Flotation buoys partner profits

Moves to allow law firms to float on the stock market are progressing. Tony Williams and Colin Ives say such a flotation offers partners numerous tax advantages, but warn there are also many pitfalls

Floating a law firm on the stock market presents partners with an opportunity to realise some of the value inherent in their firm and to benefit from any increase in its value. It also raises major issues between generations of partners, potential partners and lateral hires.

The tax implications of incorporation produce clear advantages and very significant risks. The key tax advantage applies to partners nearing retirement. If they sell their shares, the sale should be capable of attracting business asset taper relief so the maximum capital gains tax payable by them on any proceeds will be 10%.

This produces a net return some 50% higher than receipt of an equivalent gross sum by way of partnership or annuity income. In addition, the shares may qualify for business property relief for inheritance tax (IHT) purposes.

IT MAY BE POSSIBLE TO MITIGATE THE WORST NI DISADVANTAGES BY ADOPTING SLIGHTLY MORE COMPLEX HYBRID PARTNERSHIP AND COMPANY STRUCTURES

The key tax problem is the application of National Insurance (NI) to a partner's income. In a partnership, a partner earning £250,000 pays total NI contributions of about £4,680. On similar earnings as an employee, the partner pays employee contributions of £5,300 and the employer pays employer contributions of £31,350.

A partner in a partnership structure will incur an income tax and NI charge of about 43% of income (allowing for some non-tax deductible business expenses and assuming an income tax rate of 40%). In a corporate structure, the income tax and combined employer and employee NI charge is about 54%, but tax relief on employer NI contributions reduces the total cost to about 50%.

For more senior partners, or where the sale price multiple is high enough, the benefit of receiving a capital sum at a low tax rate and the prospect of capital growth may outweigh the immediate reduction in net income by the partners.

It may be possible to mitigate the worst NI disadvantages of incorporation by adopting more complex hybrid partnership and company structures whereby the partners receive some income via a partnership and some via a company (companies can, for example, be members of a limited liability partnership).

A number of such structures are being developed. However, care must be taken with this approach. If the company is listed, investors may be uncomfortable with complex structures and this may impact both the appetite for the float and the price paid for the shares.

The table compares a partner's net return in a partnership and in a floated company using an assumed price/earnings ratio of 13 and an initial sale discount on float of 15%. If the float proceeds are distributed to the partners it would take more than five years for the NI cost to exhaust the benefit of the initial 25% sale and the partner would still own shares valued at almost three years' gross pre-incorporation earnings.

Even if most of the float proceeds are used in the business, the partners would still be materially better off as this investment should produce a return to the business from which the partner will benefit through higher profits.

And, assuming a partner's residual holding is worth £707,850 after the float (i.e. assuming the flotation discount is made up but there is no further share price growth), this would, on sale, result in a net receipt of £637,065, which is equivalent to about four-and-a-half years of pre-incorporation post-tax profit distributions.

This, however, only bestows a significant benefit on partners with 10 years or less until retirement, although there is also likely to be a material benefit for the next generation (likely to be in their 40s). The concern then arises for the younger partners as to whether their 'birthright' has been sold and whether the firm will remain sufficiently attractive to both retain them and attract future lateral hires.


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This can be countered in a number of ways. First, an orderly transition of generations at no direct cost to the firm is likely to increase the earnings potential of the remaining partners. This would be particularly beneficial if partners close to retirement received shares in lieu of future annuity or other pension entitlements, thereby relieving the firm of a long-term obligation that would otherwise impact on longer term profitability and the firm's balance sheet.

Second, investments in laterals or other business areas should show a return, which enhances the firm's profitability without the partners directly bearing the funding cost. Third, performance-related and other share options and deferred vesting share bonus plans can be used to attract, encourage and retain the best talent. This may be particularly effective if shares are allocated to these schemes on flotation rather than merely being distributed solely according to current profit shares (in effect clawing back some of the effect of the significant gain and tax advantages otherwise passing to more senior partners).

Indeed, as the partners receiving shares on flotation are likely to be subject to selling restrictions for a number of years, it will be in the interests of even the most senior partners for the firm to continue to ensure the continued success after their departure in order to enhance the share price and hence the value of their overall return. Such a more imaginative approach could leave, say, 25% of the shares to be allocated in the future to new partners (both internal candidates and lateral hires) and other key partners. They would then have a clear stake in the future growth of the business and the possibility of benefiting materially from the growth of the firm.

Furthermore, the fact that the firm is listed would give it an additional currency — its shares — to use in any future merger discussions. The possibility of issuing further shares in return for a merger may make it a more appealing merger candidate than would otherwise be the case. Once again, care would be needed to ensure that shares are allocated primarily to those with a long-term role in the merged firm.

Given that most partners face a substantial fall in their income on retirement and that many firms now face a bulge of partner retirements over the next 10 years, the prospect of realising a substantial cash sum in a tax-efficient manner means that the listing of law firms, if and when permitted, is likely to become a reality.

If these arrangements are properly structured to produce a fair result as between the generations of partners and maintain the attractiveness of the firm (and its share price), a firm can have a sustainable future post-flotation. If the early listings are successful, those who are currently sceptical are likely to turn rapidly into converts. ■

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COMPARISON OF PARTNER'S NET RETURN IN A PARTNERSHIP WITH A FLOATED COMPANY

Partnership	
Profit	£25m
PPEP	£250,000
Partner income tax	£105,000
Partner NI	**£4,680**
Net partner receipt	£140,320
Return on sale	
Profits	£7.26m
Market Cap (PE13)	£94.38m
Sell 25% at 15% discount	£20.06m
Post-tax return to partner	£180,500
Assuming all float proceeds distributed and no funds retained in business	

Company	
Profit before partner salary	£25m
Partner salary	£2.5m
Employer NI	£1.6m
Profit before tax	£10.9m
Tax at 30%	£3.64m (allowing for some non-deductables)
Post-tax profit	£7.26m
Assuming all profits distributed and partners retain 75% of equity	
Dividend per partner	£54,450

Partner return in company	
Salary	£125,000
Income tax	£50,000
Employee NI	**£4,050**
Net salary	£70,950
Dividend	£54,450
Tax on dividend	**£13,610**
Net dividend	£40,840
Total partner net return	£111,790
Shortfall on net annual income	£28,530
But net sales proceed fund for almost five-and-a-half years and the partner still owns shares valued at £707,850 gross (before discount)	