# Incorporation can offer advantages

## Business structure

James Eyers

When Robert Ishak and Bill Petrovski established law firm William Roberts (their first names) in 2005, they decided to incorporate because this offered financial and structural flexibility. Ishak says this included the possibility of raising funds without the need to increase debt.

The vast majority of new law firms are set up as incorporated legal practices rather than partnerships, and many large partnerships have been considering alternative structures, including incorporation – raising the possibility that *The Australian Financial Review* partnership survey may become an anachronism.

The listing of Slater & Gordon in 2007 also drew attention to how incorporation could create avenues to growth with public capital. This week the plaintiff juggernaut announced it would raise $40 million in capital to help fund its $57 million acquisition of Trilby Misso Lawyers, a Queensland-based personal injury firm.

An Australian Taxation Office draft tax ruling on incorporated law firms is expected to be released by November this year. This is likely to catapult discussions about incorporation back to the top of the agenda at partnership meetings, as firms consider whether changing their structures will allow them to provide better levels of remuneration for staff, and deeper pools of capital to be deployed for growth.

"If you went to an incorporated vehicle and could structure it in a way where the former partners are financially better off than under a partnership model, it would give the incorporated practice a competitive advantage in the market place," says Andrew Chen, principal at WHK Horwath, who advises law firms on structuring issues.

Along with legislative changes to various legal profession acts, moves towards incorporation were propelled by a Tax Office ruling relating to service trusts in 2006, which made their tax benefits less appealing.

Robert Ishak, left, and Bill Petrovski incorporated their firm. Photo: JIM RICE

"Since the ATO brought out the service trust ruling in 2006, firms have been considering their firm structures to see whether there are other alternatives in the marketplace," Chen says. "Incorporation is one. Any new firm starting up typically incorporates and there must be some rationale behind that. The dilemma for the big firms is how do we go from this partnership model to an ideal corporate vehicle and in the same breath, overcome any tax issues of getting from one to the other."

But the ATO has also been standing in the way of incorporation, because the office considers that when a partnership incorporates, its goodwill attracts capital gains tax. The profession has disputed aspects of the ATO's interpretation.

The draft national profession reform bill fails to clarify the tax treatment of firms seeking to incorporate.

Separately to the draft tax ruling, it is understood the ATO will soon issue an alert bulletin to address issues regarding incorporation of partnerships.

Other disincentives to incorporation include potential payroll tax liabilities, and the requirement to disclose financial information to the Australian Securities and Investments Commission.

Among the large law firms, Gadens is the only one to have partly incorporated, which was possible because the firm is not a nationally integrated partnership.

**Incorporation has the advantage of allowing non-partners to provide equity funding.**

It is understood Gadens in NSW created a structure that allowed it to move from a partnership to an incorporated structure without triggering capital gains tax liability.

Freehills, Mallesons Stephen Jaques, Sparke Helmore and Norton Rose in Australia are among the firms that have previously said tax issues were preventing them from incorporating.

Despite the tax uncertainties and disclosure requirements, incorporation is widely seen as a simpler structure than a partnership.

It allows for easier entry and exit of partners, while partners' tax affairs will become simpler given they become employees receiving a salary with PAYG tax withheld.

Furthermore, the tax liability of directors in an incorporated legal practice will not accrue until dividends are paid. In a partnership, liability can accrue before cash is drawn down – which forces many firms to borrow to allow their partners to fund personal tax liabilities.

Incorporation can also reduce the potential for partners to provide personal guarantees for firm liabilities in the event they are pursued by creditors.

It also provides a more solid platform for firm growth, given that profits can be retained after tax is paid at the corporate rate of 30 per cent, strengthening the firm's balance sheet.

Incorporation can also facilitate external fundraising, allowing non-partners to provide equity funding.

Chen says that hypothetically, "you could have a private equity firm or group of [other] investors put money in the firm".

It also makes succession planning easier and provides a more flexible structure for lawyer remuneration, including allowing directors and lawyers to be issued with shares.

But Ishak says the financial, taxation and structural logistics associated with moving from partnership to incorporation has been a difficult hurdle for many established firms.

"Most partners will have set up their personal affairs with partnership and not incorporation in mind," Ishak says.

"Greater clarity from the regulators concerning the implications of changing structure will assist in driving a change to incorporation."

# TressCox cuts boost profit line

## Mid-tier

James Eyers

During a period of introspection in early 2008, TressCox invited a group of former managing partners from other firms into its inner sanctum.

The group attended a partnership meeting and then a partnership conference, where TressCox managing partner Peter Smith says their message was: "You are good, you are capable, you work in some interesting areas, but there isn't a focus in your day-to-day activities of a business-building nature that you should have."

The message spurred Smith into action. The firm revisited partner KPIs and tightened the requirements for team leverage, revenue contribution, cross-referrals of work, and what Smith refers to as partners' non-financial "footprint". Those partners who were unable to deliver the new commitments were removed from the partnership.

TressCox has made the biggest cuts to its partnership in the past 12 and 18 months of any surveyed firm. In 18 months, partners are down 34 per cent to 31.

But Smith says the majority of the former partners are still with the firm, which has also renewed its focus on core practice areas of health, infrastructure around energy and resources, commercial property and construction, dispute resolution and government.

"My gut feel is a lot of the larger firms are doing in their partnership what we, in our relevant sized mid-tier firm, focused on at the end of 2008," Smith says.

TressCox has increased revenue this financial year and expects to do so next year. Profit per equity partner is also up this year.