Pros and cons of incorporation

for law and professional firms post the 2015 Summer Budget

By Fiona Hotston Moore

Over the last decade I have had many discussions with law firms and other professional firms, such as accountants, surveyors and consultancy firms, as to the most appropriate business structure for them. Is it better for them to remain as the well understood general partnership (GP), incorporate into a limited company (Ltd), or move to the still relatively new option the limited liability partnership (LLP)?

The GP is relatively flexible but leaves the partners personally exposed to potentially large commercial claims or unexpected liabilities which may fall outside their professional indemnity insurance. New partners can be reluctant to join a traditional GP and, furthermore, in a GP the partners are taxed on all profits at their income tax rates (income tax rates are significantly higher than corporate tax rates) irrespective of whether the monies are distributed or retained for future investment.

In recent years we have seen a number of law firms incorporate into a company. The main driver for adopting a limited company structure has typically been the tax savings. The tax advantages were:

1) the opportunity to tax income distributed at dividend rates rather than the higher tax and national insurance rates otherwise applied;
2) profits that are not distributed are taxed at the company tax rate, potentially as low as 20% rather than the higher income tax rates of over 40% including national insurance; and
3) the icing on the cake has been the opportunity to transfer the partnership goodwill to the company utilising entrepreneurs relief and paying tax at 10% and creating a directors loan account which is then drawn down over a number of months or years tax free.

Altogether these potential tax savings have often been very significant.

However these savings have now been substantially reduced with the abolition of entrepreneurs relief on goodwill on incorporation in 2014 and the new dividend tax which will come in next April. The savings are now significantly lower and, in some cases, may be totally eliminated. Furthermore I suspect the dividend tax may increase in future budgets so eroding further any remaining savings, except perhaps where the business is retaining profits for future investment.

Partners’ cars (always an emotive subject) further complicate matters. Partners’ cars within a limited company can be very expensive in tax terms under the benefit-in-kind provisions whereas cars in GPs or LLPs can still be relatively tax efficient.

There are no easy generalisations on the tax savings and we recommend that the calculations of tax savings are done individually for each firm.

In summary the key advantages of a limited company are limited liability and the potential tax savings.

Historically these advantages have been tempting and yet firms have not always fully understood the disadvantages of a company and may soon discover that the tax advantages could end up being only short term. The key drawbacks of Ltd are the inflexibility in terms of allocating profit shares and the big challenges in managing succession within a company share structure. To achieve variable profit, numerous share classes may be required bringing the risk of challenge by HMRC. To deal with retirements and to bring in new partners will require sales of shares, commercial valuations and potentially capital gains tax bills even where no consideration passes. A further drawback can be that the individuals may struggle to get a partnership or home loan. Finally it is tricky to reverse incorporation so if the tax advantages reduce further in future budgets firms may be stuck in very inflexible structures with no ongoing tax savings.

Turning to the LLP, this structure is taxed similarly to the GP and benefits from the same flexibility in terms of profit shares and incoming and outgoing partners. Profits are taxed at the higher income tax rates based on the full declared profits thus making it unattractive to retain profits within the firm for future investment. Furthermore recent changes mean that salaried partners may be forced to either contribute risk capital or to suffer tax and national insurance as an employee. However the LLP offers limited liability protection and is looked on favourably by banks lending to the firm. The LLP does have to file accounts on public record unlike the GP. In my experience most professional firms are choosing an LLP over the Ltd.

So what should firms who have yet to incorporate do?

1) do the sums on the potential tax savings and consider the impact of further potential tax changes such as an increase in the dividend tax;
2) consider your business objectives and long term strategy including entry and exit of partners or future sale of the business; and
3) discuss the options with both existing and future partners.

In my opinion the Ltd remains attractive for some small firms with a few partners particularly those with financial strains or seeking to retain profits for future investment. However the key is to ensure that any decision considers fully the impact of future tax changes and whether the firm can operate effectively within the constraints of a company structure.

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