the law

AUTUMN 2022

Working with

The Law Society

Armstrong Watson's specialist publication for the legal profession

IN THIS EDITION...

ECONOMIC OUTLOOK AND LINK TO FLEXIBLE PRICING APPROACH

HOW THE RIGHT CULTURE MAY BE THE ANSWER TO YOUR RECRUITMENT CHALLENGES

EFFECTIVE LAW FIRM GOVERNANCE

DON'T LEAVE YOUR FINANCIAL PLANNING TO THE END OF THE TAX YEAR

SUPER DEDUCTION ENDING

COMPENSATION AND EARLY TERMINATION PAYMENTS - WHERE WE ARE NOW?

PLUS...

AN INTERVIEW WITH... ANNE MACDONALD, LEAD PARTNER OF HM CONNECT

ArmstrongWatson®

Accountants, Business & Financial Advisers

A track record of providing solutions to the legal profession

IN THIS EDITION...

2-3 ECONOMIC OUTLOOK AND LINK TO FLEXIBLE PRICING APPROACH

4-5 HOW THE RIGHT CULTURE MAY BE THE ANSWER TO YOUR RECRUITMENT CHALLENGES

6-7 EFFECTIVE LAW FIRM GOVERNANCE

8-9 DON'T LEAVE YOUR FINANCIAL PLANNING TO THE END OF THE TAX YEAR

10-11 SUPER DEDUCTION ENDING

12-15 COMPENSATION AND EARLY TERMINATION PAYMENTS - WHERE WE ARE NOW?

16-18 AN INTERVIEW WITH... ANNE MACDONALD, LEAD PARTNER OF HM CONNECT

Supporting, Advising and Protecting Law Firms through challenging times

For trusted information and advice on any issue surrounding your business please get in touch on 0808 144 5575 or email help@armstrongwatson.co.uk

...we're with you

ArmstrongWatson®
Accountants, Business & Financial Advisers

Cash Flow Management | Commercial Funding | Payroll | Accounting | Services Wealth Management & Financial Planning
Tax | VAT | Insolvency | HMRC Enquiries | Investments and Pensions | Dispute & Debt Resolution

Exclusively working in partnership with the Law Society for the provision of the following services to law firms.

- Strategy Planning Workshops
- Business Plans
- Benchmarking
- Mergers & Acquisitions of Law Firms
- Law Firm Valuations
- Forecasts
- Raising Finance
- Lock-up Reviews
- Pro-active Tax Planning
- Tax Compliance
- Audits
- Accounts Rules Reporting
- Accounts Preparation
- LLP conversions
- Incorporations
- ABS Applications

Armstrong Watson Accountants, Business & Financial Advisers is a trading style of Armstrong Watson LLP. Armstrong Watson LLP is regulated by the Institute of Chartered Accountants in England and Wales for a range of investment business activities. Armstrong Watson Audit Limited is registered to carry on audit work in the UK by the Institute of Chartered Accountants in England and Wales. Registered as a limited company in England and Wales, number 8800970.

This newsletter is a general guide to issues facing the legal sector. It is not a substitute for professional advice which takes account of your specific circumstances. Subjects covered change constantly
and develop. No responsibility can be accepted by the firm or the authors for any loss occasioned by any person acting or refraining from acting on the basis of this publication.

WELCOME

Welcome to the Autumn 2022 edition of The LAW, the specialist publication for the legal profession from the legal sector team at Armstrong Watson.

One of the current 'hot topics' in the legal sector is recruitment and retention. As well as previous pieces in The LAW on the 'great resignation', we've recently hosted a webinar for Law Firm Ambition (LFA) on the same subject, which can be found on the LFA website. Within this edition of The LAW, we've expanded on that webinar, focusing on poll findings from the event on the importance of culture.

In this edition, we also have a piece on management and governance in law firms, which clearly has a huge impact on people development and retention, as well as performance.

This edition also includes:

- The importance of pension contributions
- VAT issues for solicitors advising their clients in contractual matters
- The economic outlook and impact on pricing legal services
- An interview with Anne Macdonald of HM Connect on the legal sector market in Scotland

Specialists are available from all of our 18 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.

To find out more on any of the above, including how we can work with you to help you and your clients, please do get in touch with me.

Andy Poole

Andy Poole
Legal Sector Partner
@AW_AndyPoole
andy.poole@armstrongwatson.co.uk

ECONOMIC OUTLOOK AND LINK TO FLEXIBLE PRICING APPROACH

The Office of National Statistics tell us that Inflation is at 9.1% (at the time of writing!) but that worse may well be to come and such significantly rising costs are likely to cut profit margins. Your clients will also be feeling the financial strain so may be delaying payments or reducing scopes to bring costs down. In the coming months cash will be king.

THE LAW | AUTUMN 2022

Five key ways to aid the survival of your business:

1. Understand your cash position:

Turnover and profits are important, but knowing what your cash position is helps drive decision making and can be the difference between whether you survive a crisis or not. Prepare a cash flow forecast to establish the cash requirements over the next few weeks and months, and help you deal with any issues in advance.

2. Stay on top of your debtors:

Any overdue amounts must be chased immediately. Consider putting the client on 'stop' if they are late paying. In times where you may be supplying a service that is scarce (conveyancing fee earner vacancies are very high at the moment too!), you should also be looking at payments in advance.

3. Examine all your costs:

Cost control is vital. Go through all your costs line by line to see if each cost is required to achieve your turnover.

4. Manage your creditors strategically:

Always try to negotiate the best payment terms with your creditors. If your cashflow projection shows a shortage then communication with your suppliers is vital.

5. Thinking about your pricing:

If your firms own internal inflation rate is 9% (ie – don't take the ONS's version, calculate your own!) then its entirely reasonable to raise your fees by 9%. But in a scenario where you are already over capacity you may need to go further – 15%? Of course not all clients will accept this level of price rise. To an extent that is the point (If you are busy enough, at the higher rate then you don't need the work) but it also allows you to open up a conversation about scope and to be more flexible with your pricing – if they agree to go without X, or to only have one draft then you can agree to lower your price again. Of course that only works if you stick to it – be ready to raise the price again if the scope creeps up again.

Tom Blandford -
Legal Sector Partner
tom.blandford@armstrongwatson.co.uk

HOW THE RIGHT CULTURE MAY BE THE ANSWER TO YOUR RECRUITMENT CHALLENGES

The war for talent within professional services shows no sign of slowing down. For those in the industry, this is not new news - firms and recruiters alike are looking for new and innovative ways to keep their top performers, as well as attract new ones.

How best to do this though?

Increase salaries in line with inflation?

Expand benefits packages at all levels?

It turns out the answer may centre around your firm's culture.

What do candidates want nowadays?

This is a question a number of firms are currently asking themselves. For most businesses, the main focus is around salaries; more specifically around whether an increase in what can be offered will help attract top talent. Salary is obviously important to people, especially when you consider the ever rising cost of living - just recently, two of the accounting world's "Big 4" firms grabbed the headlines with inflation equalling pay rises for nearly all employees and four figure non-performance related bonuses, with both also openly stating this was in response to the "competitive recruitment market" we find ourselves in. Is this enough on its own though? And what do firms without the resources of the industry leaders do to stay competitive?

To help answer these questions, I'd like to reference a recent survey* conducted by Law Firm Ambition around what was important when considering a new employer, as it brought some incredibly interesting insights. First and foremost, the right culture and brand by far outweighed salary for those that answered (92% sited this the main driver), showing that it's not just about who pays most.

Instead, candidates these days are far more interested in hearing about what makes a business unique, what values they adhere to and what sort of people typically work there.

*Details of the survey , which was conducted during a 26 May 2022 Law Firm Ambition webinar on recruitment and retention, can be found at: https://lawfirmambition.co.uk/topics/winning-talent-acquisition-and-retention-battle

Candidates want to work for firms with a moral compass that aligns with their own, they want to work for a firm that cares about their personal development and progression and they want to work for a firm that offers them opportunity. Candidates also want to work for firms that will support them professionally and personally, again highlighting the need for firms to get their wellbeing strategy in order.

What is my firm's culture?

Your culture is defined by what is seen as the normal behavioural and procedural practices within your business. This covers everything from your polices, ethics and values as well as employees typical behaviours and attitudes.

At my own firm, Armstrong Watson, our culture is front and centre of everything we do and we constantly measure how our culture feels to our people, however in another survey conducted in the same event by Law Firm Ambition, almost 20% of those polled said their firm didn't measure culture at all!

For those businesses, it will be very difficult to know if the culture they are trying to develop is working, and more importantly it becomes difficult to sell that culture correctly to incoming colleagues. This will severely hinder recruitment strategies, even where high salaries may be on offer, as candidates want more than just a bump in wage.

How do I get culture right?

Each firm will have their own version of what the "right" culture is; for some it's a culture of long hours and perceived high rewards, for others it about flexibility and balance. The truth is, as long as your culture fairly defines what it is like to work for your organisation, then it's right. If you have a culture of working long hours and pay high bonuses as a result, tell your candidates. This may drive away individuals that want more of a work life balance as opposed to reward, but if you hire those individuals under false pretences, chances are you'll lose them in the first year of their employment anyway, which in itself can damage culture.

For most people, going into a role that marries up well with the way in which they like to work will be far more important than salary. For those individuals that purely move for salary, there is always the risk they are tempted away by the offer of more cash elsewhere, meaning they are only ever going to be with you in the short term.

Conclusion

The current trend when it comes to salaries is unsustainable for most firms, however the positive news is that candidates, for the most part, are not purely driven by the need to earn more. Instead, they want to know more about who you are and what you do, so they can make a fair assessment on whether the fit is right. This should put culture as the single most important aspect in any recruitment strategy.

Getting your culture right can also help with retention, with a high number of employees in professional services scoring things like flexibility and progression in their role as more valuable to them than salary. This is not to say that salary is unimportant, as it most certainly is, however getting culture right is proving to be far more impactful with people.

Once you have the right culture in place, think about how you can best demonstrate that culture to people outside the organisation. As an example, when you choose to interview a candidate, I would encourage you to invite that person into the office as opposed to going to Teams or Zoom as a default. As we all know, candidates and businesses alike have become used to conducting interviews virtually, mainly as it is seen as a more convenient way to meet someone. For a candidate this is almost certainly true, however it is also far more difficult to get a feel for a firm's culture virtually. Where candidates can't come into the office to interview, invite them in for a tour one afternoon so they can get a real feel for the place.

Think about the make-up of your interview panels as well. Are the people talking to candidates the best cultural representatives of your firm and are they clear on what the culture of your firm is?

Make sure that you also reference your culture in the conversation with candidates, and make sure that message is consistent. This above all else will help you differentiate from your competitors, which in turn will help you recruit the right people for you firm.

A little about the culture here at Armstrong Watson can be found at: https://www.armstrongwatson.co.uk/sites/all/themes/armstrongwatson2020/downloads/little_book_of_culture.pdf

This book of culture is issued to all potential candidates prior to any formal discussion in order to show them what they can expect from a career at Armstrong Watson.

David Ramsay -
Head Of Talent Acquisition
david.ramsay@armstrongwatson.co.uk

EFFECTIVE LAW FIRM GOVERNANCE

The governance of law firms has evolved hugely in the past 10-20 years, with firms now generally being much more professionally led and managed. Practices of all sizes have commonly moved to more of a corporate management structure, rather than having partner meetings to collectively make all management decisions.

Whilst managing partners focusing exclusively on management rather than fee earning used to be the preserve of the larger firms, it is now common for medium and smaller firms to have non fee earning managing partners. Terminology has also evolved and many a managing partner is now entitled as the Chief Executive. That title first started to appear in law firms when non-lawyers were recruited from other professions/industries to lead law firms and it has now spread to apply equally whether the law firm leader is a lawyer/not or whether they are internally/externally sourced.

Benchmarking results of law firms would appear to indicate that the firms that are able to distinguish roles between 'working on the business' and 'working in the business' tend to out-perform those that are focused on owner-management and collective decision making.

So, why have firms evolved in this way, and what does a good governance structure look like?

Why?

- Decisions are made much quicker with a streamlined management structure that does not require the need to wait until all partners are available to meet and then discuss potentially minor issues in great detail before reaching an agreement.
- Decisions that either need to be made quickly (e.g. responses to the initial Covid lock-down) cannot wait for a full partner meeting.
- Decisions that do not warrant full discussion due to their relative immateriality (e.g. renewing small leases or changing a minor supplier) should not be important enough to take the time up of all partners.
- Time is precious and should be prioritised, not wasted. Having a small group of informed people making decisions on the business, and allowing partners to focus on what they do best (fee earning/leading and developing their teams and being close to their clients) will mean that the business gets the first-rate attention that it deserves, and so does fee earning/team development and client/prospect relations.
- Having people tasked with running the business, and having clear delineations of responsibilities of all, also allows the performance of partners to be appraised more easily and having a hierarchy of management within the partner structure allows constructive line management, accountability and development. Risk management and governance procedures are also improved, as partner compliance can be managed through the improved structure.
- In limited liability structures, partners do appear to be more willing to cede control and be managed by others, presumably as they are more comfortable in the fact that their personal assets are not on the line and therefore feel the need to be involved in every decision. This is particularly so if there is a reporting mechanism to keep them informed and if certain decisions are retained with equity owners.
- The team as a whole becomes more efficient and effective if people are taking on roles that they have the appropriate skills for. Those with commercial, management and leadership skills can focus 'on the business', and those with excellent technical skills can work more 'in the business'. This concept then extends to potentially having other professionals on management/strategic/operational boards, such as chief executives/IT/marketing/HR/finance professionals.
- When roles are clearly defined, there can be more focus and the likelihood of objectives being achieved can be improved.
- When decisions are being made by those that have the skills and the time to make such decisions, and such people are immersed in those roles with the relevant information engrained in them, decisions will be from an informed basis and are more likely to effective.

What?

Although there are a huge range of potential options and how firms have achieved effective management and governance, some of the common traits include:

- Having an overall management board to focus on strategic matters, made up of a full-time managing partner/chief executive; a finance director; and typically no more than three equity partners.
- Having a service line head for each of the firm's service lines, who are effectively mini-managing directors for their parts of the firm. In order for the service line heads to focus on operations within their team, and for the board to focus on the strategic bigger picture, often the service line heads are not necessarily on the management board.
- Having a leadership team for each of the service lines, comprised of the service line head and say three others from that service line.
- Having an operations board made up of the key internal functions such as IT/HR/finance/marketing.

Key variables include:

- Defining boundaries and what decisions are made by each group/individual
- Links, communication and hierarchy between the groups
- Reporting from board/service line teams to the wider firm
- Line management / appraisal processes
- How to decide who sits on which group

There is clearly no 'one-size fits all' approach here, and it is important to bespoke structures that work best for particular firms. I have been involved in reviewing and recommending governance for a number of firms, and the end result is always different to some degree.

It can be difficult for partners to let go of control, and also to be managed by others, especially if they are an equity owner of the business. Results help in this regard, and if it is working well for the business and there is a track record of success, then that success breeds more acceptance and further success. In more difficult times, the need to change may be more important, but is much harder to obtain the buy in from the partnership for such changes – in such circumstances law firm leaders should be bold and if people aren't all on board then it may be better for them to go their own way.

Comfort should be obtained from the fact that those firms that do have effective management and governance outperform those that don't.

Andy Poole
Legal Sector Partner
andy.poole@armstrongwatson.co.uk

DON'T LEAVE YOUR FINANCIAL PLANNING TO THE END OF THE TAX YEAR

Although the current tax year doesn't end until 5 April 2023, effective financial planning shouldn't be a mad March rush. Starting your financial planning early in the year will give you a head start.

Often, as the end of the tax year is approaching, there are many financial commentators and institutions writing/advertising about how you should make sure you don't lose your valuable tax allowances. The reasons being that they allow you to reduce your tax bill or use up an allowance that may otherwise be lost after the end of the tax year.

However, those who have chosen to engage the support of a financial planner, are much more likely to be in a position where they have looked and planned ahead, rather than waiting until the final weeks of the tax year to make last minute decisions.

There are a number of areas of financial planning to consider that can benefit you both now and in the longer term, all of which are worthy of consideration. Key areas to look at include:

- Pension contributions – maximising your allowance in the current tax year and in previous years to avoid losing any unused allowances
- ISA Allowances – maximising your annual tax-free allowance - currently £20,000 per person per year. It is lost if you don't use it
- Capital Gains Tax – effectively using up any allowances and reliefs from your portfolios
- Inheritance Tax – using up small exemption allowances but also making gifts and disposals in the current tax year
- Income tax planning – reducing your income tax bill for high earners and those who receive child tax credit
- Marriage Allowance - allows you to transfer a portion of your Personal Allowance to your husband, wife, or civil partner.

Each area needs careful thought as both financial and tax planning is subject to individual circumstances and all the options and allowances mentioned are not suitable for everyone. They should also be considered as part of someone's overall financial plan and strategy i.e., part of a joined up and well thought through approach.

To try and "cram it in" to the final few weeks of the tax year could mean that something is not considered and could potentially work against your overall goals and objectives.

Aside from making full use of available allowances and reliefs there are other advantages to planning ahead, for example, by using your ISA allowance or making your pension contributions earlier you could benefit from extra potential growth, as well as receiving an element of your tax relief earlier on your pension and any pension contributions. Of course, there's also the benefit of spreading your contributions over a tax year instead of in one lump sum at the end, when it might not be affordable to you at that time.

THE LAW | AUTUMN 2022

Planning ahead is essentially what financial planning is all about, but by working with a trusted adviser, you also benefit from being kept up to date on the latest position on all aspects of relevant tax legislation which can then be signposted for both current and also future consideration.

Armstrong Watson have both Financial Planning and Tax Consultancy expertise in place "all under one roof". This allows us to provide both a bespoke and joined up service for our clients when and where specific needs arise. Please note, some of the areas within this article such as making pension contributions are provided by our Financial Planning Consultants, whereas other areas such as capital gains tax advice are services offered by our Tax Consultants. Advice on IHT issues could be provided by a mixture of the two services.

Justin Rourke -
Senior Financial Planning Manager
justin.rourke@armstrongwatso co.uk

SUPER DEDUCTION ENDING

When the Covid-19 pandemic hit, it caused worldwide economic distress. The lockdowns and forced closures of non-essential trades and effectively slowed business investment to a trickle. On the 3rd of March 2021 the then Chancellor, Rishi Sunak, announced two new temporary first year allowances to assist in boosting investment again. Companies investing in qualifying equipment would be eligible for a "super-deduction" and "Special Rate allowance".

To understand the benefit of these new allowances it is necessary to understand how companies obtain tax relief on assets that they purchase. From an accounting perspective, any asset which is acquired is recognised on the company's balance sheet, and depreciated on an annual basis in order to recognise that the assets value will deteriorate over time. For tax purposes, this annual depreciation charge is not an expense which is deductible when calculating the company's taxable profits. Instead, a company claims capital allowances against the cost of the assets acquired. The rate at which capital allowances are given against an asset generally depends on the type of the asset. Prior to the introduction of the super-deduction, companies were able to claim a capital allowance equal to 100% of the cost of a qualifying asset up to a certain overall cap which has changed on multiple occasions over the last few years. This capital allowance is called the Annual Investment Allowance (AIA), and the overall cap is currently set at £1 million.

The super-deduction provided companies with a deduction against their profits of an amount equal to 130% of an uncapped amount of qualifying expenditure on main pool plant and machinery. This would include items such as plant and machinery, office furniture, computer equipment, commercial vehicles. The Special Rate allowance provided a deduction equal to 50% of uncapped qualifying expenditure on special rate pool assets including long life assets. This would include items such as lighting, heating and water systems.

Both new allowances sparked a great deal of interest especially from company directors who had felt shortchanged by the other support packages. However, it was designed to be a temporary measure, the allowances would only be available for two years from the 1st of April 2021 to the 31st of March 2023.

The hope was that the promise of additional tax relief, alongside the existing AIA, would incentivise companies to go on a spending spree and shake off their covid-induced hibernation. It also took into account the fact that overall Corporation Tax rates were forecast to increase from 1 April 2023 and so the government did not want businesses to wait to invest until then if they would have received larger discounts to their corporation tax bills with investment taking place from that point on.

For the super-deduction, the qualifying plant and machinery must be brand new and covers everything from solar panels to computer equipment, tractors and pickup trucks. It has been a success so far with companies taking advantage of the uncapped expenditure limits, compared to the previously £1m AIA cap.

We are eighteen months into the two-year window of the super-deduction and this temporary relief will be ending shortly. The question now is, what happens next?

Our reliefs for capital expenditure have never been particularly generous when compared to the rest of world, and introducing these additional allowances suddenly put us at the top of table for the Organisation for Economic Co-operation and Development (OECD) average of net present value for capital allowances. When the temporary allowances end, we are predicted to drop down to 30th out of 38 countries on that list.

We are in the midst of a Cost-of-Living Crisis, with a newly appointed Prime Minister and Chancellor, Liz Truss and Kwasi Kwarteng. Their emergency Mini-Budget cancelled the planned increases to corporation tax which were due to take effect from 1 April 2023, keeping rates at the existing 19%. They also confirmed that the AIA threshold would be kept at £1M indefinitely.

Given the new administration's focus on reducing tax, it is perhaps surprising that they chose not to announce the extension of the super-deduction, and perhaps a further announcement could still be made at the next Budget.

In May 2022 the Treasury announced a consultation to look into several options for providing tax relief on capital expenditure. The options currently under review including:

- Increasing writing down allowances (WDAs) from 18% and 6% to 20% and 8% respectively, to directly benefit those spending over the AIA limit.
- Introducing an additional First Year Allowance for main rate and special rate assets of 40% and 13% respectively. This would provide additional support to companies investing heavily in a single year.
- Adjusting the additional relief in first year allowance to 20% rather than the current 30%, to retain the bonus element on top of 100% allowances of the expenditure.
- Introducing full expensing of expenditure in the year it occurs. Currently no other country in the G7 has implemented this strategy on a permanent basis.
- Removing the claw back on disposals of assets on which these additional allowances have been claimed.

Our new Chancellor may choose a different replacement altogether, which may improve incentives. He could also choose not to replace or extend the reliefs at all having already cemented the AIA cap at £1m.

One thing is certain, whilst the super-deduction is still available, companies should seek to utilise them whilst they can. With the proposed increases to Corporation Tax now cancelled, there is no tax advantage in delaying expenditure to the next tax year.

Sophie Murphy -
Tax Manager
sophie.murphy@armstrongwatson.co.uk

COMPENSATION AND EARLY TERMINATION PAYMENTS - WHERE WE ARE NOW?

Hydeam Sulton Tax Partner - Head of VAT and Indirect Tax at Armstrong Watson explores the impact on the legal sector of HMRC's change of policy on compensation and early termination payments.

Lord Justice Sedley famously described the world of VAT as a kind of fiscal theme park in which factual and legal realities are suspended or inverted. With HMRC's policy change on compensation and early termination payments this statement has seldom been truer in relation to the definition of 'consideration' for a supply.

For many lawyers, VAT is often a minefield at the best of times and HMRC's latest policy change makes the waters now even muddier. Scenarios where payments pass between parties which would historically have been outside the scope of VAT are now viewed by HMRC as within the scope of VAT as consideration for a supply. This is despite the fact that from a non-VAT law perspective, they would not generally be thought of as consideration for a supply contractually.

The changes will impact lawyers working across a broad range of practice areas including commercial, real estate and litigation.

It is essential that the changes in HMRC policy are understood when advising clients and drafting contracts, as the world of VAT has expanded (or at least it has in the eyes of HMRC).

Revenue and Customs Brief 2 2022

On 7 February 2022 HMRC issued Revenue and Customs Brief 2 2022 ('RCB 02/22') which provided updated guidance on VAT on early termination fees and compensation payments.

In addition, HMRC updated its internal staff VAT manuals

- VATSC05910
- VATSC05920
- VATSC05930

The updated guidance issued in February 2022 has sought to provide long awaited clarity following the fallout from the issue of Revenue and Customs Brief 12 (2020): VAT early termination fees and compensation payments ('RCB 12/20'). RCB 12/20 announced at the time a significant HMRC policy departure from treating compensation and early termination fees in a contract as generally outside the scope of VAT to generally within the scope VAT.

Background

HMRC's policy change followed judgements of the Court of Justice of the European Union ('CJEU') in *MEO C-295/17* ('MEO') and *Vodafone Portugal C-43/19* (Vodafone Portugal') and related to early termination of mobile phone contracts. The CJEU held:

MEO

- If a supplier receives a predetermined amount where a contract for the supply of services has a minimum commitment period that is terminated early by its customer (or for a reason attributable to the customer) which corresponds to the amount that would have been received in the absence of such termination, this must be regarded as remuneration for a supply of services for consideration and subject to VAT if taxable.
- The following are not decisive for classifying the amount predetermined in the services contract which the customer is liable to pay in the event of early termination:
    - The objective to discourage customers from not observing the minimum commitment period and to make good the damage that the operator suffers in the event of failure to observe that period.
    - Whether the remuneration received by a commercial agent for the conclusion of contracts stipulating a minimum period of commitment is higher than that provided for under contracts which do not stipulate such a period.
    - That the amount invoiced is classified under national law as a penalty.

Vodafone Portugal

Amounts received in the event of early termination, for reasons specific to the customer, of a services contract requiring compliance with a tie-in period in exchange for granting that customer advantageous commercial conditions, must be considered to constitute the remuneration for a supply of services for consideration and subject to VAT if taxable.

Whilst the CJEU's findings were based on the specific facts in MEO and Vodafone Portugal and arguably had limited wider application given the specific arrangements entered into in these cases, HMRC unexpectedly went significantly further in RCB/20 and overnight changed the default VAT treatment of what has always generally been considered outside the scope receipts to consideration, including with retrospective application.

Inevitably, HMRC's policy change was met with significant pushback due to the one size fits all approach which led HMRC to announce a moratorium in January 2021 until HMRC's revised guidance was published. HMRC did however helpfully provide confirmation there would be no retrospective application of the change.

The revised guidance was eventually released in the form of RCB 02/22 and the updated internal staff VAT manuals.

Continued overleaf...

HMRC's latest approach following RCB 02/22

Unfortunately, despite some limited noted exceptions, HMRC has broadly maintained its position that the starting point for compensation and early payments is that they are consideration for a supply.

Key points for HMRC guidance

It is HMRC's view that:

- Whether a payment is called compensation/damages is not determinative. What is important is whether something is done and if there is a direct link between what is done and the payment received, and reciprocity between the supplier and the customer.
- Where a supplier makes a supply available to a customer, but they do not avail themselves of all or part of that supply, and the supplier charges a payment to compensate them for having made the supply available that will normally be further consideration for that supply.
- Where fees are at a level such that they are clearly punitive and designed to prevent breach rather than to compensate for lost income, then the link between that payment and the supply is not sufficient to regard it as additional consideration, and it will be outside the scope of VAT.
- Where a contract ends as a result of an action by the customer which causes the supplier to terminate a lease, then if the supplier charges a fee to cover the costs of making the supply, or an additional fee broadly equivalent to what would have been charged under the lease had it run as envisaged, then the payment is further consideration for the supply.
- Where a supplier breaches the terms of a contract, rather than the customer doing so, then they may reduce the price they charge for the supply, as what is being supplied has been altered. This will result in less VAT being charged if the supply is taxable. If the adjustment is made retrospectively the supplier must adjust the VAT they have accounted for under VAT Regulation 38.
- Payments arising out of early contract termination will normally be further consideration for the contracted supply where the payments are linked to that supply.Although liquidated damages payments are partly designed to compensate, they are made as a result of events provided for under the contract and are therefore part of the agreement, and if they form costs to the supplier of making the supply available or equate to what would have been charged for the supply had it run as expected they may be further consideration for the supply.

Specific examples in HMRC guidance

HMRC guidance does contain a number of clarifications and examples which are helpful and arguably have wider application in determining HMRC's overall approach to whether payments are subject to VAT. However, caution is recommended in applying any of the HMRC examples more widely as these will likely be viewed by HMRC officers as an 'exception list' not an aide to interpretation.

Dilapidation payments:

- Dilapidation payments are not further consideration for the supply of a lease, but HMRC might depart from that view if in individual cases it found evidence of value shifting from rent to dilapidation payment to avoid accounting for VAT.

Hire of Goods:

- A charge for late return of a hire car will normally be subject to VAT as it is made for the supply of the car, and the customer is aware that an additional charge will be made and how much that charge will be or how the charge will be calculated.
- A charge in the event a customer writes off a hire car would not normally be subject to VAT as the supplier does not agree that the customer can write the car off, and this is not something one would normally expect as part of the supply and therefore as the necessary reciprocity does not exist.

Lease agreements movable goods:

Lease agreements for moveable goods where customers can cancel after an initial period of hire but, if so doing, must pay a termination fee to cover the loss of future rents payments are taxable.

Car Parking:

- If the fee is for the additional use of the parking space it is further consideration for the supply of parking.
- Where a fine is substantial and punitive and is designed to deter a breach of the terms and conditions of parking it will be outside the scope of VAT.

Summary

Whilst HMRC's latest guidance is welcome in terms of setting out HMRC's approach and importantly pulling back in some key areas from the position in RCB 12/20, it is not expected to be the end of the matter as HMRC position is generally too widely drawn and it is anticipated (including by HMRC) that this area will very likely be subject to ongoing litigation.

Two notable cases have already cast further doubt on HMRC's guidance.

The findings of the CJEU in *Apcoa Parking Danmark C-90/20* raises question on the treatment of parking fines as outside the scope, but given HMRC will have had the benefits of seeing the decision before publication of its own guidance it is hoped HMRC will not revise its guidance again to bring parking fines within the scope of VAT.

Although not a VAT case, the Outer House of the Court of Session in *Ventgrove Ltd v Kuehne + Nagel Ltd ([2021] CSOH 129)*, found MEO and Vodafone Portugal not to be directly in point in relation to a lease break payment.

Action to take

- When advising clients, review payments that may flow between parties, particularly those that would not ordinarily be viewed contractually as 'consideration', as to whether these could fall within the scope of HMRC's new guidance and potentially be subject to VAT.
- Standard contractual documents/templates should be reviewed to ensure that the risk from HMRC's updated guidance are clearly covered, including for example the ability to charge VAT on payments which would previously have been outside the scope of VAT.
- Where VAT has been charged/not charged on compensation and early termination payments during the moratorium period, consideration should be given to how to deal with any wind back e.g. on dilapidation payments where VAT has been charged.

Specialist advice should be taken where compensation and early termination amounts are not clearly and specifically covered in HMRC's guidance.

Hydeam Sulton -
Tax Partner - Head of VAT & Indirect Tax
hydeam.sulton@armstrongwatson.co.uk

AN INTERVIEW WITH...

Andy Poole interviews Anne Macdonald, lead partner of Harper Macleod HM Connect, a referral and support network for law firms in Scotland.

Heading a law firm network with over 400 members throughout Scotland provides Anne the perfect insight into key impacts on Scottish law firms and current developments in the market. Andy Poole interviews Anne Macdonald to explore what's hot in the Scottish legal profession:

1. What does the Scottish legal market look like right now – is it predominantly made up of smaller firms as with other jurisdictions?

I often reflect that we've had a decade of change but ultimately not much has changed, and by that I mean that the number of practice units has remained relatively stable given what at times has felt like seismic change – there are currently 1,120 law firms and when I look at my notes from a presentation back in 2011 we had 1,134 firms! The majority of practice units continues to be sole practitioner firms with around 500 such law firms, however where we have seen the most change is in the globalisation of Scottish legal market – there are over 50 multinational practice units operating Scotland and they employ almost a third of all Scottish solicitors in private practice - I think this has been the biggest, quietest, change in the market place. We have also had consolidation within the domestic marketplace with mergers between high street and rural firms to create stronger local brands and a number of mergers and takeovers by the medium/large indigenous Scottish firms to expand their footprint across Scotland and the focus here has predominantly been on private client services.

2. What are the top three concerns you hear from solicitors around managing their law firms?

A recurring topic for many years, but which has become more pronounced since lockdown, has been the talent war: recruitment and retention continues to be a challenge. We're finding many firms are too heavily geared with a predominance of more senior lawyers (and this is across the spectrum of firms) and find it difficult to compete with the international firms on attracting NQs – three year PQE level lawyers.

Many lawyers I speak with are actively looking at retirement and plans that they thought they had in place are no longer viable due to associates being attracted elsewhere (in-house or to global firms) or leaving the profession and that's putting a lot of pressure on our senior members of the profession. There also now seems to be a more realistic view on what options are available in terms of takeovers or mergers and an acceptance that golden handshakes do not exist and that premises may not be attractive to an acquirer.

Until May 2022, I served as a Council member of the Law Society of Scotland and one of the biggest take aways from my six years on Council is just how important the provision of legal aid is to fair and just society. It has been hugely important that profile has finally been given to the real difficulties encountered by solicitors when engaging with the legal aid system and the impact that this has on users of legal aid. I am hopeful that the small steps of progress that have already been achieved here is just the start of more fundamental changes.

3. What is the current status of the Roberton Review and how likely is imminent change to current regulatory framework?

The Roberton Review was published back in October 2019 and a public consultation on its recommendations ran from 1 October to 24 December 2021.

From the moment that Review was published there has been a divergence of views as between consumer groups, the profession and regulators. On 8 July 2022, the Scottish Government published its consultation report: Legal Services Regulation Reform in Scotland: Consultation Analysis, and the responses do reflect a range of views, with consumers generally favouring option one and the legal profession preferring option three. So what are the three options?

Option one: new independent regulator for all legal services in Scotland whose members would be appointed by the Scottish Government.

Option two: creation of a market regulator with an oversight role which would be in addition to existing regulatory structure and accountable to the Scottish Government.

Option three: retain the current structure, maintaining the Law Society as regulator and professional body with a renewed focus on accountability, transparency and reform of outdated procedures.

It is my understanding that the Scottish Government intend to engage further with key stakeholders before publishing their formal response in the autumn. It's a case of watch this space...

4. What about ABS? Scotland is nearly 12 years down the line since the 2010 Legal Services (Scotland) Act, do you think the Law Society of Scotland will be accepting applications from Licenced Legal Service Providers (LLSP) in 2022?

It's been a long time coming but it does now seem that applications for LLSP will be accepted from the late autumn onwards. Back in 2010 it was a debate that polarised the profession and resulted in the 49% external ownership provision. In essence since then, nothing meaningful has happened. Ironically, in England ABS has been around since 2007 and a number of these have bases in Scotland or have acquired Scottish firms, so we have had ABS through the back-door and it's created an unlevel playing field for Scottish regulated firms. LLSP in Scotland may also provide a succession planning option for smaller firms – for those having difficulties recruiting or retaining an associate to take over their law firm, matching up with an accountancy or wealth planning businesses with similar issues may help alleviate what, at times, can be a lonely place. For others it will provide the opportunity to truly recognise the crucial contribution of executive roles within law firms and permit finance directors, marketing directors and HR directors to become owners.

Anne Macdonald - Partner
Harper Macleod LLP

Take the challenge out of selecting the right technology solutions for your business with the help of our Client Technology team.

From data management and security, through to hardware and hosted telephony, our business advisers, alongside our independent information technology partners, can:

Review | Enhance | Identify | Procure | Supply
Install | Provide training | Secure | Manage

any business system, IT infrastructure, or software solution for your unique business needs.

To learn more about our **Client Technology** services download our brochure [here] or email help@armstrongwatson.co.uk

ArmstrongWatson®
Accountants, Business & Financial Advisers
www.armstrongwatson.co.uk
...we're with you