

Is the Time Right to Incorporate?

By David Gibbens



For many law firms, just as for businesses in any industry, deciding on the right business structure can be perplexing. There are a number of possibilities, and uncertainty about the potential options and what they would mean for the firm can hinder the decision-making process. Many partners have concerns about getting agreement from other partners or stakeholders, such as the bank, and can be put off by the time, effort and cost involved in change. Furthermore, it is sensible to question future tax treatment or the effectiveness of limited liability; and a final factor is simply the fear of the unknown.

The key to resolving the issue lies in properly understanding the alternatives. Only by having a clear grasp of these can there be a real prospect of making the best choice and, crucially, getting others to buy into it.

Alternatives and Implications

Assuming that the starting point is a traditional partnership structure, there are four main options:

1. Traditional Partnership

Staying as a partnership remains a very common choice, but in truth they are something of a throwback to earlier times. They have the twin burden of unlimited liability and an often unfavourable tax regime.

2. Limited Liability Partnership

Taxed in the same way as partnerships but with the attraction of limited liability, LLP is a less invasive change than full incorporation and can appeal to those who do not have the appetite for anything more fundamental, particularly where tax is not a major issue – for instance where firms enjoy only modest profits.

3. Limited Company

The main difference between companies and LLPs lies in the treatment of tax. Whereas LLP profits are taxed on the individual members personally, companies are taxed in their own right under Corporation Tax rates. The individual shareholders/directors are then taxed according to how they are paid, which typically would be a cocktail of a (generally modest) salary, dividends and possibly drawing against loan accounts created on the transfer of the partnership to the company, which is where any goodwill would be recognised. Structured in the right way, companies can be very effective in terms of tax management, especially where profits are healthy – although tax regimes are, of course, subject to change.

4. Hybrid Incorporations

There are a variety of structures that can be used as part of the incorporation process. One example involves the use of an LLP in conjunction with a company, where typically the partnership is converted to an LLP and the trade is conducted through a company. Here the broad intention is that profits will arise on the company. This can have some useful features – for instance, it may offer some flexibility in terms of assets that will be used in the business but not transferred to a company. Another alternative is to have a partnership or LLP in which the members are companies, with each company being owned by one of the original partners. There are definitely circumstances where hybrid arrangements can be useful, but in most cases such complexities are probably unnecessary for achieving an effective structure.

The Importance of Advice

With the changing legal landscape many firms are considering these issues in a bid to become more adaptable and tax-efficient, and to limit risk. Changing the business structure can help in all of these areas, but good advice is needed. Even with the existing tax system care is needed. Taxes in respect of the partnership, the transfer of the business and the company can all fall due for payment at around the same time. This need not be the case and sound planning is essential to avoid undue pressure on the cash resources of the business.

There are also other issues to consider, such as the recognition that limited liability can be something of an illusion; banks, landlords, and even professional indemnity insurers may well seek personal guarantees, and pre-existing liabilities transferred to a company can still attach personally to the old partners until they are repaid. There can also be many less obvious implications, such as the higher level of minimum indemnity insurance cover required for companies and LLPs, and the fact that there will be some public disclosure of the business's accounts at Companies House. Such factors may seem trivial individually, but together could tip the balance in favour of the status quo.

Incorporation is likely to be a very good option for many firms of solicitors, but it is a change that must be approached carefully and with the benefit of experienced advisers who are aware of the pitfalls, as well as the opportunities, and how these can best be managed.

David Gibbens is a chartered accountant and director of Poole Waterfield, where he specialises in advising solicitors. Previously he was a senior forensic investigator with the Law Society. David can be contacted at davidgibbens@poolewaterfield.co.uk.