The pros and cons of incorporation for solicitors

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INTRODUCTION

The default model for a solicitor practice was historically the partnership structure. However, since the introduction of the Solicitors' Incorporated Practice Rules in the early 1990s, allowing solicitor practices to incorporate, law firms are now also operating as limited companies and LLPs.

The take up by law firms adopting the LLP model in the UK has been particularly impressive.

Yet, many solicitors are still unclear on the pros and cons of incorporation and the costs of making the wrong decision for your practice.

Full incorporation can bring benefits to the firm, but there are some disadvantages that must be carefully thought-out.

This article is a summary of some of the key considerations regarding incorporation for solicitors.

We look at limitation of liability, flexibility, sale of practice, pension arrangements, accounts requirements, taxation on profits and owner's income, capital gains tax and inheritance tax and how they are impacted by a company's structure.

Limitation of liability

Sole trader/traditional partnership

Liability is unlimited

LLP and Limited company

For LLPs and Limited Companies, liability is limited to:

- The partner's capital account plus any unallocated profits; or
- The share capital in the company

An LLP also has joint and several liability for stamp duty land tax.

Personal liability can still fall on the members/directors if they are proven to have acted negligently.

Banks will often require personal guarantees for borrowing depending on the amounts involved.

"Whilst LLP and Limited company share the advantage of limited liability, they differ considerably"

There are many differences between LLPs and Limited Companies, and it is important firms consider these before defining their structure.

Sale of practice

Sole trader/traditional partnership and LLP

Buyers will generally prefer to buy the assets and goodwill because it can mitigate the transfer of potential liabilities. This can happen on the purchase of shares, where a buyer acquires all the assets and liabilities in the company.

Limited company

Conversely, sellers usually prefer to sell shares. This is generally seen as cleaner to the seller and also avoids double tax pitfalls, whereby income is taxed within the company and then again on the individual.

Pension arrangements

Sole trader/traditional partnership and LLP

Limited to a personal pension arrangement (E.g. Stakeholder pension, personal pension or self-invested personal pension).

Limited company

A wider range of pension arrangements are available (E.g. Executive pension plan, small self-administered scheme or a group personal pension plan)

Flexibility

Sole trader/traditional partnership

Minimal disruption to the business when partners retire or new partners come in. Necessities a new partnership deed which supersedes the existing one.

From a tax perspective, there are specific commencement and cessation rules which can be complex.

LLP

Similar to the partnership model - requires majority agreement by members.

Limited company

Ownership changes are achieved by changing shareholders. This can be done either with or without the company becoming involved. Two individuals can arrange the sale/purchase of shares or the company can issue or buy back shares.

In both cases the company continues to trade and operate without disruption.

Accounts requirements

Sole trader/traditional partnership

Partnership accounts are prepared in line with the partnership agreement and for tax purposes. Accounts information is not publicly available.

LLP and Limited company

Financial statements must be prepared, audited and filed at Companies House within nine months of the financial year-end. Exemptions are available to smaller companies.

The accounts are freely available in the public domain, although certain smaller companies can choose to file reduced disclosure abbreviated accounts.

Other information including the list of directors and shareholders must be filed with Companies House.

Taxation on profits and owners income

Sole trader/traditional partnership and LLP

Owners are taxed on the entire profits in the business attracting income tax, Class 2 and Class 4 National Insurance (NI). There is no additional tax on withdrawing money from the business, however all profits are taxed, regardless of whether the partners/members wish them to be retained in the business.

Limited company

Corporation tax at 20% on profits up to £300k.

A higher rate of 21% applied when profits reach £1.5m with a marginal rate of 21.25% for profits falling between these levels.

Shareholders are also taxed as an employee paying PAYE and Class 1 National Insurance (NI) on their salary. The company is also required to pay employers' NI.

Shareholders may also pay themselves dividends which attract lower rates of tax and are not subject to NI.

Capital gains tax

Sole trader/traditional partnership and LLP

Partners selling assets owned by the business are taxed at 28% after first deducting their annual exemption. The gain is taxed at 18% if below the higher rate of income tax.

Limited company

The sale of shares is taxed at 28% after first deducting their annual exemption. The gain is taxed at 18% if below the higher rate of income tax.

Gains from the sale of business assets are calculated using cost adjusted for changes in retail prices index and are taxed as part of the company's profits.

Inheritance tax

Sole trader/traditional partnership, LLP and Limited Company

Business Property Relief (BPR) may be obtained in respect of Inheritance Tax for business assets or shares in a Limited Company.

SUMMARY

Full incorporation can bring benefits to the firm, but there are some disadvantages that must be considered.

The structure of your firm and whether it works for you is something only you and your fellow partners can decide.

If incorporation is the right route for your firm, Hawsons' specialist legal team can help you achieve that status as efficiently as possible.

Contact our specialists

At Hawsons we have a wealth of experience in dealing with different legal structures of all sizes and the numerous tax pitfalls. We consider each case on its merits after reviewing the information provided. No two legal practices are the same and what works for one may not work for the other.

As members of HLB International, our expertise is not limited to UK operations and we have access to prompt and accurate advice on a worldwide basis.

Please visit www.hawsons.co.uk for details.

For more information on this or any other matter, please contact our specialist legal team.

Contact details are set out on page 7.

Not yet a Hawsons client?

We offer all new customers a free initial, no-obligation consultation.

This consultation will enable you to have a detailed discussion about your business and how Hawsons can help you achieve a successful incorporation.

Please contact your local office for more information.

Contact details on page 7.

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