TAX & ACCOUNTING SERVICES FOR LAW FIRMS

WORKING WITH HUNDREDS OF LAW FIRMS FOR OVER 30 YEARS

Tax and accounting issues can be ticking time bombs for law firms. A firm can lose its license, for example, if its trust account doesn't adhere to state bar association rules. Yet firms often don't know they have a problem, because the industry's accounting rules are so technical that it's easy for non-specialists to miss critical nuances.

Mitigating Risk

Armanino's dedicated Law Firm Services group has focused solely on the legal industry for more than 25 years. We've helped hundreds of law firms manage their unique tax and accounting needs and we've seen the "hidden" issues that are frequently overlooked.
These are some of the potentially dangerous issues you need to consider:

Client Cost Advances

The IRS considers client cost advances to be income, but when you pay for the filing fee, deposition or other cost, they view this as a *loan* to the client. We often see these expenditures incorrectly booked as expenses. This mistake can leave you facing an unexpected tax bill of hundreds of thousands, or even millions of dollars. If you do find yourself with a tax problem related to client costs, there are some specialized strategies that can help ease the pain, such as voluntary compliance measures.

Capital Accounts

Capital isn't something most partners think about, but it should be. A mismanaged capital account can trigger a big tax bill and seriously weaken your firm's fiscal health, which can cause good attorneys to leave and make it hard to attract new lateral partners. A common scenario is that firms borrow to pay operating expenses during a period of income volatility, then make a distribution when they have income, instead of paying down the loan; the debt service burden eventually erodes the firm's ability to operate. To avoid this situation, you need to manage your capital levels on an ongoing basis. If you have a capital deficit because of a loan (your cash exceeds your income), you should take steps to restore the capital—a process that's more complicated than simply repaying the debt.

Phantom Income

Law firms frequently have income without a corresponding amount of cash, because of factors such as client cost expenditures. To avoid an unexpected tax bill, you need to plan for the inevitable income volatility and carefully manage the *timing* of your cash and income. Tax adjustments can create phantom income as well, so you also need to know the specifics of your allowable tax deductions. For example, firms can only deduct 50% of their meal and entertainment expenses, and life insurance and country club dues are not deductible at all.

Income Allocation

Armanino helps firms navigate the highly technical issue of allocation of partner profits that changes from year to year. A common problem is some partners receiving cash without paying tax on it, while others pay tax on compensation for which they never received cash. These situations can create friction between partners and weaken the firm's capital account.

Unreasonable Compensation in a C-Corp

Firms that are structured as C-corporations typically pay out all of their profits to partners in the form of compensation. Increasingly, the IRS has determined that this is unreasonable, and firms instead need to pay a portion of profits as dividends. Unlike compensation, dividends aren't deductible by the firm, which means the money is subject to double taxation. The firm must pay corporate tax on the dividends, and the partners must pay income tax. Although there are no bright-line rules, you run a greater risk of triggering this IRS action if your firm aligns year-end distributions directly with ownership percentages or if you have a high capital base.

Partner Buy-In/Buy-Out

To make buy-ins easier for new partners, firms will often agree to spread the buy-in over several years and take the payments out of the partner's bonus. But new partners may not realize that the bonus money used for the buy-in is not considered capital. This means they're in for an unpleasant shock if they leave the firm, because they won't have any buy-in funds in their capital account. If your firm uses this type of arrangement, you need to make sure that both parties understand the details. When you return capital to a partner via a buyout, the payment is non-deductible for the firm and creates phantom income. This means you need to proactively manage the timing of any buyouts to minimize cash flow disruptions and tax issues.

Unfunded Partner Retirement Benefits

One partner retiring is a cash flow issue, but if you have several retiring at the same time, it can be a dangerously large outflow of cash from the business—particularly if the firm is doing poorly. To prevent problems, you can add a floor to your retirement benefits structure, to limit what your firm has to pay out in any given year. Retirement payments should also be structured as ordinary income to the retiring partner and as an ordinary deduction to the firm. If a partner instead wanted the payment structured as a buy-out of their interest, it would be a capital gain for the partner and either not deductible or deductible over 15 years for the firm.

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