withum

WITHUM'S LAW FIRMS TEAM PRESENTS:

# Tax Planning for New Law Firm Partners and Shareholders

POWER IN THE PLUS™

WE ARE AN INDEPENDENT MEMBER OF HLB THE GLOBAL ADVISORY AND ACCOUNTING NETWORK

# Natalie Chance, CPA
## Tax Senior Manager

- Over 15 years of public accounting experience in a variety of industries.
- Specializes in tax compliance and planning to minimize tax liabilities and ensure compliance.
- Experienced advisor for various entity types, such as C Corporations, Subchapter S Corporations, Partnerships, Limited Liability Companies, and Sole Proprietorships.
- An expert in tax structure optimization, allocation strategies, multi-state taxation for pass-through entities, entity conversions, annual tax returns and operational tax consulting.

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# Nisha J. Bhanushali, CPA, CA
## Tax Senior Manager

- Over 10 years of public accounting experience, including 4 years in India.
- Experience in tax planning, trusts, compliance, and consulting services for high net worth individuals and privately held business entities.
- An expert in stock option planning and has represented individuals and businesses before the Internal Revenue Service and State Tax Boards.
- Fluent in English, Hindi, Gujarati, Kutchi, and Marathi.

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# Law Firm Ownership Structure

## Three main types of tax structures

**Partnership, or Limited Liability Company operating as a partnership**

- Partners/members receive a pass-through tax statement called a Schedule K-1, instead of a W-2

**S Corporation**

- Shareholders receive a Schedule K-1, and a W-2

**C Corporation**

- Shareholders only receive a W-2.

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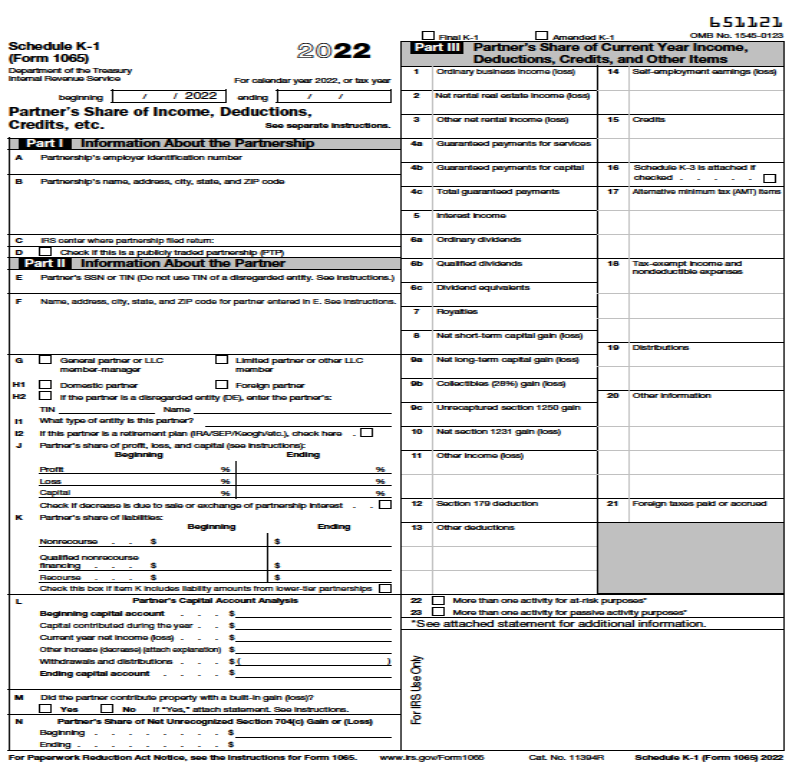
# Pass-Through Entities

## Meet your new W-2 – now called Schedule K-1



Schedule K-1 (Form 1065) 2022

Department of the Treasury
Internal Revenue Service

For calendar year 2022, or tax year
beginning / / 2022 ending / /

**Partner's Share of Income, Deductions, Credits, etc.**
See separate instructions.

651121

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

**Part I Information About the Partnership**

A Partnership's employer identification number

B Partnership's name, address, city, state, and ZIP code

C IRS center where partnership filed return:

D ☐ Check if this is a publicly traded partnership ("PTP")

**Part II Information About the Partner**

E Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)

F Name, address, city, state, and ZIP code for partner entered in E. See instructions.

G ☐ General partner or LLC member-manager ☐ Limited partner or other LLC member

H1 ☐ Domestic partner ☐ Foreign partner

H2 ☐ If the partner is a disregarded entity (DE), enter the partner's: TIN Name

I1 What type of entity is this partner?

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ☐

J Partner's share of profit, loss, and capital (see instructions):

| | Beginning | Ending |
|---|---|---|
| Profit | % | % |
| Loss | % | % |
| Capital | % | % |

Check if decrease is due to sale or exchange of partnership interest ☐

K Partner's share of liabilities:

| | Beginning | Ending |
|---|---|---|
| Nonrecourse | $ | $ |
| Qualified nonrecourse financing | $ | $ |
| Recourse | $ | $ |

Check this box if Item K includes liability amounts from lower-tier partnerships ☐

L Partner's Capital Account Analysis

Beginning capital account $
Capital contributed during the year $
Current year net income (loss) $
Other increase (decrease) (attach explanation) $
Withdrawals and distributions $ ( )
Ending capital account $

M Did the partner contribute property with a built-in gain (loss)?
☐ Yes ☐ No If "Yes," attach statement. See instructions.

N Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)
Beginning $
Ending $

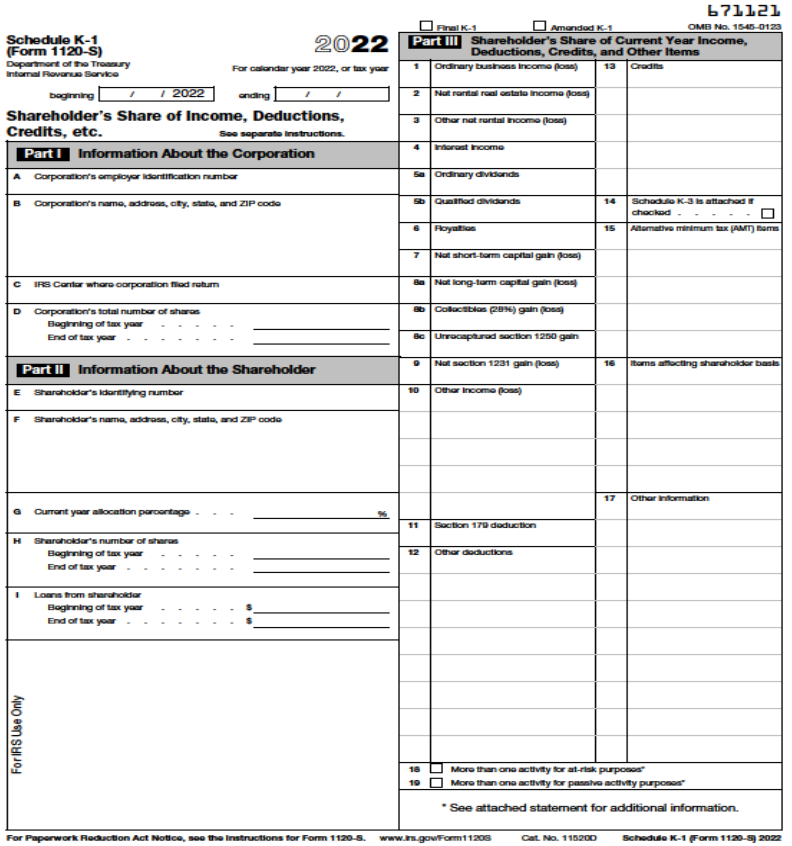
**Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items**

| | | | |
|---|---|---|---|
| 1 | Ordinary business income (loss) | 14 | Self-employment earnings (loss) |
| 2 | Net rental real estate income (loss) | | |
| 3 | Other net rental income (loss) | 15 | Credits |
| 4a | Guaranteed payments for services | | |
| 4b | Guaranteed payments for capital | 16 | Schedule K-3 is attached if checked ☐ |
| 4c | Total guaranteed payments | 17 | Alternative minimum tax (AMT) items |
| 5 | Interest income | | |
| 6a | Ordinary dividends | | |
| 6b | Qualified dividends | 18 | Tax-exempt income and nondeductible expenses |
| 6c | Dividend equivalents | | |
| 7 | Royalties | | |
| 8 | Net short-term capital gain (loss) | | |
| 9a | Net long-term capital gain (loss) | 19 | Distributions |
| 9b | Collectibles (28%) gain (loss) | | |
| 9c | Unrecaptured section 1250 gain | 20 | Other information |
| 10 | Net section 1231 gain (loss) | | |
| 11 | Other income (loss) | | |
| 12 | Section 179 deduction | 21 | Foreign taxes paid or accrued |
| 13 | Other deductions | | |

22 ☐ More than one activity for at-risk purposes*
23 ☐ More than one activity for passive activity purposes*
*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see the Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2022



Schedule K-1 (Form 1120-S) 2022

Department of the Treasury
Internal Revenue Service

For calendar year 2022, or tax year
beginning / / 2022 ending / /

**Shareholder's Share of Income, Deductions, Credits, etc.**
See separate instructions.

671121

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

**Part I Information About the Corporation**

A Corporation's employer identification number

B Corporation's name, address, city, state, and ZIP code

C IRS Center where corporation filed return

D Corporation's total number of shares
Beginning of tax year
End of tax year

**Part II Information About the Shareholder**

E Shareholder's identifying number

F Shareholder's name, address, city, state, and ZIP code

G Current year allocation percentage %

H Shareholder's number of shares
Beginning of tax year
End of tax year

I Loans from shareholder
Beginning of tax year $
End of tax year $

**Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items**

| | | | |
|---|---|---|---|
| 1 | Ordinary business income (loss) | 13 | Credits |
| 2 | Net rental real estate income (loss) | | |
| 3 | Other net rental income (loss) | | |
| 4 | Interest income | | |
| 5a | Ordinary dividends | | |
| 5b | Qualified dividends | 14 | Schedule K-3 is attached if checked ☐ |
| 6 | Royalties | 15 | Alternative minimum tax (AMT) items |
| 7 | Net short-term capital gain (loss) | | |
| 8a | Net long-term capital gain (loss) | | |
| 8b | Collectibles (28%) gain (loss) | | |
| 8c | Unrecaptured section 1250 gain | | |
| 9 | Net section 1231 gain (loss) | 16 | Items affecting shareholder basis |
| 10 | Other income (loss) | | |
| | | 17 | Other information |
| 11 | Section 179 deduction | | |
| 12 | Other deductions | | |

18 ☐ More than one activity for at-risk purposes*
19 ☐ More than one activity for passive activity purposes*
* See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see the Instructions for Form 1120-S. www.irs.gov/Form1120S Cat. No. 11520D Schedule K-1 (Form 1120-S) 2022

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# Tax Issues Related to Schedule K-1

Responsible for reporting share of business income/deductions onto Federal and various state returns.

This may mean additional state tax filings.

No tax withholdings, versus W-2.

You are now required to pay your Federal and state taxes by way of quarterly estimated tax payments (due 4/15, 6/15, 9/15 and 1/15 of the following year.

Estimated taxes can be computing using one of two methods to avoid IRS penalties.

- Safe estimate method – based upon 110% of the prior year's tax
- Annualized Income installment Method - based upon 90% of current year's projected tax.

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# Tax Issues related to Schedule K-1 (continued)

## You may be eligible for additional deductions.

- Interest on Capital Account loans
- Health insurance
- Unreimbursed business expenses
- Pension plan contributions

## You are now subject to additional taxes.

You now have to pay Social Security and Medicare. Instead of the Firm paying 50% of these taxes (when you were employee), you now are responsible for 100% of these taxes (doesn't apply to S Corp shareholders).

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# Tax Issues related to Schedule K-1 (pension)

You may be eligible for larger contributions/deductions.

Depends upon overall compensation to a maximum of $72,000(Profit Sharing)

You can also get the deferral of a 401k.

Maximum deferral for 2026 is $24,500

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# Tax Issues related to Schedule K-1 (Unreimbursed business expenses)

You may be eligible for additional deductions for unreimbursed business expenses.

- Automobile expenses
- Meals (not entertainment) expenses
- Assets like computers or furniture
- Home office expenses

These costs are picked up on your personal tax return.

Need to keep good records (calendar, receipts mileage log)

Has to be a business purpose

Cannot be extravagant

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# Partners in Partnerships/LLC's

| | | | |
|---|---|---|---|
| **Non-Equity Partner** | Usually compensated by means of a guaranteed payment ("GP") | Usually guaranteed, despite profitability of the law firm (check your partnership agreement) | This is essentially your salary. It is reported on a separate line on Schedule K-1 |
| **Equity Partner** | Depending upon agreement, you may receive a GP and a share in the Firm's profits | GP and share of profits will be reported on different line on the Schedule K-1 | Share of profits is reported on personal return (Phantom Income – profits with no cash to pay the tax (Firm may make a special "tax" distribution, so these taxes can be paid). |

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# Law Firm Owner Tax Administrative Burden

If an owner in a pass-through entity (partnership/S corporation) you may be subject to additional domestic and international tax reporting requirements, ordinarily absent from just a wage situation.

Domestic – additional forms that are needed to compute tax effects of income, deductions and credits being reported on Schedule K-1.

International – additional forms may be necessary to pick up ant foreign income or transactional activity or credits.

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# Law Firm Owner Tax Administrative Burden (continued)

If an owner in a pass-through entity (partnership/S corporation) you may be subject to additional state tax reporting requirements, ordinarily absent from just a wage situation.

The Firm may be required to make a nonresident tax payment on your behalf.

You will need to file a state return and apply these payment to any tax calculated.

The Firm may decide to make pass-through entity tax payments.

This provides q direct deduction against Federal taxable income bypassing the state tax itemized deduction limitation.

You will need to file a state return and apply these payment to any tax calculated.

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# Law Firm Owner Tax Administrative Burden (state taxes continued)

## Composite tax filings

Many states allow the law Firm to combine all their nonresident partners/shareholders onto one consolidated return, which is filed on their behalf

| | | | |
|---|---|---|---|
| You, personally do not need to file | Income usually taxed at highest state tax rate<br>• You may have a better financial result if you filed yourself | Requires you to "elect" this treatment on a yearly basis (sometimes requires an affidavit) | If you have other types of income allocable to the particular state, you may not qualify |

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# Law Firm Owner Tax Administrative Burden (Composite filings continued)

## Composite tax filings

Composite tax filings are allowed in the following states in our general geographic area: Pennsylvania, New Jersey, New York, Delaware, and Maryland

| | | | | |
|---|---|---|---|---|
| You have to elect yearly (if offered by your firm) | Income usually taxed at highest state tax rate | Highest tax rate assessed – not deductions against income generally available, if allowed by state | Not all states allow this type of filing. | If not all nonresident partners/shareholders elect in – make cause problems for the law firm, especially S Corporations (disproportionate distributions) |

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# What if your Firm is a C Corporation?

You do not receive a Schedule K-1, only a W-2.

Simpler structure and not as much administrative burden, from a tax perspective.

- However, does not offer the flexibility that pass-through entities do.

Estimated taxes not required, but tax withholding amounts and allowed deferrals (such as a 401k) need to be calculated.

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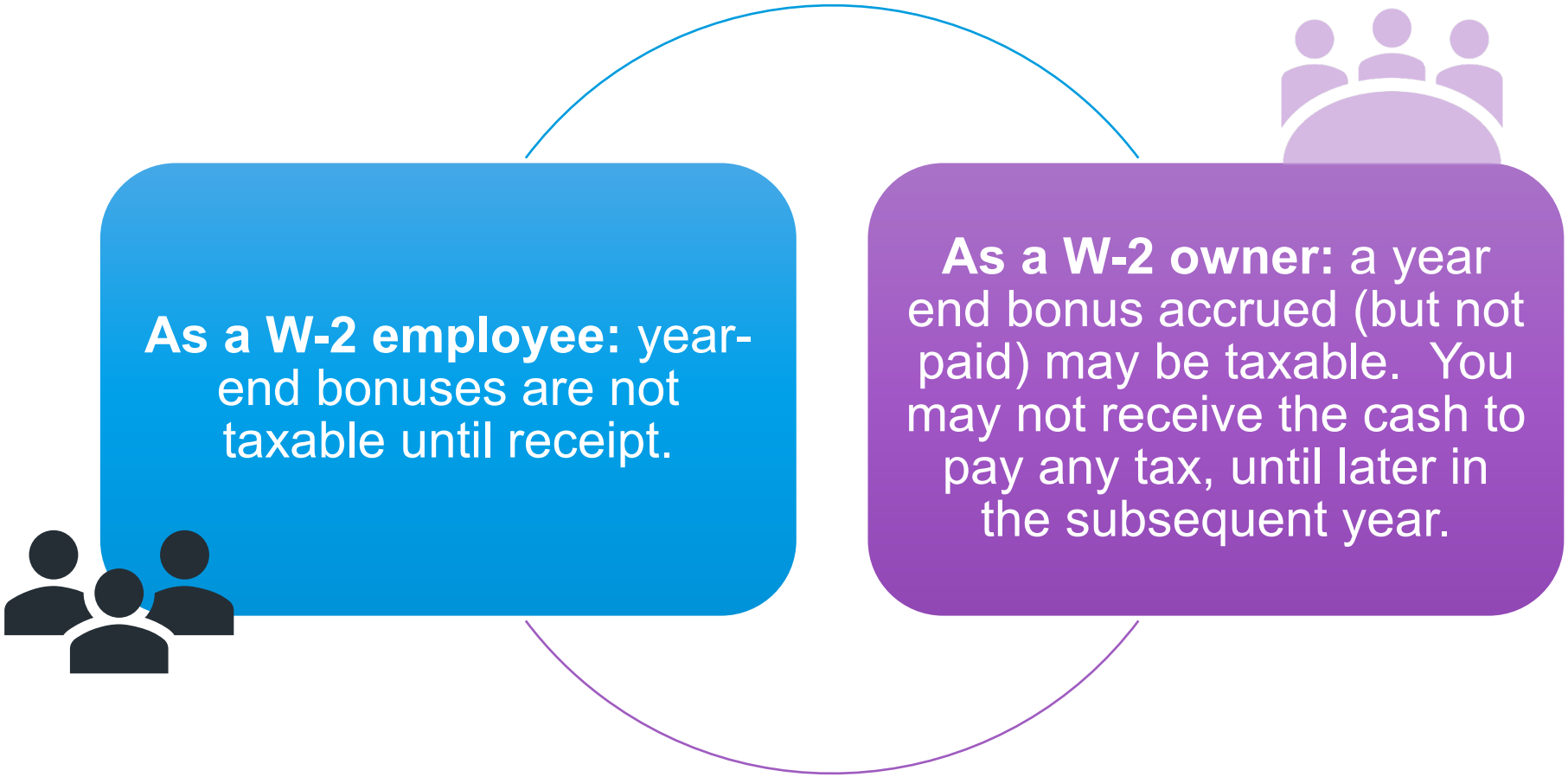
# Law Firm Ownership receiving a W-2

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# C Corporations & Benefits

## Fringe Benefits

Pass-through Entities - Fringe benefits paid by the company for greater than 2% owners are taxable to the owners

C Corporation can deduct these expenses and the owner receives the benefit tax-free

## Retirement Plans

Defined benefit plans

Defined Contribution plans

- Profit sharing plans

IRA contributions

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# Financial Implications of being a Law Firm Partner/Shareholder

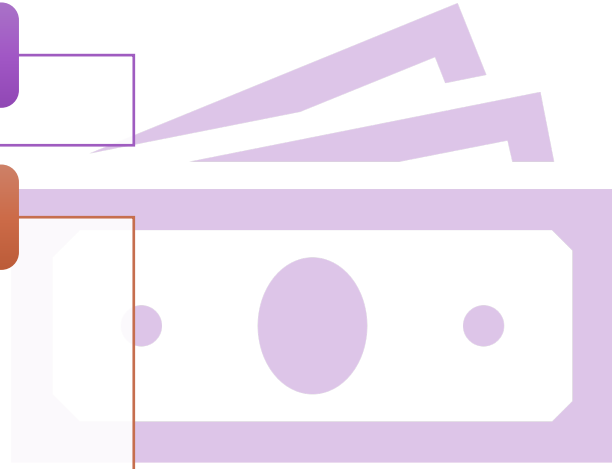
If a partner, you will be paying full cost of your benefits (taken from your distributions).

You may need or be required to make capital contributions.

If a Partner, or Shareholder in an S Corporation, you may receive a special “tax” distribution to provide the cash necessary to make April 15th taxes due.

Accordingly, it is important to manage your personal cash flow and monitor the firm’s financial status and how it affects you.

- Most law firm accounting departments recognize this and provide information from which the partners/shareholder may make tax computations.
- You need to review your partnership agreement, or corporate operating agreement to determine what you are entitled to.



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# Financial Implications of being a Law Firm Partner/Shareholder (continued)

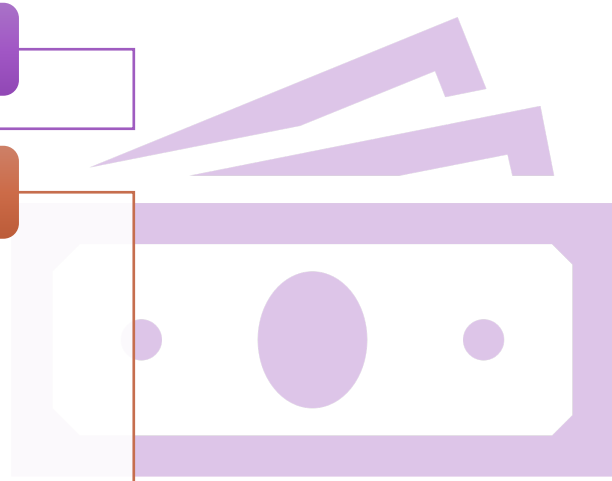
Some law firms will require “proof” of tax filings – for internal governance needs.

Cash will need to be accumulated and time carved out to calculate estimated taxes due on 4/15, 6/15, 9/15 and 1/15.

As a partner/shareholder you will need to keep good records of income and expenses to take full advantage of tax deductions (receipts, calendar, mileage log, etc.).

If your law firm has foreign operations, you may be required to file foreign disclosure statements with your tax return, even if you, personally, have no foreign dealings.

- Some law firm leadership/owners pool their resources (or those of the firm) to make investments for the benefit of the partners/shareholders, or the firm. Depending upon the type of investments, this can cause the complexity of your tax filings to increase.



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# Questions?