the law

Spring 2019

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Armstrong Watson's specialist publication for the legal profession

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- ABS Applications

Welcome

Welcome to the Spring 2019 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 17 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.

Following our Glasgow acquisition, we are now helping many more law firms in Scotland and will shortly be launching our Breakfast Briefing events in Glasgow and Edinburgh – watch this space!

For England and Wales, we are also looking forward to the **new SRA Accounts Rules,** which are due to come into effect in Summer 2019. We have started our series of formal public training courses on the new rules and the feedback from delegates in London, Leeds, Hull, Carlisle, Liverpool and Manchester has been excellent. We are also being engaged by firms for **internal courses** for their finance teams and fee earners. Please contact me if you would like to be included.

As ever, in this edition we focus on ways to improve your business and your advice to your clients, including:

- Ensuring you obtain full tax relief for partner's expenses
- Working together on trusts
- Opportunities for boosting the cashflow of PI firms via a VAT tweak
- An update on the requirements for lawyer referring clients to IFAs
- Effective use of management information to boost performance

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.

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Partner's Tax Expenses

A change of HMRC guidance

Following the conclusion of a recent tax case, HMRC has made changes to its internal guidance in respect of expenses paid personally by the partners which relate to the business, and this could mean going forward that you do not obtain tax relief for such expenses unless they appear in the accounts of the practice.

It has been long-standing practice by HMRC to accept that expenses incurred by the partners (rather than by the partnership itself) are deductible in computing the taxable profit, provided they are incurred 'wholly and exclusively' for the purposes of the partnership business and are otherwise an allowable expense. HMRC internal guidance previously reflected this as follows:

'[It is not the case that] expenditure incurred by a partner can only be relieved if it is included in the partnership accounts. You may accept adjustments for such expenditure in the tax computations included in the partnership return providing the adjustments are made before the apportionment of the net profit between the partners.'

In Vaines v HMRC (2018) EWCA Civ 45 the Upper Tribunal allowed an appeal of the Commissioners of Her Majesty's Revenue and Customs (HMRC) meaning that the taxpayer could not claim relief for a payment of £215,455. Under the facts of the case it was decided that this payment was not 'wholly and exclusively' for the benefit of the trade, but the judgement also went on to say that there needed to be evidence that the firm had decided, in accordance with the rules of that firm, that it would make the payment or would re-imburse the partner.

In his decision, Henderson LJ considered HMRC's practice of allowing doctor's expenses to be deducted in the computation of the profits of the partnership, rather than requiring them to be included in the partnership accounts, as set out in help sheet 231. He said at paragraph 35:

"In my view, Mr Vaines can derive no assistance from this help sheet. In the first place, it correctly emphasises the general rule that the only legal basis for giving relief for expenditure by an individual partner is as a deduction in the calculation of the profits of the partnership business. Thus, for example, if a doctor incurs expenditure relating to his individual specialisation, but the expenditure nevertheless satisfies the "wholly and exclusively" test; it may properly be deducted in calculating the partnership profits. Secondly, however - and here there may be a small element of concessionary treatment - HMRC do not insist on the inclusion of all such expenditure in the partnership accounts. Provided that the expense in question "would be allowable if met from partnership funds", HMRC will accept entries made in the relevant sections of the partnership tax return, by way of adjustment to the partnership accounts. Once the adjustments have been made, the expenditure will then be treated as if it had been included in the partnership accounts. There is no suggestion, however, that any expenditure by an individual doctor could be allowed as a deduction even if it failed to satisfy the "wholly and exclusively" test. Nor is there any indication that a doctor could make such adjustments in his personal tax return, which is what Mr Vaines purported to do. At most, therefore, the help sheet provides a limited measure of practical assistance for medical partnerships."

So where does this leave us? HMRC has now deleted the previous guidance and replaced it with the following:

To be allowable as a deduction for tax purposes, the expense has to be an expense incurred (typically, paid) by the partnership, for the purpose of the trade or property business carried on by the partnership or LLP, and meet the normal tests for being allowable for tax purposes.

"To be allowable the expense has to be accepted by the partnership as an expense of the partnership and it also has to satisfy the tests set out in the Taxes Acts."

Therefore, the best way to ensure no issues in this respect going forward is to make sure that any expenses, however paid, are included within the partnership accounts. If a partner pays expenses personally then an expenses claim can be submitted to document and re-imburse the partner, or alternatively the expenditure could be adjusted via the relevant partner's current account to ensure that the expense is deducted within the partnership accounts. The Partnership Agreement should also be reviewed and updated where relevant.

If a partner pays for an expense personally and tries to claim this as a deduction via their own self assessment return it will no longer be allowed.

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Using Management Information -

To increase profitability by changing behaviours

Following the theme in recent editions of The LAW, looking at management information, in this edition we focus on how good quality management information can be utilised within law firms to optimise fee earner potential and challenge detracting behaviours that may exist.

By good quality management information we mean relevant KPIs that have been prepared on a timely basis. The benefits you can generate from management information will only be as good as the information you put in and the method of communicating the output to fee earners. The more detail behind the numbers, the more analysis can be performed. Greater analysis of data by department and/or fee earner is always beneficial as it will provide more transparency, although it should not follow that all of the detail is included in the output.

When we review law firms' management information we like to keep things focussed on what our clients prioritise and for that reason every dashboard we produce is bespoke and tailored to their individual requirements, business structure and sectors. We also like to keep objectives and targets SMART; Specific – Measurable – Achievable – Realistic – Timely.

Management information can be used to calculate Key Performance Indicators ("KPIs") that should be both SMART and dissected by department or fee earner, or both where possible. It is also advantageous to compare the current set of KPIs with budgets, targets and previous year's figures where this information is available. It is vital that we don't just churn out these numbers. We need to take our time to understand them and have the capacity and ability to act on them. Taking regular time out of the business to work on the business should become a routine behaviour

The main KPI's we would look to review in detail are outlined on the following page.

Lock up

Lock up is essentially the amount of money tied up in work in progress and debtors, which we principally measure by way of WIP days and debtor days.

Excessive lock up restricts the ability of owners to access capital. We review this with law firms and advise of ways of releasing lock up. For example, it may be that particular departments or fee earners raise a bill once their work is completed, without considering whether an interim bill would be appropriate. This is a simple change in behaviour that could have a real positive impact on the cash flow of the firm with cash collection being brought forward.

Efficiency

Efficiency looks at both utilisation rates and recovery rates.

Utilisation is the measure of chargeable time recorded in comparison to the total available working time. We encourage firms to set targets for fee earner utilisation to help measure performance. This also means they should endorse a behaviour of accurate daily time recording.

Recovery looks at fees billed in comparison to chargeable time recorded. Reviewing this trend could identify large write-offs and help identify and then correct any recurring issues. For example charging time to the wrong matter or doing additional work that was not expected in the original fee quote. In this situation we would challenge the mind-set that it is acceptable to carry out additional work for clients without first bringing to their attention that the work is not within the scope of the original quote and will therefore be billed separately.

It is important to look at utilisation and recovery in unison to ensure higher chargeable time still results in low write-offs. We tend to monitor both as percentages to make it easier for fee earners to have a feel for how well they are doing.

Ongoing monitoring

These KPI's should then be compared to targets or prior years, and should be by fee earner and department. If individuals or teams fall below the desired level, decisions should be made to address the disparity. KPIs will highlight potential areas for improvement and the examples above demonstrate that it is often the case that minor changes in behaviours can have a big impact on performance.

The Legal Sector team at Armstrong Watson specialise in providing the services outlined above to the legal profession and we have recently received a raft of instructions from law firms to prepare the data, interpret the data and advise on improvements. To find out more then please get in touch or view our full range of services on our website at www.armstrongwatson.co.uk/legalsector

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Trusts -

Specialist tax advisors working with specialist solicitors

The questions that many people ask are

- **What is a trust?**
- **Why would I need such a thing?**
- **Are they complicated and expensive?**
- **How do I go about getting one?**
- **Shouldn't I also be speaking to a lawyer about this?**

When a client asks us about trusts, we take the time to listen to them, understand their needs and whether or not a trust is a vehicle that is appropriate for them based on their circumstances.

This helps us to help the trustees, and their legal advisors, more effectively. Acting for over 700 trusts, our area of expertise with regard to trusts is in the tax arena, we have a team of specialists with many years of experience to help support not only our clients, but also legal firms that require assistance when dealing with trusts and estates.

We understand that trusts have unique legal and tax rules. At times this can be complex as the trust can be in existence for a large number of years and legislation can change over time and have an impact on trusts created many years ago. In particular, legislative changes can and do sometimes have retrospective impact on trusts.

What we do to assist clients alongside solicitors

First of all, in conjunction with the solicitor, we review the terms of the trust deed to ensure that it meets the legal and tax requirements that it was originally designed to do. The nature of a trust can change during the trust lifetime and we ensure that trustees are always aware of how changes can impact upon them and their fiduciary duties. The powers that a trust can grant, together with legislation may allow certain changes to be made and fully understanding the consequences is very important.

When a law firm client approaches their solicitor directly and asks about the use of a trust, we are available either in the background, or alongside the solicitor, to help with the understanding of the implications including:

- Inheritance Tax (IHT) planning on creation
- Capital Gains Tax (CGT) for the settlor on passing assets into the trust
- Asset protection
- Ongoing management and accounts that may be required to cover IHT, CGT, Income tax and general administration of the trust.

This advice stretches beyond lifetime trusts and includes both estate tax and will trusts. Our team include members of the Society of Trust & Estate Practitioners (STEP) in both England & Wales and Scotland with some of the team having spent many years working in the legal sector and Chartered Tax Advisers. We assist in the tax planning aspects of creating a trust and support the solicitor in deciding the most appropriate trust based on the needs of the client. We extend this to the compliance side covering ongoing tax return preparation together with accounts preparation and completion of Inheritance tax forms and trust registration.

What does this do to help you as a solicitor?

We provide peace of mind for you and your firm that you have tax and trust experts to support you in regard to the taxation and administration of both trusts and estates.

Our support is tailored to your needs and can as mentioned above, be in the background or direct with your clients.

We advise firms on changes in legislation and how that will impact on trusts in general and on the trusts that solicitors administer in particular.

We review law firm's existing trusts and provide a report on the tax implications of the trust with recommendations if required. This often helps to ensure that clients are receiving the correct advice, and allows the solicitor to re-engage with their client.

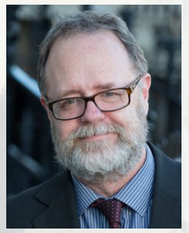
On an ongoing basis, there will be key discussions regarding the purposes of the trust and whether or not they have been met and whether the trust is still required. This is key to a good relationship between advisors and trustees; it is important that the trustees are constantly aware of changes that may impact them.

Current trust tax issues

- Since the withdrawal of the 10% notional tax credit on dividends and banks paying interest without deduction of tax, more trusts will have to submit tax returns to HMRC.

- This means that all those affected trusts will need to register with HMRC. The trust registration date has now passed for all trusts that had tax to pay in the 2017/18 tax year. If you have not yet registered you will have to do so with immediate effect. For new trusts with tax to pay in 2018/19, registration must take place by 5 October 2019.

- The Office of Tax Simplification has released their first report on IHT; a second report will be due in Spring 2019. The report touches on trusts, but has significant detail on the IHT issues surrounding estates. Contact me for more detail.



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More VAT news for law firms -

This time a little more positive?

In recent times, firms in the sector have received a relatively high amount of scrutiny from HMRC in respect of their VAT affairs, centred mostly around the most appropriate VAT treatment of disbursements (or otherwise!) based on the findings of the *Brabners* litigation.

In this climate, many firms have been taking stock and conducting reviews of their VAT position - to comply with the change in approach from HMRC in light of the above; to fulfil new obligations arising from a shifting compliance landscape (most notably the introduction of Making Tax Digital for VAT and Brexit) and also to ensure that their VAT affairs are optimised as far as possible more holistically by taking advantage of any opportunity which exists to recoup any potential losses that *Brabners* created.

The latter of these elements that has allowed us to identify a potential opportunity for law firms - and insurance companies with in-house or captive legal teams - which operate in the person injury litigation space. Having carried out reviews for a number of these clients, where the fact pattern is conducive there may exist an opportunity to adopt a different VAT accounting position in respect of services rendered to clients; or alternatively there may be scope to make changes to the status quo and adopt an alternative structure or approach to such engagements to effect VAT efficiency.

The key areas of focus is firms' current protocol around invoicing for the services they render and how they engage with and deal with third-party providers, such as car hire firms, physiotherapy or counselling providers and other similar stakeholders in the claim process. Our work to date has identified that output VAT on such services is frequently brought to account – and therefore paid to HMRC – well in advance of the most beneficial time for doing so, and that structuring changes which are administratively and practically far from onerous to adopt could be implemented in order to bring about an improved cash flow position for the provider.

We have been engaged in dialogue with HMRC on these points and have had a number of successful results which have realised real results for our clients on this point. Considering the challenges faced by the industry post *Brabners* and the upcoming legislative and political changes on the horizon, there has arguably never been a more appropriate time to reflect on an organisation's VAT affairs from an analytical perspective, and with a focus on opportunity.

If any of the issues outlined above are of interest, we would be happy to undertake an initial consultation in order to assess if scope for efficiency exists.

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The due diligence dilemma for law firms

Good business practice dictates that solicitors referring a client to a third party to provide financial services must act in their clients' best interests and ensure that; 'clients are in a position to make informed decisions about how to pursue their matter'. The SRA Code of Conduct 2011 sets out, for example, that any referral to a third party that can only offer products from one source is made only after the client has been informed of this limitation'.

In the spring 2018 edition of 'The Law' (issue 20) I asked "Are you prepared for the new SRA rules for IFA referrals?" In this article I outlined the proposed changes to the SRA Code of Conduct which included:

- All agreements relating to referrals must be in writing
- Agreements between the firm and the third party adviser should set out the terms of the agreement which governs the flow of referrals
- Your client must be informed of any financial interest
- Referring law firms must have a better understanding of the organisation to which they refer. For example, is the firm FCA regulated (it certainly should be) and what activities is it authorised to perform?
- Referrals must be based on a measured approach which aims to benefit the client
- The client needs to consent to being referred
- Referrals must be in the best interests of the client – this is a key requirement in principle 7 of the new SRA principles
- Research and reasoning of the advisory firm must be laid out in the written agreement
- Code of conduct 5.1 applies

Many solicitors who contacted me to discuss this were keen to establish how they could achieve this whilst simultaneously embracing the wider scope of the proposals, namely, to ensure that client best interests can be met and how they can demonstrate they ensured this.

Recent amendments to the SRA Code of Conduct (which will come into force on the 25 November 2019 as part of the SRA Standards and Regulations) confirm that written agreements are required where there is a fee sharing arrangement in place. In addition, solicitors and law firms will need their client's informed consent if referring to a separate business. In practice though, all referrals will need to be based on the informed consent of the individual client to make sure that client confidentiality is protected. The new Code of Conduct is principles based and firms must decide for themselves how best to achieve positive outcomes and protect clients' best interests.

How you make sure the referral is in the client's best interests will depend on the due diligence you conduct before suggesting that a referral is made. The law firm should be able to demonstrate why one referee is regarded as superior to another and that the client's interests are better served by using that provider.

The new Code of Conduct removes the obligation to have a written referral agreement, but has it changed the principle of the original draft principles? Many would argue no, but whilst the written obligation has been removed, the moral obligation has been heightened. Whenever a referral is being considered, the assessment has to be on a case by case basis.

As with many regulated professions, the SRA is placing the obligation onto the firm and the individual, the implication being, that doing the correct thing is the bare minimum expected of a professional upholding the principles of their profession.

In my experience, the law firms and solicitors I interact with already adhere to these principles as a matter of course and would almost certainly consider any other behaviour as beyond the values of their firm. Nonetheless, it is considerably easier to say you've demonstrated how you have achieved positive outcomes and protected client's best interests than to physically prove it.

With this in mind, it is my view that the financial services industry perhaps needs to meet legal connections half way, to ensure clients' best interests are always put first and foremost.

This should include an understanding of the culture and values of the financial services firm, the areas of the firm's authorisation, its fees and costs, the level of training and support afforded to staff and a clear understanding of the firm's advice process.

To help achieve this, financial services firms could provide law firms with a written due diligence document to demonstrate the suitability, culture and expertise to the potential referrer. This will help the case by case assessment of whether a referral should be made and who to. This is something Armstrong Watson Financial Planning has decided to do and we will be pleased to provide all law firms with which we engage a copy of our own document. It may be wise to contact the third-party businesses you deal with to ask for theirs.

We should not be afraid to set the bar high and agreeing in writing standards between legal and financial services firms would be an excellent way of demonstrating this.

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An interview with...

Mac Mackay, Managing Director at DAW Limited, marketing, business development and management specialists for the legal sector.

1. In your opinion, what are the key factors affecting law firm prosperity today?

Through the course of our work advising law firms we review many webpages; the primary audiences of which are clients, prospective clients, and also prospective staff.

It is an obvious fact that firms will aim to demonstrate three factors that drive their prosperity:

1. they are successful (i.e. financially robust) businesses (why would clients put their problem with one that wasn't?)
2. they put clients at the centre of everything they do; (ditto)
3. they recruit and retain the best legal minds, etc.

To be the first, to whatever degree, firms need to do the second. Fortunately, the first two things are easy to measure: P&L, balance sheet, client feedback, etc.

But what about staff that deliver those first two?

In practice, when firms look to merge or acquire, finance is paramount. Cash flow, profits, price / earnings ratios; or even replacement costs of equipment or other fixed assets may be reviewed. Client following and reputation are natural matters, too.

Investopedia states that "a replacement cost method of establishing a price certainly wouldn't make much sense in a service industry where the key assets – people and ideas – are hard to value and develop".

But think of the firm's increased value from being able to measure and demonstrate fully engaged staff. My experience suggests this is pretty poor in the legal sector right now.

2. What evidence do you have supporting the need for better staff engagement?

I have seen growing staff dissatisfaction, particularly in this decade; from mentoring undergraduates in law since 2010 (some of whom are now already leaving the profession), coaching experienced people, and delegates on hundreds of training courses I have run for solicitors over the years.

The Law Society Employment Report 2015 stated: "over three fifths (62%) of respondents are 'satisfied' or 'very satisfied' in their role''. My immediate reaction was 'what of the 38% that are not?' In their survey, "35% of 25-34 year olds say they are likely to change jobs in the next 12 months ... 26% being the overall sample. "

So, what are the recruitment costs to firms of replacing a quarter of their staff every year?

The report goes on to state that "a lack of engagement with strategic direction is a key driver of employee departure".

More recently, the Best Workplace™ Report, April 2018, quoted the UK ranked 18th out of 20 countries in levels of staff engagement and Great Place to Work® data shows that just 57% of staff in the average UK workplace is engaged.

It is no surprise that a culture that motivates staff, encourages innovation and cares about the quality of managers and leaders will ultimately be more productive.

3. What are the costs / benefits for firms from improvement in this area?

Great Place to Work® data shows that for every 1% increase in engagement scores, there is a return on investment of between £75,000 and £1,000,000.

But let's look at it another way. Suppose there are ten fee earners in a legal department that charges £100 an hour: what is the effect on the firm's bottom line from one extra hour a week from each fee-earner over, say, a 45 week year? (10 x £100 x 45 weeks =£45,000) Assuming the work is there to be done, what are the costs to the firm of billing an extra hour a week – a few phone calls, stationery, toner? OK, that's £45,000 PROFIT.

And what is an hour a week? Ten 6 minute units spread over five days – that is one unit in a four hour morning, another in a four hour afternoon.

Now, do the same number for your firm – and use a blended rate of recovery – and it is shocking what may have been lost to the firm in the last year from 'disengaged staff'!

4. How could firms take steps to measure staff engagement and improved performance?

- Poor management and leadership have a negative impact on engagement and therefore productivity. Asking people to work harder is not the answer – and time management courses will not change the culture.

- Effective engagement requires transparency and an environment where people can openly share their views or opinions on what is happening in the firm. This requires bravery. Before firms can take any actions to increase engagement, the business owners have to be brave enough to find out what is really going on in their business, the good as well as the bad.

- Keeping the lid closed on problems? They won't go away – the rest of the team are already discussing them, over lunch or by the coffee machines! Leaders' bravery comes not from hearing the feedback, but from opening themselves up to showing their vulnerability while hearing it. It takes a huge shift of mind-set for a business owner to realise that giving those problems airtime is the quickest way to resolve them.

So, how can firms address this issue?

- There is of, course, the classic staff survey – and we have run many. However, we have found several reasons why staff surveys don't work, from the frequency they occur to the way they are executed. When they are run internally, they create lots of work for those running them. Staff often don't trust them and they may not be confidential or anonymous; or certainly they are not perceived as such. Having carried out a survey it then takes a lot of time to analyse and respond, so in some cases the firm doesn't do anything with the results.

- There are nowadays digital platforms that enable firms and individuals to measure and improve engagement levels and are providing much higher participation rates – and are far cheaper to implement: easily recovered from those illusive 6 minute units recovered in half a day from engaged staff!

- At the end of the day, leaders have to be brave enough to find out where they are now, and do something about it... and I wouldn't want to merge or acquire a firm without knowing how engaged the staff were.

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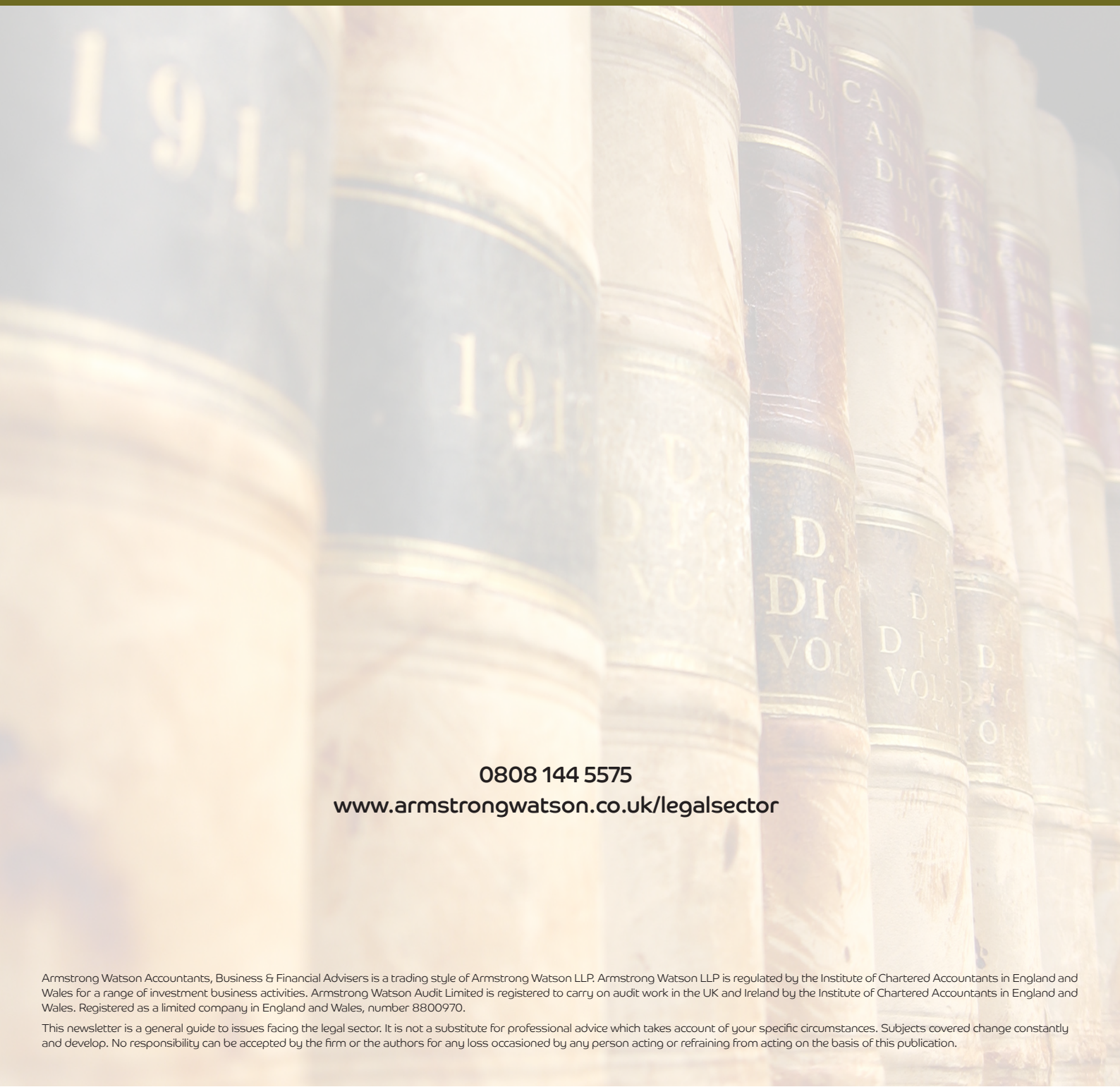

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A track record of providing solutions to the legal profession