



## Mergers and Acquisitions; does 2+2=5?

Perhaps not the best question for an accountant to pose in a lead article but one which we believe will be very relevant to law firms in 2011.

Both our own experience and those of national surveys indicate increased activity in the Mergers and Acquisitions (M&A) market with the legal press expecting a record number of transactions in the sector during 2011.

The turmoil of the last few years has damaged many firms not just financially but also strategically. Fire fighting the declines in profitability, fee income and the loss of interest income has all taken large amounts of management time and partner energy.

These factors combined with the impending changes in the sector on 6 October 2011 and spiralling PII costs means that many law firms see M&A as their only option.

Whilst some firms will have deeply considered the strategic rationale of their transaction, for many the act is a last resort in a market sapped of energy and cash.

This article is not intended to suggest all M&A transactions are bad, rather we intend to merely highlight that firms should be looking at what the transaction does for their business strategically other than simply bolting on higher income levels i.e. will "2+2=5".

To illustrate the point let's consider some potentially good and bad reasons for looking at a merger:

"We have been losing turnover and we cannot find another way to increase our income levels"

The quality and sustainability of income in the target firm is important here. Arguably if they are similar then this is just delaying an inevitable decline in income for the combined firm. Potentially resources are better spent looking at ways to develop new markets for income rather than dealing with a merger. Maybe acquiring key fee earners or investing in developing links into new markets?

"We are very similar firms both in terms of culture, work ethic and the type of work we undertake. We believe there will be good synergies from the merger"

If both firms are in their own rights successful then this could be a good merger. Equally if both are suffering strategic or financial problems then this is likely to be endemic in both the culture and work of the firm. Taking two similar firms with the same problems, in the first instance at least, creates a bigger problem. Again would time invested in merger discussions be better spent on dealing with issues affecting the individual firms?

Clearly in the above illustrations it is conceivable that variations arise where M&A is worthwhile but the point to emphasise is that firms are seeing this as a quick answer to far more difficult problems. It may well help alleviate the issue but often the result is simply a bigger firm with the same (bigger) problems in potentially a less flexible business model with time being spent worrying about M&A issues rather than their underlying business.

There are of course good reasons for M&A and some of the most successful mergers we have seen have involved sound underlying strategic rationale including:

"The target firm has strong complementary work types which will make our services more marketable and our business more stable."

"The target firm enables us to enter an area of work which is profitable and has good future prospects which we would find hard to enter in our own right."

The concern is that after several years of difficult trading, PII market issues and the advent of the Legal Services Act many firms see M&A as their only answer to survival. For some this may be true but for many our concern is that they are just creating a bigger problem to solve and just because there are more people around the table to share the pain with this will not mean it will be any easier.

A question to be asked at an early stage is whether strategically the transaction adds sufficient benefit to the firm to warrant this level of resource and whether 2+2 will really equal 5.

For more information, please contact

Andrew Allen  
aallen@winterrule.co.uk

# Post mortem of 2010

As many firms lick their wounds from 2010 it seems a sensible time to give some feedback on our view of the legal sector from a financial perspective during 2010.

In this short article we will focus on our experience in law firms in the areas of income, fee earner structure, profitability and working capital.

## a) Income

Income levels were a critical factor during 2010 and a feature set to continue into 2011. The tables below give our assessment of legal sector income levels over the last 3 years both in terms of fee income growth on prior year figures and interest income after notional interest paid to clients as a percentage of earned fees.

### Fee income levels

2009/10	(5.3)%
2008/9	(3.8)%
2007/8	(2.7)%

### Interest income levels

	Growth	Base(*)	% feesv
2009/10	(83.2)%	0.5%	0.8%
2008/9	(41.7)%	3.24%	4.4%
2007/8	72.4%	5.24%	6.9%

\*Average bank base rate in financial year to April

The patterns in the above tables show a steady decline in the average level of fees for firms with an average combined 12% decline over the 3 year period.

The changes in interest income are also very significant over this same period. In 2007/8 interest income amounted to around 7% of fees. By 2009/10 this had dropped to below 1%.

These factors have created both significant cash and profit issues in firms.

## b) Staff structure

In many law firms we have tended to see that the decline in fee income has often been reasonably well controlled through staff cost reduction and overhead efficiencies. It has however been much

more difficult for firms to cover the decline in interest income and in many cases there is a direct correlation between the declines in profits per partner and the lost interest income.

In terms of fee earner structures in firms, we have seen significant structural changes continuing during 2010. Continued rounds of redundancies have generally first focused on support staff often by making better use of previous investment in I.T systems which were not being fully utilised.

After this employee fee earners have taken the brunt of the reductions but in a fairly controlled way with firms clearly eager to keep intact their specialist skills which many paid heavily to recruit during 2004 to 2007.

As always, and perhaps most disappointingly, firms continue to hold back from "partner rationalisation". Given that this is the factor that restricts the profits per partner in most firms it has been disappointing to see that most firms have still not grasped the opportunity of the recession to deal with this thorny issue.

## c) Profitability

We have continued to see a very wide range of profits per partner in law firms during 2010; from losses of circa £75,000 per partner to profits of over £750,000.

Narrowing this down, in broad terms we have tended to see 3 clusters of profitability per partner which account for around 80% of the results we have seen:

- 20% achieving between £50,000 and £80,000;
- 40% achieving between £80,000 and £130,000;
- 20% achieving between £160,000 and £200,000.

This represents a slight shift on the 2009 results and a slight improvement in most cases arising from the disruption of more significant redundancy rounds in 2009 that were less prevalent in 2010.

## d) Working capital management

We have in general seen firms working hard to reduce their lock up in 2010; mainly out of necessity to fund tax liabilities from more buoyant years but also to guard against the increasing risk of bad debts.

In broad terms "good" firms are aiming for lock up of between 100 and 120 days in their aspirational moments. The most common actual result is between 130 and 150 days for a typical income profile law firm.

A key issue for some firms has been controlling the quality of unbilled time. Fee earners working with the fear of redundancy have a habit of recording irrecoverable time and it takes firms up to 9 months to discover this; by this point the salary has been paid. Close control over the quality of unbilled time will continue to be an important factor for law firms during 2011.

## So what for 2011?

With so much to contend with in law firms it is hard to succinctly deal with this question. In our view the key issue for firms is to refrain from being inward looking. Securing a position in the future legal market is key – where will your income come from? Who will your clients be? How will they get to you as their legal services provider? These are the bigger questions firms need to answer.

The reality on the ground at present is that firms are fighting to find cash and profits to keep the day to day business ticking over.

Those that have an eye and the resources to plan for their future are likely to be the survivors after 6 October 2011.

**For more information, please contact**

**Andrew Allen**  
aallen@winterrule.co.uk



## goodwill

"retiring partners need to be aware of ways to obtain tax relief on the amounts originally paid for goodwill"

# Don't forget your capital losses!

A common source of annoyance for many longer serving partners in law firms is the fact that when they joined the partnership many years ago they actually had to purchase goodwill from their former partners.

Whilst it is now rare in law firms to see goodwill on the balance sheet, there are still many partners that originally paid for goodwill but have never received tax relief on that acquisition.

Normally relief would be obtained when new partners join the partnership and purchase goodwill or when the partner themselves left the partnership and received a payment from the continuing partners. However these arrangements are also now rare and therefore retiring partners need to be aware of ways to obtain tax relief on the amounts originally paid for goodwill.

Once partners retire from a partnership they relinquish any interest in goodwill of the firm and whilst they may not receive any payment from the partners at that point for goodwill they may in Capital Gains Tax terms crystallise a capital loss.

### Example

Mr Smyth became a partner in Super Solicitors Partnership in 1982. To join the partnership he purchased goodwill over a number of years from various partners who were retiring or giving up profit share entitlement to Mr Smyth.

During his working life Mr Smyth paid a total of £100,000 for the goodwill in the firm.

Unfortunately Mr Smyth never managed to sell any of his goodwill to any future incoming partners and on retirement in 2011 received no payment for his goodwill from the continuing partners.

On retirement Mr Smyth has crystallised a loss of £100,000 in Capital Gains Tax terms on the grounds he effectively gave up his right of goodwill in the firm and received no payment.

In January 2012 Mr Smyth in his retirement decides to sell an investment property and some shares to provide him with income to purchase a holiday home in the Algarve. Capital Gains arose on these disposals of £250,000.

In calculating his Capital Gains Tax liability in the tax year to 5 April 2012 Mr Smyth can claim relief for the losses from the disposal of his goodwill:

By virtue of gains alone Mr Smyth is a higher rate tax payer in the tax year to 5 April 2012 so the claim of loss on the goodwill will reduce his Capital Gains Tax liability by £28,000 (28% of £100,000).

Gains from Property and Shares	£250,000
Losses from prior Goodwill disposal	(£100,000)
Less Annual Exemption for Capital Gains tax	(£10,100)
Taxable gain	£139,900

It is important that retiring partners are aware of the issues here and it is important that their tax advisers flag up this particular point and ensure the unclaimed losses are documented on the tax return at the point of retirement.

There are a number of potential complications (with both good and bad outcomes) that need to be considered, especially where goodwill has previously been on the balance sheet at some point.

For more information, please contact

Steve York  
syork@winterrule.co.uk

# Tax efficient partner departures

For many partners the “excitement” of the last few years and the prospects of the post LSA landscape mean that their thoughts have turned to retirement.

Managing the tax implications of retirement from a partnership is an important part of planning and failure to consider specific factors could result in higher final income tax liabilities which could be avoided.

## Implication of retirement dates and overlap profits

In the tax year of retirement the taxable profits of a partner are reduced by any overlap profits that a partner has. These overlap profits were created when the partner first joined the partnership or on the change to self-assessment in 1997/98 and their magnitude will be affected by factors such as the profitability of the partnership at that time, whether a lock-step applied and the year end of the partnership.

If however retirement is not planned efficiently this release of overlap profits can result in the overlap profits being wasted or at least relieved at a lower rate of income tax.

### Example – Cutting down

Mrs Abbott is a partner in a law firm which has a financial year end of 30 April. Over the last two years Mrs Abbott has been in a de-lockstep arrangement in the run up to retirement so the level of her profit share has been reducing even though the profits of the partnership have continued to grow.

Mrs Abbott has overlap profits of £125,000.

Mrs Abbott's profit shares and taxable profits have been as follows:

Accounting year	Taxable profit share	Tax year assessed
30/4/10	£175,000	5/4/11
30/4/11	£100,000	5/4/12

Mrs Abbott plans to retire on 30/4/11. As a result her taxable profit above would be

adjusted by overlap profits which will mean she has no taxable income in the tax year to 30/4/11 and the taxable income in the tax year to 5/4/11 (accounts year 30/4/10) will be reduced to £150,000 by carrying back the unused overlap profits of £25,000.

Whilst this sounds helpful overall we can see that some of the overlap profits being used in the tax year to 5/4/12 are only getting income tax relief at 20% or lower.

If instead Mrs Abbott had retired on 5 April 2011 her taxable income in the tax year to 5/4/11 would have been as follows:

30/4/10 Tax adjusted profit	£175,000
5/4/11 Tax adjusted profit	£100,000
Less overlap profits	£(125,000)
Taxable Profit	£150,000

In this situation all the overlap profits have been relieved at the highest rate of income tax of 50%. Overall by officially retiring on 5 April 2011 compared with 30 April 2011 Mrs Abbott will have saved income tax of £20,070.

### Post retirement income

Considering the level of income that partners will receive in the rest of the tax year after the retirement date is also an important aspect and can affect the overall level of tax incurred.

In the case of a true retirement from work it is usually the case that there is not significant amounts of additional income but in the case where a partner is joining another partnership or undertaking another employment the income from that activity needs to be considered.

### Example – High pension income

Mr Tired is a partner in a law firm but is working on a part time basis in his final two years prior to retirement.

Accounting year	Taxable profit share	Income Tax & NIC	Tax year assessed
30/4/10	£45,000	£10,994	5/4/11
30/4/11	£40,000	£9,454	5/4/12

Mr Tired has no overlap profits. During his working lifetime Mr Tired has made large pension contributions in years when his business produced much higher profits. In his retirement Mr Tired now expects to receive an annual pension income of £40,000.

Based on the above results in the tax year to 5/4/12 Mr Tired will be taxed on £40,000 of final profits from the partnership and £40,000 of pension income. This will result in a total tax liability for Mr Tired in the tax year to 5/4/12 of £24,959. His total tax liability for the tax years to 5/4/11 and 5/4/12 would therefore be £35,953 (£10,994 and £24,959).

If instead Mr Tired left the partnership on 5/4/11 his position would be different. In the tax year to 5/4/11 he would be taxed on £85,000 of partnership income and in the tax year to 5/4/12 he would be taxed on pension income of £40,000. His total tax liability would be £33,899.

By bringing forward the date of formal retirement from the partnership to 5/4/11 tax costs of around £2,000 can be saved.

The overall message here is that partners considering their departures from law firms should be paying close attention to their income tax position which can be significantly affected by the date of retirement, the existence of overlap profits and post retirement income anticipated in the tax year of retirement.

For more information, please contact

John Endacott  
jendacott@winterrule.co.uk