

Practice simplified

Lawyers Weekly article

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Kellie Harpley

Legal practices are likely to look more seriously at incorporation once the national professional is fully established. Kellie Harpley looks at the pros and cons

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The promise of streamlined management processes, tax breaks and greater flexibility has prompted many law firms to consider the move from a partnership to an incorporated practice. Some have tried it and not looked back; others have made the move only to switch back to the traditional partnership model.

Whether they decide to make the change or not, it is expected many more law firms will consider their options once the national legal profession is fully developed. For many who have gone down the incorporation path, the move has proven to be vastly beneficial. But they are adamant it is something that must be considered seriously by individual firms.

Andrew Perry decided on the incorporation model when he was establishing legal.consult. Perry had already practised within that structure at Gadens Lawyers, but says he would have most likely chosen the incorporation model anyway.

His company provides legal services, along with IT and telecommunications consultancy services. "Being a multidisciplinary practice, [incorporation] provides an appropriate structure within which to be able to show our proficiency in not just law but in other areas," Perry says.

"You can still technically provide multidisciplinary services within a partnership type model. But people are used to dealing with companies when it comes to consultancy services, rather than partnership models which, outside the legal fraternity, are still seen as being a small scale thing which doesn't have continuity."

Moreover, the incorporated practice offers room for non-legal directors to be appointed, something that is regarded as too complicated in a partnership. Another impetus for multidisciplinary practices is that the corporate structure allows for the limitation of liability on the non-legal services that are provided.

Perry adds that establishing an incorporated practice was no more difficult than setting up a partnership. He believes that on an ongoing basis, it is less complicated "just because it is more flexible when people come and go and you've also got the ability to have different types of shareholders and shareholdings".

"In terms of administration, I don't see it as being any more onerous than any other structures," Perry says. "We have to fill in a questionnaire from the Legal Services Commission, but that is just part of a good compliance program."

This is a reference to the Legal Services Commissioner's power to audit incorporated legal practices to assess the procedures in place and to ensure that legal services are being delivered appropriately. Generally, the Commission sends out a questionnaire asking for a self-assessment of the corporation's compliance.

If the questionnaire is not completed, or if the assessment flags any unusual issues, the Commission could conduct an audit. "That can bring an increased level of accountability," Perry says. "But then, most lawyers are focused on delivering good results, and particularly the larger firms would have most of those systems already in place. It's really just a case of ensuring that you are doing what you should be doing."

Michael Bradley, managing partner of Gadens' Sydney office, says the conversion from partnership to incorporation - which the office made four years ago - was "a bit of a hassle initially" but has presented no problems since. Only the Sydney office of the firm is incorporated and it operates as a joint venture with the national firm.

Bradley expects most firms to take a serious look at incorporation, and believes a lot will eventually convert. "The corporate structure is a lot easier to manage than the partnership structure from a tax planning point of view, both for the firm and the individuals," he says.

"It's far preferable because there is a closer link between the receipt of tax and incurring a tax liability. In a partnership, the equity holders can end up with a heavy, often unfunded tax burden.

Benefits for the business itself include the ability to retain income in the business as working capital, rather than having to distribute it all as dividends. Of course, there is also the potential to raise capital through a float or by inviting private external investors to become shareholders in the company. Perry considers this to be a benefit, but Bradley says it is an option that would have to be exercised with extreme caution.

“There are big issues involved with having external control over a professional firm,” he says. “And any firm that wanted to introduce outside capital would have to think very long and hard about the consequences because it is a big, big difference – a real sea change from a management and a control point of view.”

Niren Raj, managing partner of Raj Lawyers, which is currently in the process of incorporating, says this is one area that must be fully understood by firms considering the move. “The mindset has to be right,” he says. “You have to understand that when you incorporate, while you still have your professional obligations to your clients, the control that you currently have with a partnership, it’s diminished in an incorporated entity.”

“When you understand that, it’s about creating the best practice that you can within an incorporated entity, for both your external shareholders and your internal shareholders.”

Bernard Gild, a director of Horwath, and head of its professional practices consulting group, says many practices are finding it is more efficient to run their businesses as a corporation rather than a partnership. “If you’ve ever been part of a partnership, you’ll realise that having 20 people around the table, each one trying to contribute, can slow down the decision making process,” he says.

“The idea is to identify the appropriate business persons who can be appointed to a board of directors, and in fact some practices appoint someone who is not a partner to act as an outside director, to add extra insight.”

Another important benefit of incorporation is that it allows shareholders to reap benefits through the franking credits system, Gild says. While the company will pay 30 per cent tax, if it is structured properly, dividends can be paid into partners’ family trusts and distributed to family members or companies within the family group. If the individual’s tax rate is less than the company’s average rate of 30 per cent, the family member can claim franking credits as a refund from the government. In any case, the partner will not have to pay more than 30 per cent.

According to Gild, corporatisation also represents a better position so far as limited liabilities are concerned. “So from an asset protection point of view, you want to structure yourself so if there are any problems they are going to be restricted to that company and the responsible partner,” he says.

Tax breaks and ease of management aside, Gild says the major stumbling block for many firms is the fact that if they come under the category of a “large corporation”, they have to file their audited financial statements with ASIC as a public document.

“It usually takes just a little while for people to get used to the idea, and once they realise the benefits, they get past it,” he says. “There is the additional cost of the audit, if it is not being done already.”

However, a firm would have to be of a very substantial size to be categorised as a large corporation. To be classified it must meet two of three criteria: having more than \$10 million in turnover; having more than \$5 million in assets; or employing more than 50 people. In such a case, the firm would probably be taking the appropriate audit measures already, Gild says.

There will always be costs associated with incorporation, he says, but lawyers do have a couple of advantages. For a start, they will save on legal costs, and legal firms are eligible for an exemption on stamp duty on goodwill when rolling over from a partnership into a corporation. “That’s a benefit that doesn’t apply to other professions in NSW, so that’s also an incentive.”

However, the best suggestion Gild says he can make to firms considering the move is to get very good advice and to talk to someone who’s done it before, because there are some serious pitfalls to look out for.

“The way that you deal with debtors and the way that you deal with work in progress can have adverse tax implications, so you have to manage the process,” he says. It is also important that all partners in the firm support the move and that all key players are kept in the loop as plans progress.

“It is no use for the management committee to go off and do this. You really need to get somebody to explain to everybody involved what the implications are. You don’t want any surprises.”

The process is not, however, overly dramatic - it just needs careful planning and management, he says.

While many people are thinking about the concept of incorporation, Perry believes that until the national profession is

bedded down, there will still be a level of reticence towards making the move. "There's an expectation that if you can incorporate nationally, it will provide more stability, rather than having partnerships that change every year," he says.

"It will simplify the structure of the organisation and provide a bit more continuity in terms of the identity of the organisation."

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