Costly Surprises:
*Hidden Tax Liabilities for Law Firms & How to Avoid Them*

Presented by: Derek Barto and Ragan McCoy
Armanino LLP - Law Firm Services Group
2019 Annual Conference & Expo
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Presentation Agenda

- 2018 Tax Reform
- State Economic Nexus – Wayfair
- State Taxation Overview
- Tax Court Case on Unreasonable Comp – Brinks
- 1099 Reporting and Settlements
- Required Minimum Distributions
- Partner Capital Accounts / Partner – Shareholder Buy-Outs
- Costs Advanced on Behalf of Clients
- Phantom Income – What is it and who pays the tax?
Introduction to Armanino

**CORE PURPOSE**
To be the most innovative and entrepreneurial firm that makes a positive impact on the lives of our clients and people.

**SNAPSHOT**
- 1,000+ Employees
- 300+ Law Firms
- Largest California Based CPA & Consulting Firm
- 20th Largest CPA & Consulting Firm in the Nation

**LOCATIONS**
- San Ramon, CA
- San Jose, CA
- San Francisco, CA
- Santa Cruz, CA
- Los Angeles, CA
- Woodland Hills, CA
- San Diego, CA
- Dallas, TX
- Portland, OR
- Naperville, IL

**RECOGNITION & AWARDS**

**AFFILIATE COMPANIES**

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**Armanino’s Law Firm Services Group**

**OUR APPROACH**
Armanino is the only accounting and consulting firm in the Western U.S. with a practice dedicated to law firms.

We bring the expertise, tools and industry insights to meet the unique needs of law firms at the Firm, Partnership, and Individual levels.

**OUR SERVICES**
- For the Firm
  - Strategic & Operational Planning
  - M&A Integration
  - Benchmarking & Analytics
  - Technology Management
  - Bank Offer Outsourcing
- For the Partnership
  - Partner Compensation
  - Loan Facilities
  - Equity Valuation
  - Tax Return & K-1’s
  - Attestation for Covenants
- For the Individual
  - Tax Planning & Compliance
  - Business Management

**OUR VALUE**
- From the Firm: strategic, risk-based operations, and compliance, our clients trust us with their most challenging issues
- A broad suite of strategic business consulting, tax, accounting & business management services dedicated exclusively to law firms
- Unmatched expertise from over a quarter century of dedicated law firm consulting

**By The Numbers**
- 300+ law firms use our annual Compensation Surveys to benchmark their performance
- 30+ law firms use our annual Compensation Surveys to benchmark their performance
- 800+ law firms have trusted us to solve their toughest challenges over the past 30 years

**AFFILIATE COMPANIES**
2018 Tax Reform

- Depreciation
- Parking & Entertainment
- Meals
- Deduction for Pass-Through Entities
- Moving Expenses
- Reimbursement
A sufficient connection ("nexus") must exist before a taxing jurisdiction can require an out-of-state firm to file an income tax return and pay tax.

Recently, many states have adopted an "economic nexus" requirement - physical presence in a state is not required to establish nexus as long as the firm has an economic connection to the state.

Several states have gone so far as to adopt a "factor presence" standard – revenue attributed to that state exceeding a certain threshold automatically creates nexus (e.g. New York’s threshold is $1,000,000).

These new nexus standards combined with market-based sourcing of revenue can create multi-state filing requirements for a firm that doesn’t perform any activities outside of home state.

Example - A single-office, Chicago-based law firm providing legal services to a client located in New York with fees of $1,100,000 would likely be required to file a New York Franchise tax return even if 100% of the services were performed in Chicago.
State Taxation Overview

- When can a state impose taxation on a company?
  - Only when Nexus has been established between the state and company

- What is Nexus?
  - A substantial economic connection between the state and company

- How is Nexus established?
  - Historically - required a physical presence in the state.
  - Now – to be discussed further
Wayfair vs. South Dakota – 2018 US Supreme Court Case

• Wayfair – Online retailer with limited physical presence selling to customers to all US states

• South Dakota argued that physical presence isn’t required to create Nexus. South Dakota wants to impose sales tax collections on Wayfair

• US Supreme Court rules in favor of South Dakota overthrowing physical presence standards previously established

• Nexus implications impact state income taxation

Nexus Methodologies

• Physical Presence Nexus
  • Leasing an office, owning real estate, employing individuals

• Economic Nexus
  • Deriving a benefit from the state’s economy - generating revenue from services provided to a customer in the state.
  • Does not require a physical presence in the state.
State Taxation – Impact of Wayfair

• Physical presence was the established nexus methodology until the Wayfair ruling

• Many states have established economic nexus laws over the past decade
  • Before Wayfair, there was no legal authority to support enforcement of these laws. As a result, most companies ignored these new laws.

Complications

• State laws are inconsistent and ambiguous
  • Definitions often conflict with other states
  • Certain states have provided thresholds where Nexus is created (e.g. $500,000 of sales) while most haven’t

• Will states retroactively apply Wayfair ruling?
  • For states that had previously established economic nexus laws
Impact on Law Firm Partners

- Law Firms filing in other states may require individual partners to file and pay income taxes in those states

- Partners in California are taxed on all income earned

- If taxes are paid to another state, a credit is received in California to avoid double-taxation
  - Total taxes paid does not change, only impact is which state the taxes are paid to (increased administrative burden)

What Law Firms should be doing

- Law Firms need to analyze potential state filing requirements post-Wayfair

- Armanino Law Firm Services Group & Armanino State and Local Tax Team can assist in analysis
Tax Court Case on Unreasonable Comp - Brinks

- February 2016 – Brinks, Gilson & Lione, APC (T.C. Memo 2016 – 20)
  - Facts of the Case
  - Detrimental Tax Consequences
  - Should you be concerned?
    - Partnership: No
    - C - Corporation: Maybe
Chicago IP Law Firm
Corporation
150 total Lawyers / 65 Shareholders
The Law Firm was audited the previous year and the issue did not come up

**Issue:**
Compensation for Services vs Dividends Paid to Shareholders
*(Double Taxation)*

**Results:**
- Additional Tax: $368,000
- Penalties: $425,000

**Facts of the Case**
- Ownership of Shares = Allocation of Compensation
- Annual Comp Determination = Proportionate Adjustment in Shares
- Shareholder Agreement stated the shareholders were entitled to dividends, when declared by the Board
  (But for the last 10 years, no dividends were ever declared)
- Capital was $8 to over $9 Million
- They did not specifically ask the advice of their outside accounts
Independent Investor Test

The owners (or investors) of a business, with significant capital, are entitled to a return on their investment.

An independent (non-owner) would probably not approve of the compensation arrangement if, year after year, all profits were paid out as compensation and nothing was paid to investors.

Mulcahy v Commissioner

The Court said, when a thriving Firm that has nontrivial capital reports zero corporate income, it is apparent that the Firm is understating its tax liability.
Detrimental Tax Consequences

- This is a bad case because the issue of comp vs dividends was not litigated – it was conceded to by the Law Firm
- The only issue in this case was the dispute over penalties (although they unsuccessfully tried to re-open the comp issue)
- When the Law Firm conceded the underlying issue, they should have negotiated the penalties at that time

What Should You Do to Lessen the Risk

1. Link shareholder year end bonuses to specific criteria (new clients, reputation, extraordinary success, etc.), not to ownership percentage (and pay all staff and associate bonuses at year end also)
2. Be careful of the amount of Capital in the Firm - If it becomes significant, consider paying dividends
3. If you believe there may be a possible concern, seek specific advise
Settlements and 1099 Reporting

- Who should receive a Form 1099
  - Information Reporting
  - Section 604
  - Many Code Sections
  - 1099s for Payments

- Taxable vs. Non-Taxable Settlement
- Usually Defendant's Responsibility to file Form 1099 (not the Law Firm)
- What does the Law Firm do when they receive a Form 1099 for a large (or numerous) settlements
1. Distribute, at least, 100% of prior year stub period adjusted income

   - or -

2. Distribute, at least, 95% of current year adjusted income
Your fiscal year is July through June.

Last fiscal year the Firm’s adjusted income was $4,800,000.

As of December 2017:
- Firm net income is $1,000,000
- Shareholders salary is $1,000,000

**How much is the RMD?**

1. 100% of prior year stub period = $2,400,000
2. 95% of current year adjusted income = $1,900,000

Therefore, the Firm would need to distribute an additional $900,000 to be in compliance.

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**Partner Capital Accounts**
Partner Capital Accounts

- Firm Capital vs. Individual Partner Capital Accounts
- Accounting for Individual Partner Capital Accounts
- Buy-In – What's the difference between Real Capital vs. Fake Capital?
- Pay out upon withdrawal
  - Taxability
- What happens to negative capital accounts upon withdrawal?
- Inside / outside basis

Capital Accounts

<table>
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<tr>
<th></th>
<th>Beg Capital</th>
<th>Contributions</th>
<th>Income</th>
<th>Withdrawals</th>
<th>Ending Capital</th>
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<tr>
<td>Partner A</td>
<td>$200,000</td>
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<td>$600,000</td>
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<td>Partner B</td>
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<td>$0</td>
<td>$1,750,000</td>
<td>$1,800,000</td>
<td>$350,000</td>
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Costs Advanced on Behalf of Clients

- Hard Costs Advanced vs Soft Costs Advanced
  - Hard Costs Advanced are loans to clients until they are repaid or deemed worthless
  - They are not an expense?

Impact on Capital
- Is your firm accounting for it correctly?
- What can you do if your firm is doing it incorrectly?
  - Determine potential exposure
  - Take corrective action
    - Possibly file a Form 3115
What Causes Phantom Income?

- What is Phantom Income?
- Why is there a difference between Book Income and Taxable Income?
- What are the two different types of Phantom Income?
  - Timing Differences
  - Permanent Differences
## Phantom Income

<table>
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<tr>
<th>INCOME</th>
<th>CASH</th>
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<tbody>
<tr>
<td>Revenue</td>
<td>$10,000,000</td>
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<tr>
<td>Expenses</td>
<td>($6,500,000)</td>
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<tr>
<td>Book Net Income</td>
<td>$3,500,000</td>
</tr>
</tbody>
</table>

**Tax Adjustments (Permanent Differences)**
- Meals & Entertainment ($200,000 x 50%) 100,000
- Club Dues ($50,000 x 100%) 50,000
- Life Insurance ($40,000 x 100%) 40,000
- Gifts ($10,000 - $25 limit) 7,500

Taxable Income $3,697,500 $3,500,000

**Cash Adjustments (Timing Differences)**
- Increase in Client Costs ($300,000 to $450,000) (150,000)
- Increase in Deposits ($50,000 to $100,000) (50,000)
- Purchase of Fixed Assets ($500,000) (500,000)
- Depreciation ($350,000) 350,000

Taxable Income vs Available Cash $3,697,500 $3,150,000

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**Thank You!**