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The Newsletter from The Network of Independent Forensic Accountants

MAKING BANK COMPENSATION CLAIMS LESS TAXING

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MAKING BANK COMPENSATION CLAIMS LESS TAXING

This article considers when and how to "gross up" certain damages claims for tax in relation to claims against banks.

The general principle of English law is that a person who has suffered financial loss as a consequence of the actions of a third party is entitled to damages assessed at a level that puts him or her back in the position in which he or she would have been had it not been for the actions that caused the loss.

In cases in which the claimant is a company claiming against its bank, careful consideration needs to be given to the tax treatment in the calculation of the quantum of damages.

Claims against banks have become increasingly common, with a number of high profile allegations having hit the headlines including the scandal surrounding Royal Bank of Scotland's turnaround unit Global Restructuring Group ("GRG").

"suing Lloyds Bank Plc for £55 million"

More recently it was widely reported that a Yorkshire-based car dealership, Premier Motor Auctions, was to sue Lloyds Bank Plc for £55 million, claiming that Lloyds' Business Support Unit operated in a similar manner to the GRG. Lloyds denied the allegations which were due to be considered at a trial in April but which were withdrawn by the claimant at the eleventh hour.

In such cases, it is often claimed that banks forced their customers to sell assets, frequently property, so as to reduce the level of their bank borrowings.

The tax issues can best be demonstrated if one considers a hypothetical example. Suppose a claimant company was forced to sell a property for £400,000 in a distressed sale scenario in circumstances in which:

i. it had acquired the property originally for £400,000;
ii. its value at the date of its forced sale on an open market basis was £550,000; and
iii. its value at the date of trial was £750,000.

Consider what damages would need to be paid to the company to compensate it for having to sell the property prematurely.

The company will say that, had it not been for the actions of the bank of which it complains it would, at the date of trial, have owned a property worth £750,000. On the face of it, that suggests that it should be seeking damages of £350,000, this being the difference between the £750,000 value at the date of trial and the price actually realised of £400,000.

If the company were awarded damages of £350,000 it would have to pay corporation tax on them at broadly 20% leaving net damages of about £280,000.

"Pregnant gain"

On the one hand it could be argued that, if the company had retained its property and never sold it, it would have been subject to a latent tax liability or "pregnant" gain. In other words if it had sold the property at the date of trial it would have had to have paid tax on the profit arising on the sale of £350,000 (being the difference between the value of £750,000 and the cost of £400,000). However this latent tax would only ever be crystallised on the eventual sale of the property.

Arguably therefore the appropriate way in which to adequately compensate the claimant for its loss would be for the bank to pay "grossed-up" damages of £437,500. Corporation tax would be charged on these damages at about 20%, leaving net damages after tax of £350,000. Adding these net damages to the original sale proceeds of £400,000 would give the claimant just enough to reacquire the property or an equivalent property for £750,000.

Ultimately the "grossing up" argument relies on the claimant being able to demonstrate that its intention was always to have kept its properties in the long term, so as not to crystallise the latent gains within them in a foreseeable timescale.

HOW TO GET THE MOST FROM YOUR INITIAL ENQUIRY TO A SINGLE JOINT EXPERT IN FAMILY PROCEEDINGS

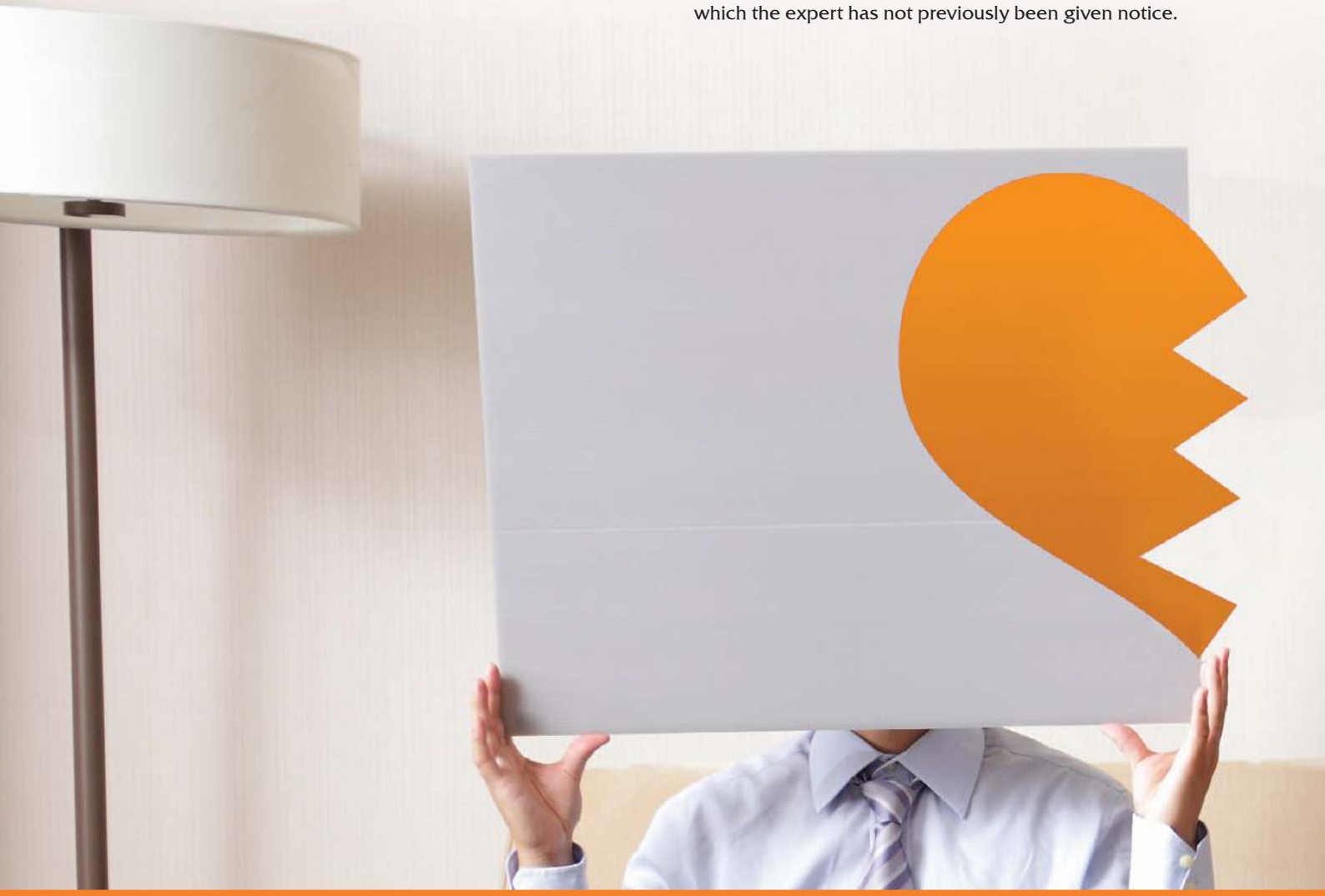
The Family Procedure Rules set out the steps to be followed if an application is to be made to adduce expert accountancy evidence in divorce cases, usually from a single joint expert ("SJE"). However the fact that such applications have to be made at a very early stage, means that they are often not straightforward. This article considers some of the issues and pitfalls that should be considered.

Conflicts of interest

On the one hand it is important to ensure as soon as possible that a potential SJE has no conflict of interests that would preclude him or her from accepting instructions. However, many instructing solicitors are wary of disclosing the identity of their clients when making preliminary enquiries. We suggest that wherever possible the clients could be asked to consent to their identities being disclosed to potential experts so that any potential conflicts can be identified as early as possible.

It is, however, important that, when making preliminary enquiries, no informal discussions with the potential experts take place that could prejudice their impartiality or even create suspicions in the mind of the other party's advisor. Resolution advises carrying out the initial enquiries by email so that there is transparency and all communications can be provided to the other side and to the court easily.

Notwithstanding this, there is nothing to stop instructing solicitors from convening three-way telephone conferences with potential experts at an early stage for the purposes of discussing complex issues and avoiding questions being put to experts that are ambiguous or unclear. It is best to avoid, if possible, issues being raised in letters of instruction of which the expert has not previously been given notice.



Expertise

Experts are required to confirm that the issues on which they may be asked to give an opinion are within their range of expertise. It is therefore very helpful if an indication can be given as to the nature of any business to be valued or, at least, the sector in which it operates.

Timescale

Experts will typically be asked about the timescales for producing reports but it should be borne in mind that their ability to meet any deadline will depend upon clients providing financial information in a timely manner.

It can often be a good idea to ask the expert for any standard lists of information that he or she typically requires recognising that more case-specific information requests may have to be made at a later date.

Wherever possible an allowance should be made in the timetable for the collation of information for the expert.

Availability

When asking an expert about periods during which he would not be available it should be borne in mind that experts typically only hold dates if specifically and explicitly requested and that most experts reserve the right to charge cancellation fees for dates that are held only to be released at the eleventh hour.

Fees

When asking the expert to estimate their likely fees it is really helpful if a set of **unabbreviated** financial statements can be provided. Failing that, details of the approximate level of its net assets, profit and turnover can give a useful indication as to its size.

As a bare minimum the expert is likely only to be able to give a meaningful fee quotation if he or she has a broad idea as to the order of magnitude of the business or assets that are to be considered, namely whether they are measured in the hundreds of thousands, the millions, the tens of millions or the hundreds of millions.

Reliance on other experts

It is sometimes necessary for an accountancy expert to rely on the opinions or reports of others. Most commonly, accountants rely on professional valuations of properties but international cases can also necessitate reliance on accountants in foreign jurisdictions to provide advice about local accountancy or taxation issues.

If it is anticipated that the accountancy expert will need to work with or rely upon the work of others, the timetable should allow time for this work to be completed.

Summary

In summary, time invested at an early stage to ensure that the enquiries made of potential experts are appropriate and comprehensive can save time and costs in the longer term for both the expert and the instructing solicitor.

THE VALUE OF LAWYERS

Having undertaken a number of instructions involving the valuation of legal practices in the context of divorce cases, this article reflects on the value of goodwill in a typical law firm.

It is trite to say that the value of an asset is governed by what someone will pay for it but, in the context of a legal practice, it is important to recognise that goodwill typically arises in one of two circumstances. The first is the admission of a new partner or new partners to an existing practice on terms whereby they "buy-in" by acquiring goodwill from the existing partners.

Sometimes the terms of these transactions are subject to provisions set out in shareholders' agreements or partnership agreements that define the price to be paid, often on the basis of a formula reflecting underlying profits or assets. The incoming partners sometimes pay the existing partners as individuals but equally commonly they are required simply to pay money into the practice to fund working capital that is credited to their own capital accounts and which they are entitled to withdraw when they leave.

> *"younger partners are less willing to take on large debts"*

When setting a value to goodwill in these circumstances affordability for the incoming partners is often an important issue. If a practice is keen to attract talented new and often younger partners it may be willing to compromise on the price it charges them as a cost of entry to prevent it from being prohibitively high. There is considerable anecdotal evidence that younger partners are not only less willing to take on large debts to fund a buy-in to a partnership but that increased housing costs mean that they may simply be unable to afford the levels of borrowing that older partners might have taken on in previous decades.

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The second way in which goodwill can be realised is on the sale of a legal practice as a whole. In recent years such sales have been far less common than mergers. In a merger, typically nothing is paid by either party to the other whereas in a sale substantial consideration can sometimes be paid, albeit usually on an "earn-out" basis.

For example earlier this year it was announced that listed law firm consolidator Gordon Dadds Group acquired two Bristol legal practices for a total consideration of £2m of which £280,000 was paid upon completion with the balance payable over five years. The vendors warranted that the fee income of the enlarged business would not be less than £20m over those five years and any shortfall will reduce the consideration on a pound-for-pound basis. Conversely the consideration increases if the fee income exceeds £20m, with the total payment capped at £6m.

"alternative business structure"

Typically it has only been firms that have been funded by external investment, such as Gordon Dadds Group, that have been in the market for this type of acquisition, with traditional law firms having little appetite for such deals. For that reason, in the absence of an acquisition by an alternative business structure, significant value is only ever likely to be paid for goodwill if the practice being acquired:

i) generated an exceptional level of profit significantly above that necessary to remunerate its principals;

ii) benefitted from recurring fees from identifiable existing clients;

iii) had a nationally recognised or regional brand; or

iv) had developed a reputation for a niche or specialism that would be difficult for someone else to replicate.

"diluted by the cost of run-off cover"

In any circumstances the value of the law firm is likely to be diluted by the cost of run-off cover that will have to be met unless the acquiring firm is willing to take on the historic risk of claims. Such cover typically costs about two and a quarter times the annual insurance premium of the practice.

If no value is ascribed to the goodwill of the practice its value should be ascertained with reference to its net asset value. In those circumstances careful consideration needs to be given to the value of unbilled work in progress which is often reflected at less than its fair value in the accounts for tax-planning reasons, especially in relation to work undertaken on a contingency basis.

Ultimately many solicitors who are sole practitioners or partners in small firms are finding that the best they can reasonably expect on retirement is that they can realise their capital accounts for full book value in sharp contrast to small accountancy firms which continue to change hands for values approximating to one times recurring annual turnover.

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