

Winter/Spring 2011

In this issue

- 1 So what now in 2011?**
- 2 Are fixed share partners really employees?**
- 3 Partners' expenses**
- 4 Seldon v Clarkson Wright**
- 5 Give LLP's some credit**
- 6 What professional firms can do with losses**
- 7 Salary sacrifice**
- 8 Restrictive Covenants**
- 9 Professional Practice Finance**
- 10 Professional and Business Services Group Update**
- 11 Pensions back in fashion?**
- 12 Provisions**

Professional firms insight

So what now in 2011?

We enter 2011 with a list of new facts and statistics to consider. Public sector cuts, rising inflation, the threat of an increase in the base rate are all matters firms must consider when planning their strategy for 2011 onwards.

Most firms we speak to feel 2011 will be another year with many challenges and while some firms are looking to take on staff, for the first time in 2 or 3 years, we hear others are considering further cuts. There are mixed fortunes out there but those businesses who have benefitted from the high level of Public spending over the past few years are already seeing clear signs of projects being put on hold or cancelled.

This edition of Profession Firms Insight looks at the promising news for professionals that pensions are once again worthy of consideration as part of a wealth management strategy and the tax relief makes it well worth a conversation with a financial adviser. We have two pieces on partners, the ongoing saga of just what is an acceptable retirement date for partners and a comment on a recent case on fixed share partners.



For those facing losses and the need for further finance, we also have some words of encouragement. As we reported in our last publication, our Senior Partner Sir Michael Snyder is chairing the Professional and Business Services Group – a cross profession group of senior and managing partners who are inputting the concerns of the professions to Government. An update of their interesting and exciting progress is on page 7.

If you have any questions or would like help on these issues please contact Julie Walsh at jwalsh@kingstonsmith.co.uk

Most firms we speak to feel 2011 will be another year with many challenges...

Are fixed share partners really employees? – new case

Over the past few years many LLPs have decided to bring in new members to both encourage participation in the business and to show progression. Some have created new members with the National Insurance savings in mind.

In a recent case Mr M Tiffin v Lester Aldridge LLP, a fixed share partner took the firm to an Employment Tribunal claiming they were actually still an employee and the fixed share arrangement was just a sham. The defendant firm won their case as they were able to demonstrate the partner did have some management responsibilities e.g. signing of cheques and the right to attend and vote at management meetings, even though they could not directly influence policy. The judge also made some helpful comments about the partner wanting the tax and other advantages of being a partner while retaining the rights of an employee. Those firms who have made wholesale changes to their firm (and in some cases we have heard of secretaries being made partners), should be aware that the tribunal did state each case would be judged on its merits. We have heard of other firms having this issue so it is worth reading this case to ensure your firm is following adequate procedures if you have created a number of fixed share partners.

If you have any questions or would like help on these issues please contact Julie Walsh at jwalsh@kingstonsmith.co.uk

Partners' expenses

It has always been important for partners in professional firms to identify and claim the tax deductions to which they are entitled. In the current economic environment and with the recent increase in the top rate of income tax, many partners are now finding this more important than ever.

At the same time as this, HMRC has issued a "Toolkit" on the subject of "Private & Personal Expenditure". HMRC's Toolkits are intended to provide guidance on various areas of tax and to reduce the risk of errors being made in tax returns. If it is ever necessary to prove that 'reasonable care' has been taken in the preparation of a tax return, HMRC are likely to be interested in whether matters in any relevant Toolkits have been considered.

The "Private & Personal Expenditure" Toolkit is – as the name would suggest – designed to ensure that no private or personal expenditure of the proprietor is put through the business's accounts. Issues such as the business use of a vehicle, or of a partner's home, are included as specific matters that should be considered.

It is of course correct that partners should consider properly any deductions they seek to put through their business accounts. They should not, for example, simply claim each year that the same proportion of their private car expenditure relates to business use, without considering whether this is actually the case.

Partners should not, however, hold back from claiming those tax deductions to which they are entitled.

The basic rule is that any expense incurred "wholly and exclusively" for the purpose of the business can be deducted from the profits of that business. If an expense has been incurred for a dual purpose, a tax deduction should be available for the business proportion of the expenditure.

Given this, we have set out below a few issues that partners in professional firms should consider in order to ensure they claim the tax deductions they are entitled to:

It may be obvious that a partner's private car expenditure has a "dual purposes", but are there other expenses that should be considered?

- Entertaining costs are generally not deductible for tax purposes, but there is an exception to this where entertainment is provided to employees.
- Many partners spent time working from home, and it is important to ensure any costs associated with this are claimed as deductions. The correct proportion of variable costs (such as cleaning, utility bills and telephone bills) should of course be identified and claimed. Many other costs would have to be paid regardless of whether or not the partner has worked from home (such as council tax or water rates) and can be easily overlooked, but if part of the home is specifically set aside for business use, it may also be appropriate to apportion such costs and claim a proportion of these against business profits.

If you have any questions or would like help on these issues please contact Tim Stovold at tstovold@kingstonsmith.co.uk or Andrew Constable at aconstable@kingstonsmith.co.uk



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Seldon v Clarkson Wright

In the recent case of Seldon v Clarkson Wright & Jakes and Secretary for Business Innovation and Skills [2010] the Court of Appeal ruled that requiring partners of a firm to retire at the age of 65 was not age discrimination because the use of this policy was a proportionate means of achieving the legitimate aim.

The court identified two legitimate aims in this case. The court considered that the use of the retirement age was justified to allow the firm to provide its associates with the opportunity of partnership after a reasonable period and to enable workforce planning with realistic expectations as to when vacancies would arise. The court further considered that it was a legitimate aim that the partnership wanted to preserve the dignity of older workers by allowing them to retire without their performance being challenged.

The judgment for this case coincided with the Government decision to abolish the Default Retirement Age from 1 October 2011.

Currently employers are able to compulsorily retire their staff at the age of 65 without being guilty of discrimination however this situation will change this year.

In the future employers will have to reconsider the way they manage their older workforce. Companies may need to introduce more rigorous performance management procedures in order to dispense with employees in order to ensure that the dismissal is not deemed unfair under employment legislation.

To that end, the Seldon case provides a useful precedent for the use of such a compulsory retirement age. However caution should be taken in relying on the legitimate aims identified in this case. The partnership in this case was a small organisation with a particular management structure that was not common in other sectors. Therefore it might be difficult to see how the justifications could apply to firms where career progression is radically different.

In the future employers will have to reconsider the way they manage their older workforce.

If you have any questions or would like help on these issues please contact Joanna Cowie at jcowie@hrinsight.co.uk



Give LLP's some credit

There has been an alarming rise in the number of Limited Liability Partnerships (LLPs) that are being given an adverse credit rating due to a lack of understanding of the LLP SORP (statement of recommended accounting practice). Professional firms are often given ratings of medium to high risk, due to the misinterpretation of some key information in the financial statements.

Credit rating reports are not just used when trying to obtain credit; they are increasingly used when tendering for new contracts and when obtaining trade credit from a new supplier. So this is not a problem limited to those LLP's wishing to obtain finance.

Some common examples of areas where credit reference agencies penalise LLP's are detailed below:

- Where there is an automatic division of profit in an LLP, in accordance with the SORP, this is classified as "Members Remuneration Charged as an Expense". Some credit reference agencies treat this as an expense and record in their reports that there have been no profits earned in the LLP.
- Members Capital is another area where the LLP SORP is misinterpreted. It is common for professional partnerships to require members to subscribe an amount of capital when they join the partnership.

- The members' agreement usually stipulates that the member may demand repayment upon retirement. In this instance the capital is treated as "Loans and Other Debts Due from Members". Credit reference agencies sometimes treat this as external liabilities of the LLP, alongside bank loans etc, despite the fact that this is usually repaid in small instalments and often repaid out of capital provided by new partners.
- LLP's are also penalised due to the fact they are recently incorporated, with no allowances being made for the fact they may have been incorporated from very profitable partnerships that have traded for many years.

This is not the case for all agencies and some of the more established providers seem to have a better understanding of the SORP. We have however, been able to talk to the users of agencies, explaining the problems with the analysis in the report with which they have been provided. This has resulted in the adverse credit ratings issued to our clients being amended.

There is a new LLP SORP, effective for periods commencing on or after 1 January 2010. The SORP provides further clarification on the treatment of "Members' Remuneration" and "Loans and Other Debts due to Members", within the financial statements; hopefully, with further clarification the credit reference agencies will learn to correctly interpret a set of LLP accounts. Until then if you feel your credit rating is unfair, please contact us for advice.

If you have any questions or would like help on these issues please contact Becky Shields at bshields@kingstonsmith.co.uk

What professional firms can do with losses

"Losses" are not things that those running businesses like to think about. Some professional partnerships have made losses in recent years however and have been forced to consider for tax purposes how these losses can best be used.

The first thing to note is that there is no concept of a "partnership loss" for tax purposes. Instead, individual partners will be allocated "loss shares", and will be able to decide how best to use their loss in their particular situation.

The main ways in which partnership losses can be used are as follows:

- They can be set against the individual's net income for the current year.
- They can be set against the individual's net income for the prior year.
- They can be set against the individual's capital gains for the current or prior year (providing the loss has already been set against net income for that year).
- They can be carried forward and set against the individual's future profits from the partnership.

In addition to the above, joining and retiring partners can be eligible for additional reliefs if they make losses, as follows:

- If a new partner incurs a loss in any of his first four years of trade, such a loss can be carried back against the individual's net income for the previous three years (rather than just the prior year).
- Retiring partners may claim "terminal loss relief" if they make a loss in their final year as a partner; this relief allows losses of that year to be carried back against partnership income of the previously three years.

No business wants to make a loss, but if you find yourself in this situation at least you can put the loss to good use.

If you have any questions or would like help on these issues please contact Tim Stovold at tstovold@kingstonsmith.co.uk or Andrew Constable at aconstable@kingstonsmith.co.uk

Salary sacrifice

Salary sacrifice arrangements are tax efficient, yet often under-used, methods of remunerating staff and we set out below five of the best ways in which employers might be able to benefit from such arrangements.

Salary sacrifice arrangements all involve an employee agreeing to give up the right to receive part of the cash salary due under his contract of employment. In exchange for this, it is usually agreed that the employee will instead be provided with certain benefits.

Salary sacrifice arrangements are tax efficient when they involve providing the employee with exempt benefits. Under such arrangements, the tax and NICs that would have been paid on the salary are saved in their entirety.

Our top five salary sacrifice ideas are as follows:

Pension contributions

Employer's pension contributions are exempt benefits, and so if an employee gives up part of his salary in exchange for a pension contributions, all tax and NICs that would have been paid on the salary will be saved.

Childcare

Providing certain conditions are met, the provision of childcare vouchers of up to £55 per week is an exempt benefit, and many effective salary sacrifice arrangements involve the provision of these vouchers.

Training

When an employee incurs training costs personally, it can prove difficult to claim a tax deduction in respect of the expenditure incurred, even if the expenditure is clearly related to the employment. When employers pay for employee's training, however, it is much easier for the expenditure to be an exempt benefit to the employee; the training simply has to be "work-related".

If an employee would otherwise have to pay for some training themselves, it may well be advantageous for the employee to sacrifice part of their salary in exchange for the employer paying for the training.

Cycle to work

There are no tax or NIC implications when an employer lends a bicycle to an employee, as long as it offers to do so to all staff, and the bicycle is used mainly in travelling between the employee's home and workplace. Some employers may therefore wish to offer their employees the opportunity to sacrifice salary in exchange for the loan of a bicycle.

Holiday days

Holiday days are not classed as a benefit at all (not even an exempt benefit), and it may be worth offering employees the opportunity to sacrifice salary in exchange for additional days' leave, if they so wish.



...there are still clear benefits of salary sacrifice arrangements, and employers would be advised to consider whether they can make use of them.

HMRC seem to be chipping away at some of the benefits of salary sacrifice arrangements at the moment. The benefit of one previously used salary sacrifice idea (relating to workplace canteens) was removed a couple of years ago, the tax benefits of providing childcare vouchers are set to be reduced from this year, and the risk has recently surfaced that some benefits provided under a salary sacrifice scheme might be liable to VAT.

Despite this, there are still clear benefits of salary sacrifice arrangements, and employers would be advised to consider whether they can make use of them.

If you have any questions or would like help on these issues please contact Tim Stovold at tstovold@kingstonsmith.co.uk or Andrew Constable at aconstable@kingstonsmith.co.uk



Restrictive Covenants

The use of Restrictive Covenants in your employment contracts is the accepted and proven method of providing protection against employees stealing clients (and at the very least, they can act as an effective deterrent).

Restrictive covenants can be used to prevent ex-employees from:

- Setting up competing businesses.
- Working with your key competitors.
- Soliciting your clients.
- Poaching your employees.
- Using your confidential information or intellectual property.

Employers can however get carried away, drafting them far too widely in terms of location or business activity. This means they are worthless as they become completely unenforceable.

Employers should ensure that the Covenants:

- Only apply to those employees who could cause damage to the business.
- Be of a reasonable duration – generally a maximum of 6 months but a longer period might be appropriate depending on your business (i.e. with contract renewal periods of 1 year).
- Be reasonable in terms of geographical scope.
- Name any specific competitors that you may want to restrict your ex-employees from working.

Where an employee breaches their Covenants you can take action. Generally, this involves quickly obtaining an injunction that will stop them from their actions and then pursuing the employee and/or their new employer for compensation (damages).

It is worth writing a letter to departing employees reminding them of their covenants. But beware if you breach an employee's contract of employment, no part of the contract will be enforceable including the Restrictive Covenants.

If you have any questions or would like help on these issues please contact Joanna Cowie at jcowie@hrinsight.co.uk

Employers can however get carried away, drafting them far too widely in terms of location or business activity. This means they are worthless as they become completely unenforceable.

Professional Practice Finance

Despite the well known issues facing high street clearing banks, they continue to make lending available to professional practices, provided you are prepared to give them exclusivity over all your banking requirements.

Most banks require you to commit your entire practice banking before they will advance funds on either an unsecured or secured basis. Several banks continue to have specialist teams supporting professionals in practice. Their aim is to provide tailor made facilities with a more detailed knowledge of the sector. Whilst this is their intention some banks have better teams than others!

The attractions for banks operating in the professional practice arena is the perceived security of earned income and therefore the ability to service any borrowing. However, some of the professions have had challenging times and banks remain cautious. Restructuring practices to LLP status has made some banks more nervous, especially when additional finance is needed or when renewing existing facilities previously granted in stronger times.

Whether you are buying new practice premises, expanding by purchasing a block of fees or just wanting a new banking relationship, it is worth taking independent advice. Feeding into the correct banking relationship team is key.

Loyalty to one's existing bank accounts for very little and can be counter productive. Often more attractive lending terms can be negotiated outside of an existing, long established relationship. It is prudent for all professional practices to at least be aware of what is available from the full market place.

Some banks promote lending schemes offering 85% funding for practice premises and up to 90% for personal residential mortgages but it is important to choose a lender that doesn't wrap you up in small print and does provide you with the right specialist funding support going forward.

If you have any questions or would like help on these issues please contact Beverley Ham at bham@kingstonsmith.co.uk



Professional and Business Services Group update

Following on from our article introducing the PBSG back in the Summer/Autumn edition, the Group has since made a lot of ground in working with Government to influence key issues affecting the professional business services sector.

The Group has been asked by the Chancellor of the Exchequer to work with Business Innovation and Skills department and the Treasury to produce a report highlighting the main concerns of the sector and where the opportunity for growth lies which will then be fed into the Government's upcoming Growth Budget.

Some of the key areas that the report will address are:

Employment law

- Removal of the Default Retirement Age.
- Tribunal System Reform.
- Guidance on Stress at work claims .

Migration

- Limit set too low - based on employment figures from the recession.
- Intra-company transfers should be fully exempted from any cap.
- The definitions of ICTs are not too tightly drawn (PBSG firms have a series of member firms across the world, operating under an umbrella of one firm, but with completely separate legal entities and ownerships in each jurisdiction). Don't want to preclude or inhibit transfers within the overall firm across the world.

Taxation

- Reducing corporation tax further and review Capital Gains Tax arrangements for start-ups in order to stimulate growth.
- Reduce higher rate of tax on profits retained by partnerships.

The report will also cover other issues including: Regulation, Skills, EU and International barriers to growth, Public sector reform, Information services, Infrastructure and Limitation of Liability.

If you have any facts or figures on any of these issues (for example, if you have information regarding any of your clients moving abroad or no longer doing business here in the UK because of the higher rate of taxation or immigration caps) please do let us know as it would be very helpful in influencing legislation on these issues.

If you have any questions or would like help on these issues please contact Leanne Davies at ldavies@kingstonsmith.co.uk

Pensions back in fashion?

Pension rules have been under attack in recent years. The previous government was intent on restricting income tax relief on pension contributions and introduced complicated anti-forestalling provisions to prevent higher-rate taxpayers from making large pension contributions and claiming higher rate income tax relief. These plans have now been scrapped and a new regime will come into effect from 6 April 2011. Here are a number of the key points which are likely to be of interest to professionals:

- 50% tax relief on pension contributions for top rate taxpayers in 2011/12.
- New Annual Allowance contribution limit of £50,000 to apply at least until 2015/16. This increases the tax relieviable contributions for 'high earners' from £20,000 in 2010/11.
- Option to 'carry forward' previous 3 years unused contributions limits going back to 2008/09, based on an Annual Allowance of £50,000 for those years.
- Potential to make a contribution in certain circumstances of £200,000 and in exceptional circumstances of £250,000 in 2011/12 by using carry forward allowances if no contributions have been made.
- The overall lifetime allowance (LTA), i.e. the maximum size of your pension savings pot, is to be reduced from £1.8 million to £1.5 million from April 2012. There will be rules to protect the higher LTA for those who may exceed the £1.5 million limit.
- No requirement to buy an annuity (or use ASP) at age 75 from April 2011.
- Possible to use drawdown from age 55 for life (instead of only until age 75), although income limits are to be reduced from current levels.
- New 'flexible drawdown' facility allowing unrestricted access to pension funds if a minimum pension income of £20,000 per annum is secured.
- Once flexible drawdown has been used, no further contributions can be made.
- The ability to pass pension funds to beneficiaries free of tax before accessing benefits or reaching age 75, if earlier. 55% tax on lump sum benefits paid out on death after age 75, or on funds that have been accessed before age 75.
- Pension funds will not be subject to Inheritance Tax at any age, either before or after 75.



50% tax relief on pension contributions for top rate taxpayers in 2011/12.

With so many recent changes to pension legislation, you should review the new rules with a financial advisor as we have not covered everything in this email alert but the attraction of higher rate relief on more substantial sums and greater flexibility on draw down means pensions have become more interesting again.

If you have any questions or would like help on these issues please contact Andy Stowers at astowers@kingstonsmith.co.uk

Provisions

Some readers will remember how, before changes to accounting standards came into play in 1998, there was little guidance as to when provisions could be raised and reflected in a set of accounts. Some businesses used the “prudence” concept to put some very cautious provisions through their accounts, and the result of this was often a reduction in taxable profits.

Accounting standards have been tightened up and as the tax treatment of provisions is based in part on whether they have been prepared in accordance with accounting standards, the opportunity these businesses took to reduce their taxable profits has been removed.

Certain provisions can, of course, still be made, and in a time of high tax rates (which, in the case of corporation tax at least, are set to fall in the future) professional firms may wish to consider whether they should be reflecting additional provisions in their accounts.

Increases in provisions are allowable for tax purposes if the provision meets the following conditions:

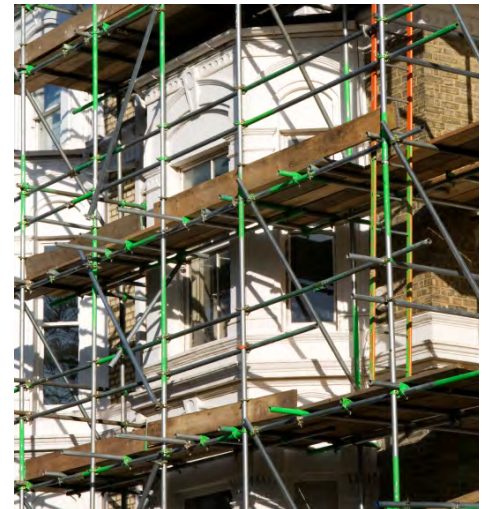
- They relate to normal allowable expenditure.

- They have been calculated with sufficient accuracy.
- The business has a present obligation, arising from a past event, as a result of which it is probable that a payment will be due.

Clearly, provisions for future operating losses will not be allowed (as there is no present obligation), nor will provisions that are based solely on an unpublished management decision (for the same reason). These are the types of provision that the accounting standards were amended to deal with.

Provisions can, however, be made for amounts which will fall due under onerous contracts as soon as the net loss is foreseen. A provision for the rent payable on a vacated property can therefore be allowed, as can a provision for the costs of work that might need to be carried out under warranties.

Dilapidation provisions are also something that some professional firms may want to consider. Where a business is responsible for delivering a leased property at the end of a lease in the state it was in at the beginning of the lease, they can make provisions each year for the costs of the repairs that become necessary during that year. As long as the costs of making the repairs would be allowable if actually carried out in the year, the increase in the provision in a particular year will be allowable.



Provisions can no longer be used in the way they were fifteen years ago, but professional firms would be wise to consider whether there are any valid provisions they could and should be putting through their accounts; doing so could give rise to tax relief now instead of later when tax rates may be lower.

If you have any questions or would like help on these issues please contact Tim Stovold at tstovold@kingstonsmith.co.uk or Andrew Constable at aconstable@kingstonsmith.co.uk

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