

brief

SOLICITORS' UPDATE

VAT and Disbursements YOUR COST OR YOUR CLIENT'S?

If you are a VAT Inspector, your job is ostensibly to make sure that the correct amount of VAT is accounted for at the right time. In practice, many VAT officers view their role as being to issue an assessment as often as possible. I can say this with a reasonable level of certainty because I once was one. If I visited a business that acted as an agent for its clients at any time, I was pleased as I knew that I had a pretty good chance of issuing an assessment. The reason for this was that the business would be keen to treat some costs, particularly non-VAT bearing ones, as disbursements.

What type of costs can be treated as disbursements for VAT purposes is clearly something that many solicitors ponder over. This is evidenced by the occasional airing of this subject matter in the VAT Tribunals. The relevant EC legislation is found in EC Sixth Directive Article 11A (3) (c). There is no corresponding UK legislation but Public Notice 700 paragraph 25.1 sets out the conditions that must be satisfied before a payment can be treated as a disbursement, namely that:

- 1) You acted as the agent of your client when you paid the third party;
- 2) Your client actually received and used the goods or services provided by the third party (this condition prevents your own travelling and subsistence expenses, telephone bills, postage, and other costs

being treated as disbursements for VAT purposes);

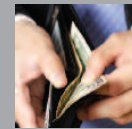
- 3) Your client was responsible for paying the third party (examples include estate duty and stamp duty payable by your client on a contract to be made by the client);
- 4) Your client authorised you to make the payment on their behalf;
- 5) Your client knew that the goods or services you paid for would be provided by a third party;
- 6) Your outlay is separately itemised when invoicing your client;
- 7) You recover only the exact amount which you paid to the third party; and
- 8) The goods or services, which you paid for, are clearly additional to your supplies made to the client.

HMRC's instructional notes to visiting officers state that common areas where mistakes are made by solicitors are in respect of telegraphic transfer fees and contributions to professional indemnity insurance. In both cases these are part of a solicitor's own costs and should be included in the taxable amount shown on the invoice.

In the recent tribunal case of David John Curtis (VTD 20330), Mr. Curtis recharged TT fees and land registry copy document charges at cost. He also treated land searches as VAT free disbursements on the client invoice because he incurred no VAT himself, charging VAT only on the profit element he had included. The TT fees and copies failed to meet 1, 2, and 3 of the criteria and the search fees failed to meet Condition 7.

If you would like to discuss anything mentioned in this article or any other VAT related issue, please contact me at gill.yates@burgisbullock.com or on 01926 451000 ■

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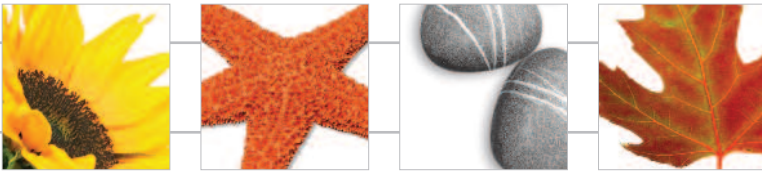
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Residual Client Balances

Many firms found that the previous rules on old balances for clients who could not be traced were very tedious. SRA approval was needed for any withdrawal. This generally meant accruing of such funds, with no action being taken, particularly with very small balances, where it was unprofitable to carry out lengthy searches.

The Solicitors Accounts (Residual Client Account Balance) amendment rules 2008 amend the SAR 98 with effect from 14 July 2008.

Under Rule 22, as revised, solicitors will be able to withdraw leftover balances of £50 or less per client and donate them to charity without prior SRA authorisation. However, in order to comply with the new rule, firms must take the following action:

- Establish the ownership of the owner of the money or make reasonable attempts to do so;
- Establish the appropriate destination of the money and return it to the rightful owner unless the reasonable costs of doing so are likely to be excessive in relation to the amount held;
- Pay the funds to a charity;
- Record the steps taken and keep all relevant documentation, including receipts from charity;
- Maintain a central register for each donation, giving details of the client, the charity and the amount donated.

Firms will have to apply to the SRA for balances over £50 per client, or can still apply to the SRA for prior authorisation in all cases if they prefer.

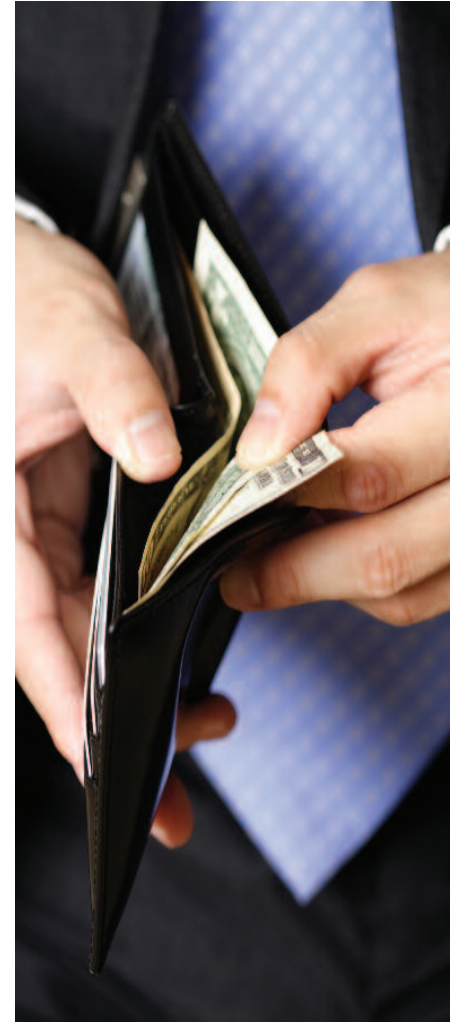
It will be very important for firms to keep the central register and records of the actions taken, as these will have to be reviewed by the reporting Accountant and can be inspected by the SRA. ■

Effective Dates

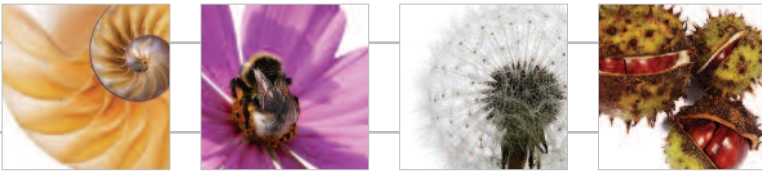
These rules came into effect on 14 July 2008 and they are not retrospective. The requirement to return client money promptly and report to clients at the end of the matter and annually on funds held will apply to balances arising on or after 14 July 2008. However, solicitors will be able to deal with residual balances arising on or after 14 July 2008 using the new Rule 22A procedure.

Summary

Firms need to take action now, if they have not already done so, to make sure that they have the correct procedures in place. The first step that should be taken is a thorough review of the client ledger to make sure that no client funds are being held which are no longer needed, and they should be returned to clients. Firms should also consider the following changes to procedures;



| New Rule | Key Change | Procedures and Systems |
|------------------------|---|--|
| 15 (3) | Return surplus client funds 'promptly' to the client. | Firms will need controls to ensure timely closure of files. For example: 1) When a final fee is raised, finance /the cashier reminds the fee earner of any client balance to be returned and sends a file closure request to the fee earner. 2) Regular review of client balances which are old or have not moved to make sure the funds should still be held. |
| 15 (4) | Inform the client in writing of amounts held at the end of the matter, giving reasons for retention. | Client balances could be included as part of a standard letter sending out the final bill, or even added to the bottom of the bill. |
| 15 (4) | Inform the client at least once every 12 months after that of client money held and the reasons for doing so. | One approach is to produce an electronic statement annually for every client on a set date. This can be monitored by the finance/cashier function. |
| Guidelines 4.6 and 4.7 | New procedures are required to ensure compliance with the new rules. | See above. |



Qualified SAR Reports

It may interest you to know that of the practices reviewed by the Forensic Investigation Team, over 50% had an adverse report being issued against them.

Most of the inspections were as a result of complaints or other information being given to the Law Society. An inspection may be triggered by the delayed or late submission of an Accountants' Report, as this is one of the accepted indicators of a practice or accounting system under pressure.

Of the thousands of qualified Accountants' Reports that are submitted only a small percentage are investigated. The Law Society accept that human error is inevitable and instead place emphasis on how quickly such errors were discovered and corrected. The amount of error, the frequency of the error (potential weakness in the system) and the steps that have been taken by the practice to avoid such errors in the future will also be considered.

The most frequent errors reported include:

- The failure to transfer funds, earmarked for settlement of properly delivered bills of costs, to office account within 14 days of rendering a bill;
- Client money paid into a bank account which does not have 'client' in the title or it is shown as an abbreviation;
- Not correctly distinguishing between paid and unpaid disbursements on bills;
- Failure to transfer funds held for payment of unpaid professional disbursements to office account when the disbursement has been paid;
- Late banking of receipts – these should be banked 'without delay' which is defined as being on the day of receipt or on the next day;
- Not including all client bank accounts in the monthly reconciliations – all client bank accounts, including designated deposit accounts should be included. A reconciliation statement should be produced that compares and reconciles the total of all the client bank accounts to the total client ledger balance. The reconciliation must be to the total of the credit balances on the client ledger and thus debit balances should be disclosed as

a difference on the reconciliation. It is best practice for a partner to sign the reconciliation as evidence of approval;

- Money held for unpaid professional disbursement in the office account;
- Debit balances on the client ledger;
- No written authority for TT's;
- Improper use of suspense accounts;
- Improper use of office/client account when handling matters for principles or employees;
- The raising of an invoice to cover any balance, or the assumption that it relates to a disbursement such as postage or photocopying, and thus transferring the balance to office;
- Bank interest credited to the general client account;

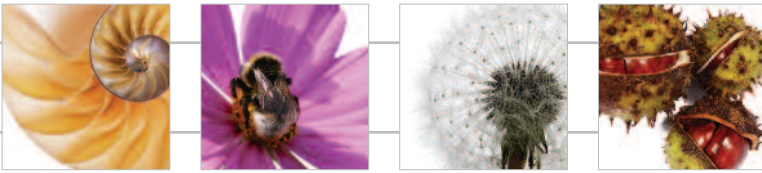
- Improper clearing of old client ledger balances without SRA authority (although the rules relating to residual balances has been amended).

Where the Forensic Team pass their report to the director legal it will be adjudicated resulting in either:

- Internal sanction;
- Practising certificate conditions being imposed;
- Referral to Solicitors, disciplinary tribunal;
- Intervention.

The ultimate sanction of intervention will be considered when there is dishonesty and serious mismanagement which could or would give rise to public interest concern. For more information please contact sarah.flint@burgisbullock.com or **01926 466248** ■





Succession Issues

Partnerships

The most popular vehicle for providing main stream legal services has traditionally been a professional partnership. This structure has inherent problems with respect to the succession and the continuation or expansion of financing. Many firms have an ageing partnership profile with large capital accounts that require an exit route. In the past they have relied on the availability of younger professionals who could be eased into equity partnership to enable the older partners to release their capital. This strategy is proving difficult to maintain in the modern environment. Firstly, issues such as falling pension performance and second marriages mean that existing partners may want to work for longer thus blocking the entry of younger partners. Secondly, and more critically, younger partners tend to have limited debt capacity due to large amounts of student debt and high housing costs, which is made worse by the current crunch on financing. Locking finance in a capital account is also very restrictive in terms of partner mobility, which is more of an issue for the younger professionals' of today.

Legal Disciplinary Practises (LDP's)

The constraints of partnership are likely to increase the pressure for external investment in the future. The Law Society has given its support to the concept of LDP's, both internally and externally owned. A LDP allows non lawyers to be partners in entities providing legal services to the public, but the range of services provided by the entity would be no wider than is permitted for traditional solicitors' firms. The externally owned LDP's however, would allow for outside investment.

External ownership and regulation

An obvious downside of external ownership is that it may lead to a relaxation of regulations or professional ethics or to conflicts of interest. Approved regulators will be required to address this issue. External owners will have to meet "fit and proper" tests. This will probably address areas such as honesty, integrity, reputation and financial soundness. Clear rules will also have to be

provided to address the prospect of potential conflict of interest between an investor and a legal professional in particular cases and also to address the amount of influence that the investor is allowed over the firm's management.

Is this the solution?

The new legislation will provide an alternative to the problem of seeking additional capital and releasing capital already in the firm. Other professionals such as investment bankers have in the past made the transition from partnership to externally funded corporate entity very successfully. It may be that legal firms may do the same. However, any existing partners seeking outside investment will need to look carefully at how their firm can attract investors. Private investors are likely to look for significant growth in the short term, an exit route, business stability, minimal dependence on individuals (who might be tempted to leave and take a large part of the business with them), and effective management with plans for expansion and succession. This may be a tall order for some firms, but may be no more than a partner promoted from within would expect. For further information please contact wende.hubbard@burgisbullock.com or **01926 466225** ■

Truth and Nothing but the "Truth"

Lifetime Financial Planning

You will often be called upon to give advice that depends upon financial information. This might be at the time of divorce, compensation calculations, business decisions or merely getting things straight and tidy. Our new service aims to provide you and/or your client with the information needed as a basis to decisions, taking into account an understanding of future lifetime needs.

The service "Truth" aims to identify the amount of money needed to live the desired lifestyle. The process will answer important questions and undoubtedly raise others. The outcome is a clearer, more ordered picture of the individual's financial future needs.

We build a model of the client's financial life, projected into the future. Included will be a personal balance sheet, income and expenditure schedules other sundry

schedules and most importantly, a lifetime cash-flow. Each of these is calculated for every year going forward using assumptions agreed with the client or you. Various scenarios or 'what-ifs' can be included to show you the effect of changes.

After the construction of the Truth model, we provide a report as a record of the results. This forms the basis of any decision making and future reviews or amendments that might occur if things change.

This process is not designed with a product sale as the inevitable result; it is totally separate and stands alone as a service. If you would like to discuss this idea in more detail, or would like to receive some case studies, please contact Malcolm Smith on malcolm.smith@burgisbullock.com or **01926 466421** ■



Give Us A Call

If you would like information on Burgis & Bullock's wide range of services, please contact your local B&B office:

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