

# LAW FIRMS: IS YOUR INTEREST INCOME A CAUSE FOR CONCERN?



As bizarrely as it sounds, if your firm is holding client funds in a general account from which your practice now gains significant interest, you need to consider whether you should be recovering all your business VAT.

Many law firms are earning proportionally higher amounts of interest from client funds on undesignated client accounts thanks to high Bank of England interest rates (currently 5.25%).

The Solicitors Regulation Authority (SRA) will often dictate that some of this interest is paid to clients, and legal firms will be aware of those rules but retained interest might still be substantial. What does it mean for VAT recovery though?

If the money is in a designated client account from which the client receives the interest, this is entirely beyond the scope of VAT. No further action is required as the interest is not income belonging to the law firm.

However, if the funds generating interest are being held in a general account for which the practice itself retains the interest (even if it is required to or chooses to pay some of this to clients), then this may present a problem. This interest is regarded as exempt income for VAT purposes. Where the practice has other exempt sources of income, this adds further complexity.

The receipt of exempt income means HMRC expects a proportion of total input VAT to be

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attributed to this income, and potentially disallowed from your VAT reclaim.

So, it is a requirement that businesses receiving exempt income undertake a ‘partial exemption’ calculation annually to determine their VAT recovery position.

The gross interest received as a proportion of total income is applied to the practice’s general overhead input VAT, and if the resultant sum is more than 50% of the total input VAT incurred or £7,500 per annum, then the whole VAT attributed to the interest income in this way is disallowed.

It is possible to agree a special method of calculation with HMRC that produces a fairer and more reasonable result. However, this must be agreed by HMRC in advance of operating any new method.

You have been warned!

# HOW CAN WE HELP?

Should you have any questions or wish to discuss this matter further, please contact:



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