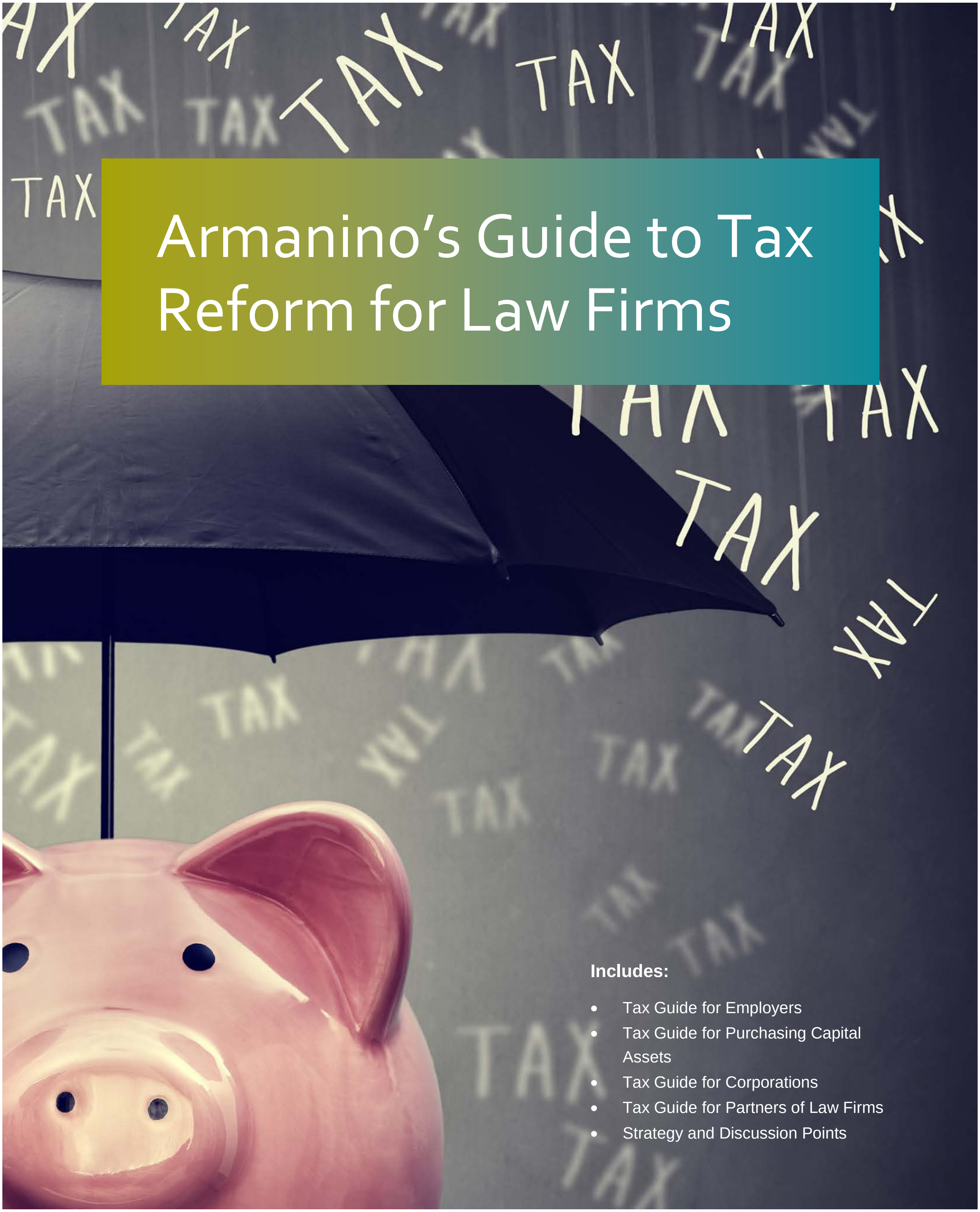

Armanino's Guide to Tax Reform for Law Firms

Includes:

- Tax Guide for Employers
- Tax Guide for Purchasing Capital Assets
- Tax Guide for Corporations
- Tax Guide for Partners of Law Firms
- Strategy and Discussion Points

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For Employers

Employers can't deduct cost of providing qualified transportation fringes and other transportation benefits

PRIOR LAW

The value of a qualified transportation fringe benefit provided by an employer to an employee is excluded from the employee's income, subject to monthly limits.

Code Sec. 132(f) defines a "qualified transportation fringe" as:

- **(1)** transportation in a commuter highway vehicle for travel between the employee's residence and place of employment;
- **(2)** transit passes;
- **(3)** qualified parking; and
- **(4)** qualified bicycle commuting reimbursement.

Under pre-Tax Cuts and Jobs Act law, a deduction wasn't barred for the expenses of providing qualified transportation fringe benefits or other transportation or commuting benefits to an employee.

NEW LAW

The Tax Cuts and Jobs Act provides that no deduction is allowed for the expense of a qualified transportation fringe, as defined in Code Sec. 132(f), provided to an employee of the taxpayer, except in the case of qualified bicycle commuting reimbursements which may no longer be excluded from an employee's income.

Although the Tax Cuts and Jobs Act denies the employer a deduction for the qualified transportation fringe benefit, it doesn't change the employee's exclusion of the benefit from income under Code Sec. 132, except in the case of qualified bicycle commuting reimbursements.

The Tax Cuts and Jobs Act also provides that no deduction is allowed for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer for travel between the employee's residence and place of employment, except as necessary for ensuring the employee's safety.

New credit for employer-paid family and medical leave

PRIOR LAW

No credit is provided to employers for compensation paid to employees while on leave.

NEW LAW

For wages paid in tax years beginning after Dec. 31, 2017, but not beginning after Dec. 31, 2019, the Act allows businesses to claim a general business credit equal to 12.5% of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave (FMLA) if the rate of payment is 50% of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%. To qualify for the credit, all qualifying full-time employees have to be given at least two weeks of annual paid family and medical leave (all less-than-full-time qualifying employees have to be given a commensurate amount of leave on a pro rata basis).

Employer's deduction for entertainment expenses and certain fringe benefits are limited

PRIOR LAW

A taxpayer may deduct up to 50% of expenses relating to meals and entertainment. Housing and meals provided for the convenience of the employer on the business premises of the employer are excluded from the employee's gross income. Various other fringe benefits provided by employers are not included in an employee's gross income, such as qualified transportation fringe benefits

NEW LAW

For amounts incurred or paid after Dec. 31, 2017, deductions for entertainment expenses are disallowed, eliminating the subjective determination of whether such expenses are sufficiently business related; the current 50% limit on the deductibility of business meals is expanded to meals provided through an in-house cafeteria or otherwise on the premises of the employer; and deductions for employee transportation fringe benefits (e.g., parking and mass transit) are denied, but the exclusion from income for such benefits received by an employee is retained. In addition, no deduction is allowed for transportation expenses that are the equivalent of commuting for employees (e.g., between the employee's home and the workplace), except as provided for the safety of the employee.

For tax years beginning after Dec. 31, 2025, the Act will disallow an employer's deduction for expenses associated with meals provided for the convenience of the employer on the employer's business premises, or provided on or near the employer's business premises through an employer-operated facility that meets certain requirements.

Employee achievements awards

PRIOR LAW

Employee achievement awards are excludable to the extent the employer can deduct the cost of the award-generally limited to $400 for any one employee, or $1,600 for a "qualified plan award." An employee achievement award is an item of tangible personal property given to an employee in recognition of either length of service or safety achievement and presented as part of a meaningful presentation.

NEW LAW

For amounts paid or incurred after Dec. 31, 2017, a definition of "tangible personal property" is provided. Tangible personal property does not include cash, cash equivalents, gifts cards, gift coupons, gift certificates (other than where from the employer pre-selected or pre-approved a limited selection) vacations, meals, lodging, tickets for theatre or sporting events, stock, bonds or similar items. and other non-tangible personal property. No inference is intended that this is a change from present law and guidance.

No deduction for amounts paid for sexual harassment subject to nondisclosure agreement

PRIOR LAW

A taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. However, among other exceptions, there's no deduction for: any illegal bribe, illegal kickback, or other illegal payment; certain lobbying and political expenses; any fine or similar penalty paid to a government for the violation of any law; and two-thirds of treble damage payments under the antitrust laws.

NEW LAW

Under the Act, effective for amounts paid or incurred after Dec. 22, 2017, no deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement.

Deduction for local lobbying expenses eliminated

PRIOR LAW

Businesses generally may deduct ordinary and necessary expenses paid or incurred in connection with carrying on any trade or business. An exception to the general rule, however, disallows deductions for lobbying and political expenditures with respect to legislation and candidates for office, except for lobbying expenses with respect to legislation before local government bodies (including Indian tribal governments).

NEW LAW

For amounts paid or incurred on or after Dec. 22, 2017, the Code Sec. 162(e) deduction for lobbying expenses with respect to legislation before local government bodies (including Indian tribal governments) is eliminated.

Exclusion for moving expense reimbursements suspended

PRIOR LAW

Code Sec. 132(a)(6) provides that gross income doesn't include any fringe benefit that qualifies as a "qualified moving expense reimbursement." Code Sec. 132(g) provides that "qualified moving expense reimbursement" means any amount received (directly or indirectly) by an individual from an employer as a payment for (or a reimbursement of) expenses that would be deductible moving expenses under Code Sec. 217 if directly paid or incurred by the individual.

NEW LAW

Temporarily suspends the exclusion from income of qualified moving expense reimbursement for tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, except in the case of a member of the U.S. Armed Forces on active duty who moves pursuant to a military order and incident to a permanent change of station.

For Purchasing Capital Assets

Increased Code 179 expensing

A taxpayer may, subject to limitations, elect under Code Sec. 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions.

PRIOR LAW

The maximum amount a taxpayer could expense was $500,000 of the cost of qualifying property placed in service for the tax year. The $500,000 amount was reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the tax year exceeds $2 million. These amounts were indexed for inflation.

In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business, and includes off-the-shelf computer software and qualified real property (i.e., qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).

Certain passenger automobiles are eligible for Code Sec. 179 expensing only to the extent of defined limitations. For sport utility vehicles above the 6,000 pound weight rating and not more than the 14,000 pound weight rating, which are not subject to the passenger automobile limitation, the maximum cost that may be expensed for any tax year under Code Sec. 179 is $25,000.

NEW LAW

For property placed in service in tax years beginning after Dec. 31, 2017, the maximum amount a taxpayer may expense under Code Sec. 179 is increased to $1 million, and the phase-out threshold amount is increased to $2.5 million. For tax years beginning after 2018, these amounts (as well as the $25,000 sport utility vehicle limitation) are indexed for inflation.

"Qualified real property." The definition of Code Sec. 179 property is expanded to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging. The definition of qualified real property eligible for Code Sec. 179 expensing is also expanded to include the following improvements to nonresidential real property after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

Temporary 100% cost recovery of qualifying business assets

PRIOR LAW

An additional first-year bonus depreciation deduction was allowed equal to 50% of the adjusted basis of qualified property, the original use of which began with the taxpayer, placed in service before Jan. 1, 2020. The 50% allowance was phased down for property placed in service after Dec. 31, 2017.

NEW LAW

A 100% first-year deduction for the adjusted basis is allowed for qualified property acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023. Thus, the phase-down of the 50% allowance for property placed in service after Dec. 31, 2017 is repealed. The additional first-year depreciation deduction is allowed for new and used property.

In later years, the first-year bonus depreciation deduction phases down, as follows:

- **80% for property** placed in service after Dec. 31, 2022 and before Jan. 1, 2024.
- **60% for property** placed in service after Dec. 31, 2023 and before Jan. 1, 2025.
- **40% for property** placed in service after Dec. 31, 2024 and before Jan. 1, 2026.
- **20% for property** placed in service after Dec. 31, 2025 and before Jan. 1, 2027.

First-year bonus depreciation sunsets after 2026.

For the first tax year ending after Sept. 27, 2017, a taxpayer can elect to claim 50% bonus first-year depreciation (instead of claiming a 100% first-year depreciation allowance).

Automobile depreciation limits increased

Code Sec. 280F limits the Code Sec. 179 expensing and cost recovery deduction with respect to certain passenger autos (the luxury auto depreciation limit).

PRIOR LAW

For passenger autos placed in service in 2017, for which the additional first-year depreciation deduction is not claimed, the maximum amount of allowable depreciation deduction is $3,160 for the year in which the vehicle is placed in service, $5,100 for the second year, $3,050 for the third year, and $1,875 for the fourth and later years in the recovery period. This limitation is indexed for inflation.

For passenger automobiles eligible for the additional first-year depreciation allowance in 2017, the first-year limitation is increased by an additional $8,000. This amount is phased down from $8,000 by $1,600 per calendar year beginning in 2018 Thus, the Code Sec. 280F increase amount for property placed in service during 2018 is $6,400, and during 2019 is $4,800.

NEW LAW

For passenger automobiles placed in service after Dec. 31, 2017, in tax years ending after that date, for which the additional first-year depreciation deduction is not claimed, the maximum amount of allowable depreciation is increased to: $10,000 for the year in which the vehicle is placed in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years in the recovery period. For passenger automobiles placed in service after 2018, these dollar limits are indexed for inflation. For passenger autos eligible for bonus first-year depreciation, the maximum first-year depreciation allowance remains at $8,000.

For Corporations

Corporate tax rates reduced

PRIOR LAW

Personal service corporations pay tax on their entire taxable income at the rate of 35%.

Note: Non- Personal service corporations are subject to graduated tax rates of 15% (for taxable income of $0-$50,000), 25% (for taxable income of $50,001-$75,000), 34% (for taxable income of $75,001-$10,000,000), and 35% (for taxable income over $10,000,000).

NEW LAW

For tax years beginning after Dec. 31, 2017, the corporate tax rate is a flat 21% rate.

Modification of net operating loss deduction

PRIOR LAW

In General a net operating loss (NOL) may generally be carried back two years and carried over 20 years to offset taxable income in such years.

NEW LAW

For NOLs arising in tax years ending after Dec. 31, 2017, the two-year carryback and the special carryback provisions are repealed, but a two-year carryback applies in the case of certain losses incurred in the trade or business of farming.

For losses arising in tax years beginning after Dec. 31, 2017, the NOL deduction is limited to 80% of taxable income (determined without regard to the deduction). Carryovers to other years are adjusted to take account of this limitation, and NOLs can be carried forward indefinitely.

Corporate Alternative minimum tax repealed

PRIOR LAW

The corporate alternative minimum tax (AMT) is 20%, with an exemption amount of up to $40,000. Corporations with average gross receipts of less than $7.5 million for the preceding three tax years are exempt from the AMT. The exemption amount phases out starting at $150,000 of alternative minimum taxable income.

NEW LAW

For tax years beginning after Dec. 31, 2017, the corporate AMT is repealed.

For tax years beginning after 2017 and before 2022, the AMT credit is refundable and can offset regular tax liability in an amount equal to 50% (100% for tax years beginning in 2021) of the excess of the minimum tax credit for the tax year over the amount of the credit allowable for the year against regular tax liability. Accordingly, the full amount of the minimum tax credit will be allowed in tax years beginning before 2022.

For Partners of Law Firms

New deduction for pass-through income

PRIOR LAW

The net income of pass-through businesses- sole proprietorships, partnerships, limited liability companies (LLCs), and S corporations-was not subject to an entity-level tax and was instead reported by the owners or shareholders on their individual income tax returns. Thus, the income was effectively subject to individual income tax rates.

NEW LAW

The benefit of this deduction is limited in how it applies to law firms, which are considered service businesses. Only partners earning below $415,000 will receive any benefit as detailed below.

Generally for tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the Act adds a new section, Code Sec. 199A, "Qualified Business Income," under which a non-corporate taxpayer who has qualified business income (QBI) from a partnership, S corporation, or sole proprietorship is allowed a deduction related to such income.

QBI is generally defined as the net amount of "qualified items of income, gain, deduction, and loss" relating to any qualified trade or business of the taxpayer. For this purpose, qualified items of income, gain, deduction, and loss are items of income, gain, deduction, and loss to the extent these items are effectively connected with the conduct of a trade or business within the U.S. under Code Sec. 864(c) and included or allowed in determining taxable income for the year. If the net amount of qualified income, gain, deduction, and loss relating to qualified trade or businesses of the taxpayer for any tax year is less than zero, the amount is treated as a loss from a qualified trade or business in the succeeding tax year.

QBI does not include reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered with respect to the trade or business; any guaranteed payment to a partner for services to the business under Code Sec. 707(c); or a payment under Code Sec. 707(a) to a partner for services rendered with respect to the trade or business.

The 20% deduction is not allowed in computing adjusted gross income (AGI), but rather is allowed as a deduction reducing taxable income.

Limitations. Except as provided below, the deduction cannot exceed the greater of:

(1) 50% of the W-2 wages with respect to the qualified trade or business ("W-2 wage limit"), or

(2) the sum of 25% of the W-2 wages paid with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all "qualified property." Qualified property is defined in Code Sec. 199A(b)(6) as meaning tangible, depreciable property which is held by and available for use in the qualified trade or business at the close of the tax year, which is used at any point during the tax year in the production of qualified business income, and the depreciable period for which has not ended before the close of the tax year.

The above limit does not apply for taxpayers with taxable income below the "threshold amount" ($315,000 for married individuals filing jointly, $157,500 for other individuals, indexed for inflation after 2018). The application of the limit is phased in for individuals with taxable income exceeding the threshold amount, over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for other individuals). Thus, for 2018, the limit fully applies to married taxpayers with taxable income over $415,000 and other individuals with taxable income over $207,500.

For a partnership or S corporation, each partner or shareholder is treated as having W-2 wages for the tax year in an amount equal to his or her allocable share of the W-2 wages of the entity for the tax year. A partner's or shareholder's allocable share of W-2 wages is determined in the same way as the partner's or shareholder's allocable share of wage expenses. For an S corporation, an allocable share is the shareholder's pro rata share of an item.

Service businesses. Except as provided below, the deduction does not apply to specified service businesses (i.e., trades or businesses described in Code Sec. 1202(e)(3)(A), but excluding engineering and architecture; and trades or businesses that involve the performance of services that consist of investment-type activities). However, the disallowance of the deduction for specified service trades or businesses of the taxpayer does not apply for taxpayers with taxpayer income below the threshold amount described above. And, the benefit of the deduction for service businesses is phased out over the next $100,000 of taxable income for joint filers ($50,000 for other individuals). Thus, for 2018, the limit fully applies to married taxpayers with taxable income over $415,000 and other individuals with taxable income over $207,500.

The deduction does not apply to the trade or business of being an employee.

Strategy and Discussion Points

Expert Commentary and Analysis

The Tax Cuts and Jobs Act effects changes for all law firms and their partners. The ramifications of these changes will vary for each firm and partner or shareholder. Although there is no 'one-size fits all' strategy, law firms should be considering the following:

CHOICE OF BUISINESS ENTITY

The new corporate tax rate of 21% makes a C-corporation worth a discussion.

- Should your firm consider whether to operate as a C-corporation?
- Should a law firm partner hold his/her partnership interest as a C-corporation (rather than as an individual or an S-corporation)?

EXPENSE DEDUCTIONS

There are numerous changes to the deductibility of business expenses and fringe benefits.

- Does your firm pay for employee parking or other transportation benefits, if so, how will your firm treat these for tax purposes?
- Does your firm need to re-evaluate policies surrounding client and other entertainment?

ACCELERATED DEPRECIATION OF FIXED ASSET ADDITIONS

The Tax Cuts and Jobs Act makes most fixed asset purchases immediately deductible in the year the assets are placed in service. However, accelerating depreciation may not always be strategic for the firm or its partners and shareholders. For example:

- Accelerating depreciation may also reduce distributable profits or cause capital accounts to go negative,
- Firms may wish to align the depreciation deduction for asset purchases financed by debt with repayment of the loans to avoid future phantom income issues,
- Frequent changes in partner interests may create inequities amongst partners,

RECONSIDERING THE STATUS QUO

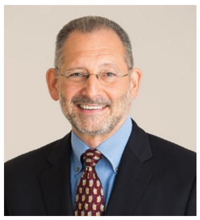
Law firm partners are mostly excluded from the 20% deduction for qualified business income for their income derived from legal practice; however, some firms may be able to segment their business processes or revenue streams so that a portion of income may qualify for the deduction. Such thoughtfulness may mean the difference between a 20% deduction on this income or no deduction at all. Has your firm considered:

- Alternative operational structures,
- Segmenting revenues/operations between those that are service related and all others?
- Can you "manage" your income to maximize any available pass-through deduction in slower years?

Questions or Comments?

Contact our experts

If you have any questions or would like to discuss any issues or concerns you may have please contact us:



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Dave has more than 30 years of experience working with law firms of all sizes. He and his group have consulted with more than 1,200 law firms regarding strategic planning, partner compensation arrangements, succession planning, partner withdrawal and retirement, organizational reviews, profitability improvement, partner retreats, dissolutions, and mergers and acquisitions. David has authored numerous articles for the American Bar Association Journal and California Lawyer, and he co-authored "Financing the Start Up Law Firm," published by the American Bar Association's Law Practice Management section.

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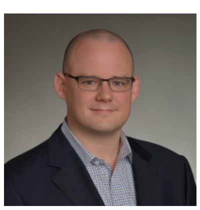
Gerry Clancy is a Tax Partner at Armanino LLP. He specializes in Taxation and Business Advisory services where he works with clients in law firms, manufacturing, distribution, technology, retail, service and construction and real estate. For more than 25 years, Gerry has assisted clients in structuring mergers and acquisitions, representation before tax authorities, general business advisory, strategic planning and taxation for partnerships, C-corporations, S-corporations, individuals, estates and trusts. Prior to Armanino, Gerry was a partner at Comyns Smith McCleary & Deaver LLP and held various roles at Deloitte and PricewaterhouseCoopers.



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Derek is a Principal in Armanino's Law Firm Services Group and has been consulting with law firms of all sizes on financial and strategic issues for the last 10 years. He also serves as a temporary or outsourced controller/CFO. Derek is a CPA with a master's degree in Law Firm Management from George Washington University.