The SPG’s Karen Purdy explores options for setting up and running an independent law firm.
This guide is designed to give you the options for setting up an independent law firm. It’s been written by Karen Purdy of the Sole Practitioners Group – an experienced sole practitioner herself.

It’s the second in our series from the SPG giving tips to firms just starting out.

You can download the first report, Going Solo, on the what, how and why of setting up as a sole practitioner, on the Business of Law Blog.
Introduction

Perhaps you are considering setting up your own law firm or are having a healthy re-evaluation of your firm’s structure? If you’re wondering what the pros and cons are of the different structures, hopefully we can guide you through to see what suits you!

People make choices based on tax, based on how comfortable they feel regarding liability and all sorts of other reasons. In October 2011, the Solicitors Regulation Authority (SRA) introduced outcomes-focused regulation. They said that this:

“ replaces a detailed and prescriptive rulebook with a targeted, risk-based approach concentrating on the standards of service to consumers. There is greater flexibility for firms in how they achieve outcomes (standards of service) for clients.”

So, this gave scope for greater freedom in how you could structure your law firm, including the new Alternative Business Structures (ABS).

This guide will ask you some questions about your firm, and explore four potential options for establishing and growing your practice. Each area is based on experiences of those who’ve been there before, plus industry experts, to help guide you in deciding what’s right for you.
1. How many people are there?

Is it just you? That’s fine – there are still lots of options. You can be a recognised sole practitioner (i.e. you’re a sole trader), but you can also set up as a Limited Company where you are the sole director or you could be an LLP. An LLP needs two members, but you can be one and a company where you are the sole director can be the other member.

Personally, I really enjoy being a sole practitioner – it gives me the freedom to make decisions without a huge layer of management bureaucracy. Some SPs work entirely on their own, but you can have employees (solicitors and support staff), so it doesn’t have to be lonely! The Sole Practitioners Group has events, a LinkedIn forum and website to help provide support and there are some active local groups too.

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2. Are some of the people involved non-solicitors?

- If they aren’t solicitors, but are other types of lawyers (barristers, notaries, licensed conveyancers, legal executives, patent and trade mark agents, law costs draftsmen) then the non-solicitors could form a variety of structures as an legal disciplinary practice (LDP). The SRA says:

  “An LDP is the phrase that David Clementi used to describe the first new type of practice permitted by the Legal Services Act. For consistency, we have continued to use the description. LDPs can be owned and managed by a combination of different types of lawyer, and up to 25 per cent non-lawyers. There can be no external ownership of an LDP.”

(Although called a legal disciplinary practice, it could be a partnership or a company or an LLP. See the Law Society’s practice note online.)

- If they aren’t lawyers at all, then you’ll need an Alternative Business Structure (ABS).
3. How much will it cost?

How much you spend on marketing and any business premises etc is very much dependent on what you want to do and how many people are involved etc. However, one thing you must have is **Professional Indemnity Insurance**.

Richard Brown at insurance broker Willis (formerly Prime Professions) gives us his reflections:

“The factual difference between becoming incorporated in any way be it Ltd/LLP/ABS and being classed as a sole practitioner or partnership is the requirement for levels of cover under the SRA minimum terms and conditions. SPs and partnerships are only required to carry £2m each and vary claim in cover whereas all other entities are required to have £3m each and every claim as a minimum. The increase in premium to go from £2m to £3m should be in the region of 35 to 40% of the £2m price.

This has the potential to change however as the SRA have recommended reducing the compulsory level of cover for all firms to £500,000. A decision by the Legal Services Board is awaited. If this does happen then it will be for each practitioner to assess and purchase the appropriate level for their firm. Some careful consideration (and advice) will be required!

The real issue perhaps is the attitude of insurers to one structure rather than another. The answer is that whilst they still have concerns around their exposure to non-payment of premiums and forced run-off cover, they are becoming more used to covering incorporated status firms and as such are becoming more relaxed.

The concerns they do have are tied up under the wording of the policy that they have to abide by and the constraints put on them under the SRA minimum terms. These mean that underwriters cannot cancel the policy if a business fails and indeed they have to provide six years of run-off cover if the business closes even if the premium is not paid. In addition, if claims are made then the insurer must also pay the excess payable under the policy even if the client does not, or cannot, reimburse them. Of course it is highly unlikely that any of these monies will be paid in such circumstances.

If the above were the case then underwriters would naturally look to how they could recover such premiums and excess. Where there is an SP or partnership then there is personal and joint and several liability, which therefore enhances greatly the chances of recovery. With corporate structures it is virtually certain that no recovery can be made. So from this point of view it will not be a surprise to hear that insurers prefer the traditional structure of sole trader or partnership.”
4. What paperwork will I need?

In terms of SRA forms, there used to be different ones for setting up as an SP, but now there is one generic one for the firm, for the individuals and an additional one for corporate managers/owners available online.

To get your Professional Indemnity Insurance you will need a detailed business plan and, following on from Richard’s comments

“underwriters are asking more and more to see the reports and accounts of firms and you should expect to be asked to provide these at incorporation.”

For each structure you will need bank accounts and if you aren’t going to hold client monies or hold very little you should apply for a waiver from the annual Accountants Report for Solicitors Accounts Rules purposes.

5. What about my liability and taxation?

When I converted from a sole trader to a limited company, it was a great thing to do for taxation, but along the way I got some pretty rubbish advice. Please learn from my mistake – find a firm that specialises in advising solicitors and is authorised to prepare the annual accountants report for solicitors accounts rules purposes.

James Knights, of Knights Lowe Chartered Accountants is an expert and he has set out some of the pros and cons and tax planning tips here for you over the next page.

One significant tax planning point that links all of the following is that a business generates goodwill as it trades. If this trade is carried out in a sole trader or partnership and then incorporates, the goodwill generated is recognised on incorporation and a payment can be made from the company to the sole trader for this goodwill. This payment is taxed via capital gains tax, usually at 10%. This tax rate is extremely low, and provides a very good tax planning opportunity. The obstacle to this is the additional administration burden of changing the SRA registration etc.
### Sole Trader/Partnership

**Pros**
- No formation costs, and no formal requirement to produce accounts and file them with any public body.
- Complete confidentiality of financial/accounting information.
- Any losses generated by the sole trader/partner can be set against other income in that tax year.
- Income is taxed on the individual’s tax return, and at their own tax rate, dependant on other income etc.
- Partnerships offer flexibility regarding profit shares, and internal organisation issues.

**Cons**
- Profits are taxed at 40%+ if income is in excess of £32,010. The total profits are taxable, whether or not you have drawn it in the year.
- The individual are liable to the debts and other liabilities that may arise on the business.

### Limited Company

**Pros**
- A company is a separate legal entity, and as such provides protection to the owners from the liabilities of the company.
- Shares in a company are generally transferable, therefore ownership of the business can change.
- Profits up to £300,000, are charged at 20%. Therefore undrawn profit can be sheltered in a company with a smaller tax charge of 20%, and this gives the possibility of extracting it at a tax efficient time for the individual, either via income or as a capital gain in the future.
- Corporation tax is payable 9 months after the year end, an individual is likely to be making payments on account towards their tax liability during the year.

**Cons**
- Companies are required to formally incorporate, and produce accounts and records in line with Companies Act requirements. This therefore can be more time consuming and costly.
- First year losses can only be carried forward to offset against future profits.
- If all profits are drawn out of the company, at higher levels double taxation can occur as the company pays tax at 20% and the individual may then be taxed on their remuneration from the company at 40%. Giving an effective tax rate of above 40%.
- Being a separate entity, at incorporation the company has no assets, therefore if borrowing is required personal guarantees may be required.

### Limited Liability Partnerships

**Pros**
- Separate legal entity from its members.
- Tax transparent, and therefore offers the flexibility and some of the pros of a sole trader/partnership.

**Cons**
- Limited liability means that formal Companies Act compliant accounts must be filed annually, along with the details of all members.

### Limited Liability Partnerships

These are Law Society-defined entities, which will fall into the form of one of the above options for tax purposes.

Richard Brown’s reflections on ABS:

> "I think it is fair to say that when the idea of Alternative Business Structures was first proposed, underwriters had severe misgivings believing that this was possibly an opportunity for certain elements to be able to exert undue influence, control and pressure on a legal practice. In reality I think that they have come to the conclusion that it is in fact a positive development that has enabled experienced business managers to run legal firms from a position of equality and authority, thereby allowing solicitors to concentrate on practising the law."
Conclusion

Hopefully that has guided you through the options and perhaps led you to some conclusions on what might be best for you...

The SRA say

“...We welcome innovative structures. Some innovation may, however, carry significant commercial risks. Whilst we cannot stop firms failing, our concern is whether applicants have tested their business model thoroughly and have thought through the implications for clients and the public interest should their firm experience financial difficulties.”

It sounds intimidating, but ensuring that you have thought through how you ensure supervision of the work and who will take on each role within the firm is a practical way to make sure that you’re also adopting the most appropriate structure.

Taking advice from a specialist advisor is also high up the list of things to do – it gives you confidence to know that you can go off and focus on your job, helping clients.

And talking to fellow lawyers who have set up in different ways is really helpful. It is a frequent topic at SPG Conferences and on our LinkedIn forum. The Business of Law Blog also has a comment section where you can share your thoughts.

Best of luck, we look forward to hearing your success stories!
About James Knights

James is a director of the family owned accountancy practice, Knights Lowe. Based in East Anglia with over 50 staff, the firm strives to provide a personal service, attention to detail and sound advice for large and small businesses. This involvement and experience in helping run a practice has given him an insight into how to help his clients, many of which are in similar position.

James deals with SRA reporting, audit and compliance as a responsible individual within the firm, combines both the necessary compliance work whilst still being able to provide a value added service to their clients.

Knights Lowe’s ethos is to be general accountancy practitioners, with all the necessary skills to help their clients with the complete range of services from the personal tax return to the statutory audit or SRA report, and everything in between.

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About Richard Brown

Richard is an Executive Director of Prime Risk Solutions a trading division of Willis Limited, he has specific responsibility for sole practitioners and manages the firm’s relationship with The Sole Practitioners Group (SPG). In addition Richard is heavily involved in Compliance and Regulation consultancy.

Richard has been a regular speaker at Law Society seminars and both the national conference of the SPG and regional group meetings. The advice that he has given covers risk management, where claims come from and how to approach renewal to achieve the best outcome.

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