

## **CLLS – Response to Consultation on ICLA Scheme**

1. This is the City of London Law Society's (CLLS) response to the Consultation issued by the Ministry of Justice (MoJ) proposing a scheme whereby it takes up to 75% of the benefit of interest on client account money held in the legal sector. This is described in the Consultation as the Interest on Lawyers Client Account Scheme (ILCA). As will be apparent the CLLS considers the proposal to be fundamentally flawed and for that reason we have not sought to answer directly the consultation questions but have set out our views below.
2. The CLLS represents City lawyers through individual and corporate membership, including some of the largest international law firms in the world. The CLLS represents over 21,000 solicitors who are members of the profession in the City of London. They represent 12% of all practising solicitors in England and Wales and which means that the CLLS is one of the most influential and largest local law societies in this country. The CLLS responds to a variety of consultations on issues of importance to its members through its specialist committees. This response has been prepared by the CLLS Professional Rules and Regulation Committee.
3. Legal services are a crucial part of the UK economy generating £44bn in turnover and employing more than 311,000 across the UK in 2022. The services that lawyers provide span a multitude of areas from supporting families through divorce, facilitating multi-million pound mergers and acquisitions, settling disputes and buying and selling houses. Lawyers provide crucial services to consumers, helping people at times of trauma and often when they are at their most vulnerable. The legal sector contributes significant revenue to the Treasury. In 2020 CityUK estimated that the total tax contribution of the legal and accounting sectors to the UK public finances was £20.5bn which has recently been added to both by the increase in employer NI contributions and also an increase in the Economic Crime Levy which has fallen mainly on CLLS members. It is vitally important that the Government recognises the need to maintain the global competitiveness of the sector while doing nothing to undermine the contribution that the sector makes to economic growth. Indeed where the Government is undertaking initiatives such as the English Law Promotion Panel to promote English law it is odd that it should consider taking steps that would damage the sector.

## **Observations on the ICLA proposal**

4. In contrast to the schemes in other jurisdictions referred to in the consultation, the intention of the ICLA scheme is to use the money raised for purposes that would have historically been funded by general taxation or through court fees. The ILCA scheme is a fundamentally different scheme than those that operate in other jurisdictions where funds realised are used for charitable or other purposes which would not normally be the subject of government funding. Such a scheme would have some merit but the proposed ILCA Scheme is no more than an additional tax on the legal profession. In that context the proposal is problematic in a number of respects which we will group as objections in principle and those that are caused by the operation of the market.
5. Before dealing with the relevant issues our understanding is that CLLS members do not rely to a large extent on interest on pooled client accounts as a source of income, although this will vary from firm to firm. However, most firms account to their clients for a high proportion of the interest accrued. As such CLLS members do not have a significant financial interest in maintaining the status quo.
6. Clearly other law firms outside the CLLS do rely more on income from interest which we will deal with below. It is implicit in the terms of the consultation that this income is in a sense unearned income which is therefore fair game for the ILCA proposal. However, absent any proper analysis this does not necessarily follow. One possibility is that interest based income is being used by firms to subsidise the low market price for residential conveyancing. Removing that source of income will inevitably cause disruption to the legal services market as it currently operates and is likely to undermine the benefits this market provides to the economy and government revenue. The question is how great that disruption will be. The consultation is frustratingly silent on any attempt to analyse this issue.

## **Objections of Principle**

7. Around half of the proposed money raised is already paid to the Treasury through the taxation of law firm partners' income. As such the purported aim of the scheme is to divert these funds directly to the MoJ rather than passing through general government revenue. The consultation does not deal with this issue and how that may affect the budget of the MoJ. Even if the scheme were to achieve its intended purpose then the MoJ's budget would become, at least in part, dependent on fluctuations in the base rate of interest. Reliance on such an unpredictable benchmark would not be a sound basis for an individual government department whose budget is set by prospective multi-year spending reviews. In addition, it is likely that in the medium term technology will supplant the role of lawyers needing to hold client money in commercial transactions and as such this source of revenue may disappear at an indeterminate point in the future.
8. Whilst the consultation characterises the additional tax as a way of supporting the justice system from which the legal profession benefits, this is inaccurate and fails to recognise the diverse nature of the UK legal sector. The ILCA tax will predominantly impact residential conveyancing transactions and more broadly commercial transactions, neither of which directly benefit from the justice system. Conversely,

the additional tax is imposed on only a part of the legal profession and does not seek any contribution from those members of the profession that work directly in the justice system, most notably barristers.

9. The proposal also seeks to impose an additional tax on interest earned by clients of law firms who use regulated legal services providers for a transaction. Again these clients are unlikely to have obtained any direct benefit from the justice system as part of the retainer. At this risk of stating the obvious these clients will be taxed on interest earned on their own money above and beyond the general tax system simply for using a regulated law firm. This makes no sense and causes the CLLS great concern.
10. In addition, the scheme as a whole effectively removes any incentive to earn interest on client money, particularly when taking into account the additional administrative burden the scheme will generate. This is likely to lead to firms and their clients restructuring of internal arrangements in order to legitimately minimise or eliminate payments under the scheme. The alternative would be to introduce extensive and complex anti avoidance provisions that will add to the cost of administering the scheme.
11. There is a real prospect that the effect of the scheme may well be to remove income from law firms while at the same time creating additional administrative cost to the MoJ which is not covered by the fluctuating revenue from the scheme. There is no evidence in this proposal that MoJ has modelled the effect of the scheme.
12. Finally, it is difficult to reconcile the ILCA scheme with the wider regulatory framework. The SRA's declared policy intention is to move away from client accounts altogether as they consider that such an approach would reduce the regulatory burdens on the sector. The ILCA scheme would effectively make MoJ a stakeholder in the existing regulatory arrangements, and indeed if the scheme does raise additional revenue then the MoJ would be incentivised to oppose change to protect its interests irrespective of where the public interest lies. In any event, if the SRA's direction of travel with regard to eliminating client accounts is to succeed a profitable group of third party managed fund providers will need to be created to fill the gap left by law firms. Taxing them in the manner suggested will inhibit that development.

## **The Operation of the Market**

13. In order to assess the impact that the ILCA scheme could have on the legal services sector, it is important to understand the economic model used by many law firms. Most law firms are, in substance, partnerships although they are now mostly Limited Liability Partnerships. Such firms generate revenue through the provision of legal services. The majority of that revenue pays the salaries of those it employs, premises, insurance and other costs. What is left is distributed to partners. It is important to emphasise that the only source of income for the partners is the profit pool. Capital in the business is normally not derived from shareholder investment but comes from capital contributions from partners. The firm is likely to be funded by bank borrowing. The financial model is that firms pay out all profit after the end of the financial year. It is in the context of this dominant business model that the impact of ICLR needs to be assessed.

## Impact of ILCA

14. As we have made clear above, the MOJ has not provided evidence of any modelling or stress testing as to the impact this proposal will have on the legal market as it currently operates. One available source of likely impact is research carried out by Taha & Watmough<sup>1</sup> which stress tested the impact of ILCA on the legal services market. This took the latest published accounts of 24 firms of between £15m and £30m revenue and applied a stress test with the following parameters:

- Reduced revenue by 10%
- Increased Salary Costs by Inflation (3.2%)
- Increased Operating Costs by 7.5%
- Removed all Interest Income from the business

15. Such stress tests are commonly used by lenders and firm's themselves to assess financial stability and the resilience of a business. The effect of the stress test was that 3 of those businesses became insolvent, 11 of the 24 were left with profit per partner of less than £100k, and the average profit pool across the group fell by 62%. We understand that this general picture is reflected in analyses included in other consultation responses.

16. If a law firm becomes insolvent then it may be that the assets are sold to another firm by the Administrator. However that will lead to losses to creditors including banks and other lenders. An insolvency process is normally overseen by the SRA who will be concerned to ensure that client money and clients' interests more generally are protected. This has a regulatory cost. Where a sale of the business is not possible then it is likely that the SRA will intervene into the practice. In 2022/23 the SRA spent £20.5m on 65 interventions through its Compensation Fund. An increase in insolvencies will place further demands on the SRA which is funded by the profession as a whole. This will drive up overall cost to the sector, including to CLLS members.

17. However, even if a firm continues to make a profit, reduced partner earnings, are likely to have one or more of the following effects: (1) reduction in investment which may affect long term viability of the firm; (2) reduction in staff; (3) partners leave and find another firm which pays more thereby undermining the viability of the firm. In other words, the depression of law firm profits may trigger a chain of events that will lead to the insolvency of a number of law firms.

18. We appreciate that the Taha and Watmough research is based on a small sample of mid-sized law firms. However, there is no basis to suggest that the Taha & Watmough sample would not broadly apply across the sector (currently comprised of around 9000 law firms regulated by the SRA) in a similar way. If so, that would mean that that 12.5% of law firms would be directly at risk of becoming insolvent due to the impact of ILCA (e.g. around 1,125 firms) and a further 45.8% would likely be placed in financial distress

(say 4,122 firms). Of course this could be an overstatement of the impact but as MoJ has not undertaken an assessment of the impact of its proposals on the market then the available evidence suggests that ILCA will be catastrophic for the legal sector.

19. On any analysis the proposal is likely to impact on access to legal services by diminishing suppliers. Clients of firms that fail will also have their affairs disrupted particularly if the SRA intervenes into the firm that acts for them. In addition, the current cross subsidy of legal fees in relation to conveyancing by client account interest will cease with increased cost on the sale and purchase of residential properties.

## **Conclusion**

20. Whilst it is clear that the ILCA proposal is likely to have a less direct impact on CLLS members, it will impact our clients who will have to pay an interest tax. In addition, we are concerned at the potentially wide ranging impact that these proposals could have on the legal profession as a whole and the harm it will cause to clients. In these circumstances CLLS members will also have to bear a significant proportion of the increased regulatory costs that result from implementation of ILCA.

21. The negative impact on the legal sector which we expect to be caused by ILCA is likely to reduce both the size of the sector and the government revenues derived from the sector. This reduction in net revenue is likely to exceed any additional net income the MoJ may gain from the scheme. As such, this appears to be an extraordinary self-defeating act on behalf of the MoJ and the Government more widely. Also extraordinary is the fact this concern has not been addressed at all by the MoJ in advance of the proposal as the department failed to undertake a proper assessment of the effect that the ILCA proposals would have on the legal services market.

22. It follows that the proposals in their current form are inadequately considered to the point where it is questionable that a decision to implement the scheme could be lawful.