



# MHA Professional Practices Newsletter

Summer 2014

Welcome to the Summer edition of our Professional Practices newsletter. This edition will focus on Cashflow with articles on:

- Revised Guidance re Salaried Members of LLPs
- Cashflow Management

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## Revised Guidance re Salaried Members of LLPs

By MHA member Tait Walker

Revised guidance published by HMRC on 21 February 2014 regarding the status of members of LLPs has crushed any hopes that sense would prevail and the proposed changes to categorisation of members of LLPs would be abandoned or at least deferred.

The revised guidance confirms the Government's desire to stick to the three condition test previously put forward that had been the subject of widespread criticism. The new inclusion in the revised guidance that the rules are to be applied using a common sense approach seems to be a tacit acceptance that the three condition test applied literally will have the tendency to produce something other than the desired outcome.

Broadly, the conditions remain as previously published, an individual will be viewed as employed unless they can fall outside of at least one of the three conditions:

- They are paid for their services on a basis that is substantially fixed without reference to the profitability of the firm (what is termed "disguised salary");
- They have not got significant influence over the affairs of the LLP;

- Their capital contribution to the LLP is less than 25% of the element of their profit share that is not fixed by reference to overall profitability (the disguised salary).

As previously announced, targeted anti avoidance rules will apply to deal with attempts to prevent re-categorisation to employee status.

### Application

In applying these rules, it is necessary to consider the payment for provision of services and significant influence test at 6 April 2014 for existing members, date of admission for new members and wherever there is a change of circumstances thereafter. It is necessary only to consider a change of circumstances if it can result in a change of status (an increase of capital by an individual who is treated already as self employed will not be relevant as will an increase of a fixed profit share for an individual viewed as an employee). A change in profit sharing arrangements may of course impact not only the individual directly affected by the profit sharing change but also each other individual in the LLP and therefore one must be mindful of the law of unintended consequences.

The capital contribution tests are applied at 6 April 2014 (with a period of three months grace to 6 July 2014), on entry for new members (with a two month grace period) and in certain cases where there is a change in contribution.

### Overview

#### *Tax and the real world*

These rules if implemented are (poorly drafted) tax deeming provisions: the status of the individual members of LLPs as a matter of general law will surely remain the normal tests for deciding employment. It should not necessarily be assumed that an individual taxed as an employee will be



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employed from a general viewpoint or indeed an individual taxed as self employed will not necessarily be employed!

## *The way forward*

The commencement of the consultation process regarding the status of LLP members on 20 May 2013 identified that the HMRC proposals regarding a definitive test for LLP members was widely viewed as, at best, ill conceived.

That HMRC pursued this route in the face of such wide criticism and the resulting technical note and guidance of 10 December 2013 calls into question the reason and purpose of consultation exercises. At that stage, it was stated that “the Government would not expect to make significant changes to the published legislation”. That it was necessary for revised guidance to be issued and that that revised guidance was itself delayed says something of the problem created. It would appear based upon the guidance of 21 February 2014 that we are left with proposals that remain deeply flawed. The underlying feeling that one gets from the revised guidance, is that the Government has decided to continue on a journey, which it would have been better not to have started.

The fact that LLP structures tend to follow the personality and objectives of the particular group of individuals involved coupled with the history of the business means that the first two tests i.e. payment for provision of services and significant control is likely to vary significantly from case to case. The cost of recategorisation of individual partners is not to be underestimated: the combination of employers’ NI and benefit in kind taxation is likely to bring costs to the business and the individual alike.

The lack of realism in the revised guidance means that many LLPs are now left in a situation where they do not know definitively if the amount payable to a fixed share member should be subject to a deduction for PAYE and NIC. Non-statutory clearances can be submitted to HMRC in respect of each LLP that could be caught by the new rules.

We are already discussing the submission of clearances for a number of clients. However the number of clearances is likely to swamp HMRC and this will leave us with a situation where at the end of April an LLP may not know if it should make a return for a fixed share member under RTI.

LLPs may also wish to seek to obtain whatever protection they can from individual members by way of indemnity regarding payroll taxes. This may be difficult to achieve insofar as employers’ NIC is concerned.

Finally, whilst getting the tax right is important, it is vital that the commercial issues are not lost in an effort to ensure that the impact of these rules are properly considered and addressed.

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## Cashflow Management

### By MHA member Moore & Smalley

Strong and sustainable cash flow is essential for any successful business. It is one of the single most important reasons why many businesses fail, regardless of how productive and profitable it is.

Results from the SRA (published in November 2013) indicated that 5% of law firms were at risk of financial difficulty.

The SRA conducted some research which was published in February 2014, entitled ‘Steering the course’ which highlighted some key characteristics of firms in financial difficulty. In this study the SRA reviewed 76 case files where financial stability had been an issue and in nearly 40 per cent of these cases, the firms’ situation had been caused by poor financial and business management, examples of which included autocratic management, partner drawings in excess of net profits, and failure to control billing.

It is therefore essential that you understand and recognise the specific threats which impact on your firms business and its cash flow.

### SRA poor behaviours

By now, we should all be aware that the SRA have published guidance on what they feel constitutes



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poor behaviours in relation to financial stability. One of these poor behaviours is partner's drawings exceeding net profits. The Law Management Section Benchmarking Survey even reported this as a headline finding in 2013 with results indicating that for 21% of the firms that took part, total drawings (including income tax payments) exceeded profits for both 2012 and 2013. This is quite an alarming result as the SRA believe that this behaviour may indicate that some firms are in denial as they carry on trading in the hope that things start to get better.

## Partners' drawings

Minimising the amount partners draw from the business will inevitably improve cash flow. Have you actually considered how much your firm can afford to pay out in drawings? Do you and your fellow partners' drawings regularly exceed the profits generated from the business? Consider:

- Changing your firms' drawings structure. Does your 'drawings plan' correspond with 'profit' targets or 'cash collected' targets? Remember, the business can be highly profitable with a negative cash flow so structuring the partner's drawings in line with the cash you collect is a bullet proof way to keep control of your firm's cash flow.
- Reducing drawings to meet the partner's specific financial needs. If your business is struggling to meet on-going financial liabilities, should you reduce your Partners drawing's? Are you risking insolvency by paying partners before your other creditors?
- Including partners' tax liabilities in your firms 'drawings plan'. If it is decided that the partners meet their own tax payments, drawings can be structured without taking these payments into account but no additional draw should be allowed to cover personal tax liabilities. If it is decided that the firm should fund these tax payments, a provision should be made against the partner's drawings and cash set aside in a

separate bank account to meet these liabilities as they fall due. If the firm adopt a 'cash collected' drawings plan then a tax provision should be deducted from this before drawings are paid to the partners.

It is important that drawings are controlled responsibly and tax payments are taken into account. Short term borrowings can be costly and will inevitably impact on cash flow in the future. Also remember that lenders require sight of the financial accounts before they agree to provide finance and high borrowings compared to low profits could lead to a failed lending application.

## Billing

As we know, lockup (being unpaid bills, unbilled disbursements and unbilled work in progress) differs depending on the type of law being practiced but every firm must still measure their own lockup regularly to ensure cash is released as quickly as possible. One way of reducing lockup is to review your billing system.

## Bill Promptly

Bill your clients as soon as the matter is completed or agree with your clients to interim bill if a matter is expected to continue for a long period of time. Having an inconsistent billing system will give the impression that you are in no rush for payment, and leaves money in your clients pockets which could be in your bank account.

## Establish a billing method

### *Time-served fees*

Where matters are billed on a time-served basis, you may wish to discuss this with your clients and agree to bill more frequently. E.g. Probate fees that have historically been billed quarterly could instead be billed on a monthly basis to enable a client bank account to office bank transfer sooner.

### *Fixed fees*

Where a fixed fee has been agreed with a client you could arrange a payment plan which breaks the fee into smaller monthly payments until the

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matter is completed. This should also prevent the client from querying the bill on completion.

## *Payments on account*

Ask for payments on account before you start any work. This could help with payments of disbursements until the matter is completed and a final bill is raised.

## *E-billing*

Consider sending bills via email. This will reduce the time it takes for the bill to reach the client and may speed up payment times.

## *Client care*

It is important that your billing policy is agreed with your clients at the outset of the matter, and included in your client care letter. This should prevent fee disputes once final bills have been delivered and also achieve the outcomes outlined within the SRA Handbook.

## **Review your payment terms**

Your bills should clearly state the payment due dates and you should send regular statements; clearly stating which bills are overdue.

Managing your clients' credit is an important part of cash flow management so you should flag up those clients who have a history of slow payment and do not act for clients who do not pay their bills. Chasing clients for outstanding bills costs your firm time and money. If you are engaging with a new client it may be worth having them credit checked before you start any work to reduce the risk of non-payment.

Only agree to extend credit terms if the client has a good track record for sticking to payment agreements. If a client has a history of slow payment, changing the credit terms (say to a monthly payment plan) or even eliminating credit entirely may be necessary.

## **2014 MHA Benchmarking Report**

Our latest benchmarking report—a national insight into the trends in the legal sector was released this month. You can request or download a copy from the MHA website

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## **Future Activities**

Further matters for consideration include Billing and VAT—these will be covered in our next newsletter which is due for release in...

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## **About MHA**

MHA is an invitation only UK wide association of progressive and respected accountancy and business advisory firms.

Each MHA firm offers a broad range of services including accountancy, tax and corporate finance as well as sector specialisms and work collaboratively under the MHA banner when clients have multiple locations or specific national needs.

MHA firms are characterised by their strong regional reputation for providing outstanding accountancy and business advice to entrepreneurial businesses. With 47 nationwide offices MHA is able to balance national access and capability with the local insight and perspective that individual member firms offer their clients.