if there are assets which are business assets.

This has been the subject of many tax tribunal cases in recent years, namely the Balfour Case in 2010 which successfully claimed BPR on a large landed estate in Scotland which included many cottages and other rental properties.

This is a very brief summary of a complex area and, as with all things tax related, there are pros and cons to each way of owning the property.

Pensions - The times they are a changing

Toni Carver, Business Development & Technical Manager

Following introduction of major pension reforms in April most of the media coverage of pensions seems to have focused on how to access lump sums, but there has been little on how to sustain an income in retirement, or indeed, the tax planning opportunities.

The popular convention with pensions was that you accumulated your fund during your working life, this grew with no deduction of tax and contributions benefitted from tax relief. At retirement there were broadly two options; take a secure income by purchasing an annuity, or more recently, an unsecured income via a drawdown arrangement.

On death an annuity ceased unless a spouse's benefit was included at the outset. However until the new rules came into force, taking a pension via drawdown meant that on death the fund could be hammered by taxation - with a 55% charge levied against the remaining fund value, leaving a meagre 45% for your nearest and dearest.

Thankfully the new rules have changed the treatment of pension funds upon death. They are now considerably more flexible with some distinct tax planning advantages, particularly for estates subject to Inheritance Tax, as accessing funds other than pensions may make sense in certain circumstances.

The new rules on death work as follows:

- Income payments taken from a pension can be paid to any nominated individual.
- If the pension member was under age 75 at their date of death and the payment is made within two years, the beneficiary will receive the entire pension fund tax free.
- If the member dies beyond the age of 75, the pension fund will be taxed at the beneficiary's marginal rate of Income Tax.
- If death benefits are paid in the form of a lump sum prior to 6 April 2016, the beneficiary will pay tax at a transitional rate of 45%.

These changes mean that anyone can benefit from someone's accrued pension, no matter their age; what remains of this inherited pension fund can subsequently be passed on to their own nominated beneficiary with no limit to the number of times the fund can be passed on. Importantly, it is the recipient's age and not the previous member's age that affects how the beneficiary will (or won't) be taxed.

This revised flexibility also means that those who move into consultancy or part-time work over the age of 55 can take a series of lump sums to meet their income requirements, meaning that it is easier to maintain a tax-efficient, sustainable income.

Those with earnings over £110,000 can take advantage of higher rate tax relief, but should be aware of restrictions being introduced in April 2016, which will limit how much you can contribute and still receive tax relief upon. This is especially important to those earning more than £150,000, who will also see a reduction in the Annual Allowance of £1 for every £2 earned above this figure.

Planning using pensions is now far more attractive given the greater control and flexibility that now exists, particularly for the over 55s, so to discuss the impacts of these changes with a Financial Planning Consultant please contact us or visit our website.

An interview with ... Jeunesse Edwards

Strategic Engagement Director at Augusta Ventures LLP, providers of third party litigation funding

How do you see the current litigation market?

The litigation market appears to be in a constant state of flux. New legislation and regulation such as the costs reforms and increased court fees continue to make both lawyers' and litigants' lives challenging, which in turn provides opportunities for those who are prepared to adapt and change.

There is certainly room for growth with over a third of UK SMEs not taking action to resolve their disputes due to the costs involved.

What specific difficulties are litigation lawyers facing?

In an increasingly competitive market, lawyers must become marketeers and PR gurus in order to generate new business while maintaining fee earning work. We were told anecdotally by one of our approved lawyers that even when work comes in the door, the prospect of his fees, disbursements and the potential adverse costs risk leads to around 35% of clients deciding not to pursue their cases.

More clients are seeking a firm who will share the financial burden of running their claim by acting on a CFA or DBA, or indeed working to a cap or fixed fee. Those firms who have not shied from tackling the finance 'elephant' in the room are creating new and innovative ways to meet their clients' needs and as a result are growing their businesses.

How can litigation funders provide solutions to some of those difficulties?

Litigation funders are far more than just a source of funds. A good funder will enable a lawyer to take on meritorious matters for impecunious or risk-averse claimants which may otherwise never be pursued. This grows the business of the firm. In addition to reducing their attrition rate of good cases due to lack of funds, litigation funders can be a direct source of work for reputable firms. At Augusta we are frequently approached by claimants directly asking us to recommend a trusted firm to engage.

The relationships that we are developing with law firms will be the basis upon which we grow our business and the law firms grow their businesses. From the firm's perspective, we offer certainty of funds which assists with cash flow management, we can bring stability to a claimant, and we are actively interested in the claim. In many instances we become one of the few parties in a matter with whom a lawyer can discuss their matter candidly.

From the claimant's perspective, I believe litigation funders are there to level the playing field for those coming up against defendants who use tactics such as security for costs applications and delay in the hope that they do not have the legs to see the matter all the way to trial. Litigation funders are there to shoulder risk and financial burden; understand litigation and form a great relationship with claimants.

Lastly – we are there to provide a 'sanity check' and comfort to a firm who takes on risk under a CFA and for a claimant who is staring down the barrel of a litigation stoush.

Are all lawyers aware of those solutions?

Awareness amongst the legal profession of alternate financing options is growing, but there are still a number of mis-conceptions. It is not solely for multi-million pound disputes, and we (amongst a handful of others) have developed solutions to enable mid-range cases to access financing.

At Augusta we have financed a case for damages of £50,000, while our average investment is £210,000 per case. This is right in the sweet spot for so many firms and demand for our service is being driven by the one with the power in the relationship – the client.

One thing is for sure, it will be those who have recognised early that the empowerment of the claimant due to the breadth of online resources available now has changed the way that people both buy and pay for legal services that will come out on top.