ALA Association of Legal Administrators

New York City Chapter

July / August 2013 www.alanyc.org

NEW YORK

NEW YORK

OUR MISSION

To provide the broadest level of education and relevancy to law firms and corporate legal departments of all sizes, cultures, interests, and practice areas.

{in this issue}

business

Law Firms: Why Entity Type Matters

Russell B. Shinsky, CPA
Anchin, Block & Anchin LLP Accountants and Advisors
russell.shinsky@anchin.com

Structure matters when attorneys think about setting up a new practice, merging into or acquiring another firm, or making a lateral move. The tax and financial ramifications are significantly different for each of these entities and must be evaluated as early as possible to avoid costly mistakes.

LLPs and LLCs

Today, most firms are structured as Limited Liability Partnerships (LLPs) or Limited Liability Corporations (LLCs) if there is only a single member. That's because there are some major advantages to this type of structure, the most important of which is its flexibility, both in compensating shareholders and the relative ease of bringing on lateral partners.

LLPs are treated as partnerships for income tax purposes, so they generally are not income tax-paying entities. However, LLPs conducting business in New York City and some other municipalities are subject to the New York City Unincorporated Business Tax (UBT) or similar entity level tax in other areas.

The partnership tax structure also allows a firm, subject to a properly drafted and executed partnership agreement, to allocate income and expense in percentages that may not be pro rata to equity ownership percentages. For example, suppose a two-partner firm made $1 million of profit and the partners were each 50% owners. On its face, that would mean that each partner would get an equal share of the profits, but the partners could agree to divide the profits according to a different formula if they wish, as long as the decision is made before the partnership's income tax returns are filed. Since the firm's income passes through to the partners, each partner is responsible for paying tax on their share of the income reported to them. If partner A in our example received 60% of the profits and Partner B got 40%, then partner A would have to pay tax on $600,000 of income, while Partner B would be reporting $400,000.

Equity partners in the firm are not employees and, as such, their compensation is not reported on a W-2 form. Instead, they receive a draw from which no payroll or withholding taxes are deducted. Each partner is responsible for paying estimated income tax payments instead of the withholding tax they would have had on a paycheck, as well as self-employment taxes (i.e., the equivalent of the employee and employer portions of Social Security and Medicare taxes). Normal employee benefits such as health insurance and profit sharing contributions related to partners usually are charged as a draw to the individual partner, not as expenses of the firm in the partnership structure.

LLPs also provide flexibility in bringing in lateral partners. Compensation for these partners (whether equity or non-equity can be a formula based on performance and collections, or can be a fixed amount. The structure allows final compensation to be determined after year end and still reported to that partner on a schedule K-1 for the appropriate tax year, even if part of the payments are not distributed until the following year.

continued on page 20

law firms: why entity type matters

continued from page 19

Unlike most general partnerships (where each partner could have unlimited liability), each partner's liability in a LLP is limited to his or her capital investment in the firm. There is an exception to this rule: a partner who commits (or directly supervises someone who commits) what is determined to be a tortuous act may be personally liable beyond his or her capital contribution. As such, partners in these entities are aware of the exact amount of their maximum exposure to creditors or claimants against the firm as long as they are not personally responsible for the commission of a tortuous act.

Professional Corporations

Law firms can also be organized as professional corporations (PCs), which can be structured as either C Corporations or S Corporations. The personal liability protections of these entities generally are similar to those of an LLP. Although stockholders in these entities often refer to themselves as partners, they are actually stockholders in a corporation.

C Corporations

C Corporations are tax-paying entities similar to most public companies. All employees (including stockholders) are paid a salary from which withholding and employment taxes (i.e., Social Security and Medicare) are deducted. Stockholders may also receive a pro-rata distribution of the corporation's after-tax profits in the form of a taxable dividend, which would be paid pro rata based on stock ownership. The advantages to this type of firm structure involve less complex tax reporting and better deductibility of certain fringe benefits such as health insurance and profit sharing contributions.

The disadvantage of C Corporations is that the firm needs to have a "crystal ball" to be able to determine what the profitability will be at year end so it can allocate the profits and pay them out as salary before the end of the year. If the estimate is not accurate, a larger than expected corporate tax bill will result, which can create a potential drain on cash flow and inadvertently harm the firm's financial results for the year. The process can be quite stressful based on tight deadlines and the negative impact of an inaccurate projection of income.

S Corporations

S Corporations pass income through to their stockholders, similar to a partnership. The key differences are that:

- There may not be more than 100 stockholders.
- An S Corporation must allocate profits to its stockholders based on ownership percentages in effect during the year. If the firm chooses to make any "special allocations" on profits, that must be decided and paid out as salary adjustments before the end of the year.
- The firm's income (after stockholder salaries) is reported on a Schedule K-1. Stockholders receive a W-2 for their wages. However, the amount reported on the K-1 may not necessarily be the same as the amount of cash a partner or shareholder receives during the year, as there could be certain profits retained as capital, and many firms distribute a certain level of annual profits after the year has closed.

Summary

The decision about how an entity should be formed is complex, and depends upon many tangible and intangible factors. For instance, if future mergers or acquisitions are a consideration, it may be wise to review how potential merger candidates are structured. It is much easier and far less costly to merge two partnerships (or two PC's) than to merge a PC and an LLP. If you're creating a new firm, entity structure is extremely important because it will be key to expansion or exit strategy. The best advice is relying on your professional advisors to review and analyze the firm's particular situation before making a decision.

Russell B. Shinsky, CPA is a Partner at Anchin, Block & Anchin LLP Accountants and Advisors. He can be reached at russell.shinsky@anchin.com

Quick Guide to Law Firm Entity Structure

	Taxation	Fringes and expenses		Personal liability	Other
LLP or LLC	Taxed as partnership; Equity partners do not receive W-2s and are not subject to payroll tax deductions	Fringes such as health benefits and profit sharing are not a firm expense	Expenses usually charged as draw to the individual partner	Partners' personal assets not at risk as long as they do not commit tortuous acts; liability limited to the partner's capital contribution	Partner compensation not necessarily on pro rata basis; advantages to lateral partner compensation agreements
PC-C Corp	Taxed as corporation; partners receive W-2s	Salaries, health benefits and profit sharing are considered expenses of the firm	Expenses considered expenses of the firm	Stockholders' personal assets not at risk as long as they do not commit tortuous acts; liability limited to the stockholder's capital contribution	Taxed at flat rate of 35 percent
PC-S Corp	Taxed as pass through entity; partners receive W-2s on salary and profits or losses reported on the firm's K-1	Salaries, health benefits (depending on ownership percentages) and profit sharing are considered expenses of the firm	Most expenses are considered expenses of the firm	Stockholders' personal assets not at risk as long as they do not commit tortuous acts; liability limited to the stockholder's capital contribution	100 stockholder limit; taxed at Partner's individual tax rate

special events

ALANYC Presents the 2013 Financial Forum

Letters From Attendees

To Our Financial Forum Committee: What an amazing, awesome, great job. I never heard anything but kudos all day. You helped put together a program which:

- Had the chapter gain a new Founders Level Business Partner — Anchin Group — who got rave reviews
- Engaged a member (for the first time) here at home who is a national ALA speaker — Fred Esposito — who got rave reviews
- Had national members (including a firm managing partner!) come from Florida (2), Delaware, Washington, D.C., Long Island, New Jersey, and Boston (2)
- Re-engaged a member who dropped out and subsequently rejoined the chapter
- Provided a segment of our membership education who had been under served

And we had a great time and made some new friends along the way! Here are some messages that were sent to me from attendees of this year's Financial Forum:

MaryBeth Tamulevicz, Posternake Blankstein & Lund LLP

Patricia, as a member of the Boston Chapter and an attendee at yesterday's Financial Forum, I wanted to extend my thanks and my compliments for a wonderful event. The sessions by Russell Shinsky and Bob Crumley were exceptional and the other sessions were equally well done. I am sure you and your committee put a tremendous amount of effort into the program and it really showed. The conference center facility was just great. I had the opportunity to speak with Patti Genn, Sharon Stewart and Henry Macchiaroli several times and they extended every kindness to me, even though I am a Red Sox and Bruins fan. Thanks again for ALANYC's hospitality and I hope to meet you again at future events.

Frank W. Monfalcone, CPA, Harris Beach PLLC

Hi Pat. Great job coordinating the forum. Loved the sessions. Looking forward to next year.

Robert Williams, Perlman and Perlman

Pat: I don't often have the opportunity to step away from the office to attend seminars, but this was well worth it. You and the other members did a great job of organizing and executing this session. Look forward to more!

Debra Crandon, Simpson Thacher & Bartlett LLP

Patricia, in my opinion, yesterday's Financial Forum presented the attendees with a useful array of beneficial topics relevant not only to Financial Managers, but to Law Firm Management as a whole. The keynote speaker, Russell Shinsky, Partner at Anchin Block & Anchin, was a good choice to commence the day. Thanks to all for putting together a great event.

John Stedman, McCarthy Fingar LLP

It was a success! Every program had something to offer. Presenters were great. Thank you to you and the team's hard work to put out this program.

The educational materials from our ALANYC Financial Forum can be found on our chapter's website:

http://www.alanyc.org/index.php/en/new-members-list-2/financial-forum

Keynote Address

Peter Manzi introducing speaker

Laura Eichenseer
First American Equipment Finance

Ian Matyjewwicz, Esq.
Herbert Jamison & Co.

Russell Shinsky, CPA

Russell Shinsky, CPA

Barbara Allen-Watkins, Briane Grey, Scott Hennon, Peter Manzi
City National Bank