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2023 Year-End Planning Guide

Law Firm Group

As we go to press with our year-end planning guide, we can look back at a challenging year, both economically and in terms of tax planning. This past year has shown how the impact of high inflation and market volatility can alter how we live and do business. Staying one step ahead in this environment means being informed by understanding the current rules, being flexible by keeping abreast of potential changes, and being ready to act by starting to prepare for what might come.

This guide offers a variety of strategies for reducing your taxes in the current environment and a discussion of issues that could impact your firm. We encourage you to use this guide to identify the best strategies for your situation, along with guidance from your tax advisor, who can keep you apprised of any new tax law developments that might affect you. With many facing difficult and uncertain times, solid financial and tax planning is required now more than ever before. The sooner you focus on your tax situation and the available tax planning opportunities, the more likely you are to put yourself in a better financial position. While we *cannot* predict the future, we *can* assist you with your current and future tax planning.

Navigating business and tax planning is a complex undertaking. Thoughtful planning goes beyond simply reducing taxes for the current and future years; it requires consideration of various factors and adherence to a multitude of rules. The intricacies involved in tax planning necessitate a comprehensive approach, acknowledging the multifaceted aspects of the process.

As you go through the guide, it is important to remember to consider what type of entity your firm operates as, e.g. - a Professional Corporation ("P.C.") has different considerations than a Limited Liability Partnership ("LLP"). We hope you find the tax strategies and business considerations outlined in this publication helpful.

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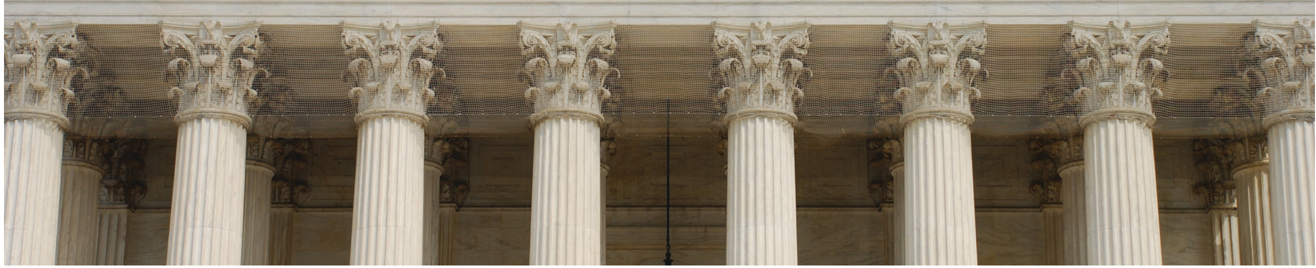


State of the Industry

Presently, the legal industry finds itself at a pivotal moment, with the potential to reshape the future of law firms in ways that were once considered unimaginable. Many law firms have recently announced the adoption of significant increases in associate bonuses and base salaries. In light of the current economic landscape, signing bonuses have diminished; however, firms must now consider substantially raising rates to sustain profitability amid rising expenses. It is important for firms to consider whether clients will accept another round of substantial rate increases or resist covering the costs associated with first-year associates.

In 2023, a significant number of law firms, some of which had been operating for over a century, closed their doors. Partners leave firms for various reasons, such as the prospect of higher compensation, a lack of associate support, in-house opportunities, and a loss of faith in management. Partner lateral movement has slightly decreased since last year and associate lateral moves have decreased significantly which is likely due to the uncertainty of the current economic climate and reduction in demand. Counsel and associates leave firms for compensatory increases, better opportunities, better quality of life promises and a potential or faster route to becoming partner at their new firm. It is no surprise that some of the most prestigious law firms in the AmLaw 100 are considering for the first time, or have already created (or expanded), a non-equity level to retain their senior attorneys, who may be offered the prestige of a Partner title at another firm.

The challenges facing law firm management today include reduced billable hours/demand, a decline in M&A work of up to 40% year-over-year, which had been booming even throughout most of the pandemic. Additionally, associates coming out of law school indicate they are not looking to stay beyond three years at their first firm, when it takes several years to achieve full profitability in their role. In addition, law firms are facing challenges in bringing their employees back to the office, with some firms now instituting mandatory four-day in-office work requirements, and more firms considering this to facilitate attorney development.

The most significant challenge for the future of law firms is the impact of Generative Artificial Intelligence (GenA.I.), often colloquially referred to as ChatGPT. While firms have integrated discriminative A.I. services like eDiscovery for years, law firms are just beginning to explore the potential of GenA.I. in the performance of legal services. An earlier Walters Kluwer survey of managing partners indicated they overwhelmingly think that GenA.I. will greatly enhance firms' efficiencies and differentiate successful firms from unsuccessful ones. However, most believe it won't significantly affect the real value-added work involved in high stakes litigation and M&A. In their recent survey, 73% of law firms, corporate legal departments and business service firms expect to integrate GenA.I. into their legal work in the coming year. But, with challenges, come opportunities. First, while inflation has been increasing, it has slowed of late; the recession we have been expecting hasn't fully materialized, and the latest consensus from the Blue Chip Economic Indicators report has dropped to just under 50% for a recession to materialize in the next 12 months. The Fed has indicated interest rates may start coming down in 2024, legal departments indicate a further interest in outsourcing work, and GenA.I. may allow adaptive firms to work even more effectively.

In summary, the legal industry is undergoing significant transformation, grappling with challenges and opportunities that redefine the future of law firms. As the legal landscape evolves, strategic adaptation and innovation will be key to shaping the success of law firms in this dynamic era.

Considerations for Traditional Year-end Tax Planning

As the year-end approaches, it is important for your law firm to consider the opportunities and planning strategies below as they may provide alternative outcomes which can ultimately result in cost savings and meeting your financial targets. Before acting on any of these, taxpayers should thoroughly analyze the proposed financial activities and alternative outcomes. Although tax planning is a 12-month activity, year-end is traditionally the time to review tax strategies from the past and revise them for the future.

As the end of 2023 approaches, major tax changes from recent years remain in place. This makes year-end planning more predictable. In addition, the impact of inflation makes the planning process even more important for most taxpayers.

Acceleration or deferral of revenue and deductions

In managing year over year bottom line, if your law firm uses the cash method of accounting, you may want to consider managing revenue and/or expenses. For example, you may need to make a push for collections or accelerate or delay expenses.

Treatment of client retainers

Law firms, commonly opt for simplicity in financial management, often utilizing either the modified cash or income tax basis of accounting as the preferred method. They often find the cash basis approach more straightforward given their service-based industry where billable hours and client retainers are key sources of revenue. But an issue is often raised: Is a retainer taxable to the firm upon receipt or deferrable for a cash basis taxpayer?

In general, a cash basis taxpayer records income at the time cash is received, and records expenses when paid. If a retainer fee is received by a law firm and is deposited in the general operating account, the firm has an unrestricted right to the funds, and it would typically be considered taxable income in the year it is received. This is because the firm has ownership and control over the funds, regardless of whether the services associated with the retainer have been performed. However, there are certain situations where the Claim of Right Doctrine might apply. The Claim of Right Doctrine allows a firm to defer the inclusion of income if there is uncertainty about their right to access the funds, perform future services, or a potential refund of the retainer if services are not fully rendered. A firm may be able to defer the recognition of that income until the right to retain it is established. Under this approach, the retainer must be deposited into a segregated escrow account and the firm may not keep interest earned on the funds.

It is important to note that tax laws and interpretations can be complex, and the recognition of income from retainers can vary based on numerous factors. Additionally, the ethics rules under various State Bars may have different requirements in dealing with retainers. Specific retainers required to be segregated from the general operating account are excluded from income as no accession to wealth has occurred. Specific terms should be incorporated into the retainer agreement and caution needs to be exercised when accounting for, and depositing retainers, into their respective accounts.

Client costs

Law firms typically incur costs for work on a client's behalf. These costs can be grouped into two categories: hard costs and soft costs.

Soft costs are non-specific, internal expenses that do not require a separate client payment but are attributable to a client matter. Examples of client related soft costs include phone calls, photocopies, and internet services. Since these are expenses that the firm already pays, they are considered necessary costs of doing business and are currently deductible.

Hard costs are expenses incurred specifically on behalf of a client, where payment is made directly to a third party. For example, when a firm pays for deposition or expert witness fees, some may assume the law firm can deduct these payments as a business expense, regardless of their fee agreement, but that is not the case. Out-of-pocket hard cost expenses incurred by a firm on behalf of clients are not deductible because reimbursement is expected once a settlement or judgment has been obtained. Plus, since ethics rules generally require clients to bear the costs of a litigation, these outlays are treated as client advances (i.e. – loans). Therefore, the correct course of action is to treat client costs as a loan receivable from the client until the case is settled. Once a case has concluded, hard costs are generally recovered from the proceeds of the settlement first. The remaining share of the judgment proceeds that the firm receives is recorded as fee income. If the expenses are deemed uncollectible, then the costs are written off as a bad debt.

If you are deducting hard costs as you pay them, then the Internal Revenue Service ("IRS") can assign them to the earliest open year giving rise to tax, penalties and interest. There are many cases out there, such as *Pelton & Gunther*, *P.C. v. Commissioner* and *Boccardo v. Commissioner* that prove firms lose this battle when challenged by the IRS (unless using a gross fee arrangement but, then you will need to prepare to go before the Ethics Committee).

Is Your Law Firm Eligible for Enhanced Depreciation Opportunities?

Below are discussion points on some of the methods available for taxpayers to accelerate depreciation and reduce current year income and related taxes. There are several options and scenarios law firms need to consider when assessing what is most beneficial for them, particularly if looking to match cash flows to phantom income on debt repayment if used for funding buildouts.

Internal Revenue Code (IRC) Section 179 Expensing

Under IRC Section 179, law firms may elect to expense qualifying property up to certain dollar limitations. To be eligible, property must be purchased for use in a trade or business. Tangible personal property, e.g. - furniture, fixtures, carpets, etc., is eligible for this deduction.
For law firms, the cost of "qualified real property" is also eligible.

This includes qualified improvement property (discussed below) as well as the following expenditures made to nonresidential real property after the property was originally placed in service: HVAC, fire protection and alarm systems, as well as security systems. Land improvements are not eligible.

For tax year 2023, the maximum deduction under Section 179 is $1,160,000. This is set to increase to $1,220,000 for tax year 2024. There is a dollar-for-dollar phase out once the amount of qualified Section 179 property placed in service exceeds $2,890,000 in 2023. For example, if a taxpayer has $3,200,000 of qualifying property, the maximum deduction they can claim for tax year 2023 is $850,000 ($1,160,000 reduced by $3,200,000 less $2,890,000 ceiling). The deduction is completely phased out if $4,050,000 of qualifying property is placed in service during 2023. This limitation is potentially calculated twice: once at the firm level and then again at the owner level if the firm is a pass-through entity.

In addition to the limitations discussed above, Section 179 expensing is limited to the trade or business income of an activity. Unlike bonus depreciation (discussed below), it cannot create a net loss for the firm. For purposes of this deduction, trade or business income is calculated before factoring in any deduction under Section 179.

Firms need to understand the state tax implications of Section 179 expensing. For example, New York State and City follow the federal tax treatment of Section 179; however, some states such as California and New Jersey limit the deduction to $25,000.

Additional First Year Depreciation (Bonus Depreciation)

Currently, bonus depreciation enables taxpayers to depreciate 80% of the purchase price of qualifying property in the year it's placed in service (60% in 2024). To qualify, the property must have a recovery period of 20 years or less, be depreciated using the modified accelerated cost recovery system (MACRS), and placed in service after September 27, 2017, and before January 1, 2024. For law firms, this typically includes, but is not limited to, furniture, fixtures, equipment and qualified improvement property as discussed below.

Law firms can take bonus depreciation on qualified improvement property (QIP). QIP is defined as property that is an interior improvement, placed in service after the date the building was first placed in service, made by the taxpayer, and placed in service after December 31, 2017. QIP does not include elevators and escalators, internal structural framework and improvements that relate to the enlargement of the building. Law firms that are considering receiving tenant allowances should be aware that there may be adverse tax consequences based on the terms of the lease agreement. If not properly structured, these tenant allowances could be deemed taxable income currently, with corresponding deductions spread over the life of the asset relating to the tenant allowance. Care must be taken when negotiating lease agreements.

Bonus depreciation will gradually be eliminated over the coming tax years. Any qualifying assets placed into service in 2023, will only be eligible for bonus depreciation equal to 80% of the purchase price. The deduction will continue to drop by 20% per annum until bonus depreciation is completely phased out for assets placed in service on or after January 1, 2027.
When considering bonus depreciation, law firms need to assess the state implications for their owners. Many states do not conform to federal bonus depreciation. At the state level, there is typically an addition and subsequent subtraction adjustment over the depreciable life of the asset passed through to the owners that reverse the federal benefit of the bonus depreciation.

De Minimis Exception

In addition to Section 179 and bonus depreciation elections, also consider the election that is available for *de minimis* asset purchases if certain requirements are met. With this election in place, your business may simply expense costs that fall below a specified level to the extent that the amounts are deducted for financial accounting purposes or in keeping with your books and records. The *de minimis* threshold can be up to $5,000 if your firm has financial statements audited by an independent certified public accountant (CPA) or issued to a state or federal agency; the threshold is $2,500 for businesses without such financial statements. This is applied on an item-by-item basis.

Cost Segregation Studies

Cost segregation studies provide law firms with a powerful depreciation accelerator when leased space is being or has been renovated. A cost segregation study identifies and quantifies the various components of both purchased and constructed assets. This quantification enables law firms to depreciate components of their renovated leased space using shorter lives. If the assets are eligible, law firms can take accelerate depreciation on the segregated leased space components.

Cost segregation studies do not need to be performed in the year the leased space was renovated. Law firms can implement studies in subsequent tax years. If a business chooses to implement a study in a future year, they must recalculate the depreciation that was in effect the year the renovated leased space was placed in service. For example, a law firm places a property in service during 2023. They have a cost segregation performed in tax year 2024 subsequent to the filing of the 2023 tax returns. The law firm can still accelerate depreciation, e.g. - bonus depreciation 80%, on any eligible property when the adjustment is made on the 2024 tax return since it relates to a 2023 purchase.

Conclusion

The above discussion highlights some of the high-level items that law firms need to analyze when strategizing how to maximize their depreciation. Careful planning and analysis of future projects is critical to make sure depreciation is utilized in the most tax efficient manner.

Excess Business Loss Limitations – Federal and New York Considerations

Generally, most law firms do not operate at a loss. However, for law firms operating as a pass-through entity (Partnership or S Corporation) that do generate a net operating loss, e.g. – class action firms, the individual partners/shareholders of these firms may be subject to the "Excess Loss Limitations."

Prior to the Tax Cuts and Jobs Act (TCJA) of 2017, individuals were able to deduct their total law firm loss against their other sources of income. If the law firm losses exceeded the other sources of income, a net operating loss would be created.
This loss could either be carried back to offset income from prior years or carried forward to future tax years at the election of the taxpayer.

The TCJA limited the deductibility of business losses for individual taxpayers beginning with the 2018 tax year. For 2023, trade or business losses are limited to $578,000 for married couples and $289,000 for single taxpayers.

Any "excess business loss" that is not deductible in the current year is carried forward as a net operating loss which can be used to offset income from a future tax period (under an 80% limitation rule).

The Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020 suspended the excess business loss limitations for tax years 2018 - 2020 at the Federal level. It was set to sunset December 31, 2025, but the Inflation Protection Act of 2022 extended the excess business loss limitation through 2028.

Impact on New York State Taxpayers

Careful consideration and planning surrounding New York (or other states with similar regimes) who may or may not have decoupled from Federal depreciation guidelines is needed when assessing the benefits of accelerated depreciation. Additionally, the rules relating to net operating losses and the excess loss limitation may differ between Federal and State tax treatment.

Managing the Deductibility of Interest Expense

For tax years beginning after December 31, 2017, the TCJA limited the interest expense deduction to 30% of adjusted taxable income.

For tax years beginning after December 31, 2021, adjusted taxable income does not include the addback adjustment for depreciation and amortization.

The sunsetting of the depreciation and amortization adjustment provisions further limited the deductibility of interest expense for law firms. Any limited interest expense is suspended until there is either future income or a disposition of the activity.

Law firms that are considered “small business taxpayers” are exempt from this interest expense limitation.

To qualify, a taxpayer’s average gross receipts from the prior three years must be less than $27 million.

State and Local Taxes

Pass-Through Entity Tax (PTET)

The state and local tax deduction was limited to $10,000 for tax years after 2017 under the Tax Cuts and Jobs Act. Taxpayers in high tax states lost a significant deduction that reduced their federal income tax liability.

Some high tax states proposed various work-arounds to provide residents with a way around the $10,000 limitation. The most popular work-around was to impose a tax on pass-through entities where the owners of the pass-through entity would receive a credit on their individual returns offsetting the tax liability due on the pass-through income. In turn, the pass-through entity would deduct the state taxes paid thereby reducing the federal income ultimately passing through to the partners/shareholders.

In November of 2020, the IRS issued Notice 2020-75, clarifying that a pass-through entity would be entitled to a deduction equal to the state taxes paid to a state for an entity tax where the partner or shareholder would receive a credit of up to 100% that would reduce their state tax liability by the amount of taxes paid. With the release of this Notice, some 36 states and New York City have passed or proposed their own PTET regime. California, Connecticut, Massachusetts, New Jersey, New York and New York City have, to name a few. Each of these has different requirements to participate as well as different methods of calculating/utilizing the PTET credits.

- **New York State (“NYS”) PTET.** To participate in NYS’s PTET for 2024, the pass-through entity is required to file an election prior to March 15, 2024. NYS has different methods of calculating the tax for a partnership and a “resident S corporation” (all NYS resident shareholders) than it does for an S corporation with both NYS and non-NYS resident shareholders.

Partners and shareholders who receive an allocation of the NYS PTET credit will be able to offset their NYS (and NYC if applicable) tax liability with any excess eligible to be refunded. Please refer to our earlier Anchin Alert for more details on the NYS PTE Tax (https://www.anchin.com/news/anchin-alert-new-york-provides-clarity-on-the-new-pass-through-entity-tax-an-opportunity-for-tax-savings).

- **New York City ("NYC") PTET.** The NYC PTET is only available for partnerships with NYC resident partners and S corporations of which all shareholders are NYC residents. Nonresidents of NYC will not receive any benefit under the regime because the NYC personal income tax only applies to City residents. The NYC election is now available online; however, opting into the NYS PTET is required to be eligible for NYC's PTET election. Please refer to our earlier Anchin Alert for more details on the NYC PTE Tax (https://www.anchin.com/articles/official-guidance-on-the-nyc-pass-through-entity-tax/).

  Estimates. For both the NYS & NYC PTET regimes, estimates must be made in 4 equal quarterly installments based upon 100% of the prior year liability or, 90% of the current year liability. Annualization is not allowed within the PTET regime and this creates significant challenges for firms with significantly changing income throughout the year.

- **California PTET.** A PTET election is made on the entity's tax return. For tax years 2023 through 2025, an electing CA PTE must make two payments. The first payment for the greater of 50% of the PTET paid for the prior year or $1,000, must be made by June 15th of the taxable year for both calendar year and fiscal year pass-through entities. The second payment must be made by the pass-through entity's filing deadline without extensions. If the June 15, 2023 payment was underpaid or not paid, the entity is not eligible to make the election for the 2023 tax year. There are currently no exceptions to this rule, even if an entity anticipates its 2023 PTET liability to be less than 50% of its 2022 liability. Please refer to our earlier Anchin alerts regarding the CA PTET for more details (https://www.anchin.com/articles/what-you-need-to-do-now-to-be-eligible-for-californias-2022-ptet/, https://www.anchin.com/articles/will-you-benefit-from-the-expansion-of-the-pass-through-entity-tax-ptet/)

- **New Jersey ("NJ") PTET.** Tax year 2022 also saw law changes to enhance New Jersey's version of the PTET known as the Business Alternative Income Tax ("BAIT"). Specifically, the law modifies how the BAIT is calculated so that more income is subject to the tax, thus enabling a larger credit to be obtained. Under the revisions, a partnership's distributive proceeds upon which the tax is computed now include both in-state and out-of-state income for resident partners. The changes also provide that pass-through entities do not need to make nonresident withholding payments on behalf of a nonresident partner if the nonresident expects a refund of the withholdings as a result of the BAIT credit. Finally, a BAIT credit will be permitted for tiered partnerships and S corporations that are partners in partnerships. Such credits can be passed through to the partners or shareholders or applied against the tax liabilities of the partnership or S corporation and its BAIT liabilities. For additional information on these NJ changes, please see our Anchin Alert (https://www.anchin.com/articles/new-jerseys-bait-updates-provide-an-even-greater-tax-benefit/).

While the benefits of the PTET can be significant, before deciding to participate in a PTET, careful consideration should be given to where the owners live. If they are a nonresident of the state where the pass-through entity is domiciled, it is possible that their resident state would not allow an offsetting credit equal to the tax paid in the nonresident state (the PTET state). The impact on other tax attributes, such as the IRC Section 199A 20% pass-through entity deduction (if applicable), and the cash situation of the pass-through entity should also be considered.

Further, one should factor in potential PTET refunds which are generally taxable for federal income tax, as well as the economics of opting in specifically due to the rate differential between the PTET and the partners' individual income tax rates.

***Practice Tip:** Firms should be certain their operating agreements provide for the flexibility necessary for the PTET regimes. Planning should be done in advance to address withholding from partner/shareholder distributions to facilitate payments of PTET estimated taxes and the timing related thereto, and finally, true ups will be needed upon the filing of the actual PTET returns based upon individual credits vs. deductions.

State tax payments made on behalf of partners/shareholders:

A composite return is a state income tax return that may be filed by a law firm that is organized either as a partnership or S corporation that reports state income and pays the respective state income tax for nonresident attorneys. Composite returns are filed by law firms on behalf of their eligible partners/shareholders who are nonresidents of states from which their law firm derives income. This is done in lieu of the nonresident attorney filing a nonresident individual state income tax return on his or her own. Each state has their own set of rules regarding composite income tax returns. Some states require all nonresident partners/shareholders to participate in the return. Other states require each individual partner/shareholder to formally elect into the respective nonresident state's composite income tax return. Please keep in mind that if a partner/shareholder chose to not elect into a composite income tax return, that specific state may require the partnership/S corporation to pay nonresident withholding to that state instead of composite return estimated tax payments. The payment by a partnership/S corporation of composite income taxes and nonresident state withholding are typically treated as partner/shareholder distributions and not an expense of the firm.

Distributions reduce partners' capital or shareholders' AAA. Additionally, each partner/shareholder's composite income taxes and nonresident withholdings may **NOT** be in the same percentage as their overall income and/or ownership percentage. Each distribution will be allocated based on the specific partner/shareholder share of the taxes that are being remitted on their behalf by their firm.

State Income Sourcing - Law Firms

Law Firms, like other service businesses need to contend with two concepts in state taxation:

1) **Nexus.** Is there enough of a connection to a state or local tax jurisdiction to require the filing of a return?

- **Physical.** The firm has enough of a physical connection to a state, e.g. – property or payroll within the state.
- **Economic.** Where there is enough of an economic connection, even without a physical one to require the filing of a return with the state.

2) **Revenue Sourcing.** How is income apportioned amongst the states?

- **Cost of Performance ("CoP").** Where the services are physically performed.
- **Market Based Sourcing ("MBS").** Where the benefit of the service is received.

Most firms have long been familiar with the traditional CoP concept, meaning "boots on the ground", but not the MBS rules.

MBS first came into being back in the 1980's, and since then, almost 40 states have adopted MBS rules for both corporate and unincorporated businesses. While the CoP concepts are fairly straight forward, the MBS provisions are far more complex. Here a firm must determine where the benefit of the service is received which is not always clear.

Different practice areas have different rules in determining where the benefit is received as do different types of clients. More and more states have been adopting MBS sourcing rules as these do not penalize employers for having property and payroll within the state and can bring in significantly more tax revenues from out-of-state businesses.

Telecommuting. Inquiries from clients about attorneys moving out of high-tax states have increased each year since the early days of the COVID-19 Pandemic, and 2023 was no different. The pandemic has proven that we can work remotely and has prompted many to explore and think about where they want to live and work.

Telecommuting Nexus. Employees working in multiple states create payroll withholding and state tax nexus issues for the employer and employee. Failure to properly withhold and/or remit payroll taxes can come at a high price if a state imposes a penalty on the employer. If a state considers the employer's failure to withhold to be intentional, it may have the power to impose a penalty as high as 100% of the amount of tax not withheld. Consideration must be given to employees that have transitioned to teleworking permanently or that have relocated during the pandemic as those work arrangements are no longer deemed temporary and will most likely require a change in reporting. This, of course, assumes the employer is aware of such changes on a timely basis which is not always the case. While interstate moves are most prevalent, international moves could create a Permanent Establishment ("PE") subjecting the firm to taxation in a foreign country.

States are continuing their attempts to implement and enforce their laws to find nonresident, non-filing taxpayers. Nexus remains a crucial element of managing a business's state tax risk. Nexus is a relationship or connection between two or more elements, entities or factors. In tax law, it is a relationship between a taxing authority, such as a state, and a business. A nexus must exist before a taxing authority can impose a tax on the enterprise, and it requires that there be a definitive link between the jurisdiction and the business. With employees relocating to other states and state budget shortfalls expected to continue into 2023 and beyond, taxpayers should expect to receive nexus inquiries from various state and local taxing authorities.

***Practice Tip:** For those employers allowing employees to work remotely, nexus implications need to be thought out not only for income, non-income and sales taxes but also for state payroll withholding taxes and unemployment insurance. Both physical presence and economic presence must be thoroughly analyzed for all potential state taxes when undergoing a nexus study to understand and better manage risk.

***Caution:** Due to significant fiscal constraints as a lingering result of the pandemic, all signs point to an increase in state audit activity. State letters with an intention to audit as well as nexus questionnaires and notices should be taken seriously and should be addressed timely. We stand ready as your expert partner to assist you in handling such communications and to help you proactively plan.

***Anchin Observation:** Law firms should, if they have not already done so, communicate with their employees to obtain the necessary information to determine possible state filings.

Sales & Use Tax

Generally, fees received for legal services performed are not subject to sales tax so many law firms do not file Sales and Use tax returns. However, law firms are required to pay sales tax on purchases of tangible personal property used in their trade or business. For example, if a law firm purchases a computer online and is not charged sales tax, that firm is required to remit use tax on a timely filed Sales and Use tax return. If a Sales and Use tax return is not filed, there is no statute of limitations. For non-filers, most states will audit and assess on the past six years. For routine filers, the statute is usually three years. Tax exams can be quite tedious and time consuming. General ledgers and invoices for an exam will be needed for the past three or six years. If you do not have all your invoices for the past six years and cannot provide proof that you paid the sales or use tax, then the state has the right to assess the tax, even if you did pay it.

The popularity of buying supplies online from out-of-state vendors is also problematic. While this type of purchasing, as well as catalog purchases, are likely to save money, they could also create a use tax liability.

When purchasing goods, it is important to keep in mind the state location of your vendors. If the vendor does not have nexus in your home state, then they might not necessarily be required to collect or remit sales tax pursuant to the *Wayfair* decision. However, it is still your responsibility to remit the use tax to the state in which the goods are received.

Form 1099 Reporting

The legal industry has its own set of unique challenges when it comes to 1099 reporting for both issuers and recipients alike. The IRS has recognized these challenges and provided guidance in the form of audit technique guides to help navigate those issues unique to the legal industry. Unfortunately, the unique 1099 reporting issues for legal services have still left much confusion. It is important to understand the issues for successful management of 1099 reporting. Following below are the basics on 1099 reporting:

Why is 1099 reporting important?

1099 reporting is a critical component of the U.S. tax system. 1099 reporting serves a crucial role in income reporting and documents deductions among other tax compliance functions. These forms serve as a major source of information for the IRS and state tax authorities.

Lawyers and law firms receive and send more 1099s than most taxpayers due to the extensive reporting requirements specific to the legal industry. The handling of client funds by firms sometimes involving significant amounts also attracts closer scrutiny.

1099-MISC versus 1099-NEC

In 2020, the 1099-NEC was introduced in an attempt to clear up confusion surrounding the 1099-MISC and self-employment income reporting. The general use of each form is outlined below as it applies to legal services:

- **1099-MISC –** Use this form if your business is paying another lawyer or law firm for items such as taxable damages (box 3) or settlement proceeds (box 10) in a legal dispute. *Note: The amount reported in either box should not be reduced by attorney's fees. The deductibility of attorney fees is separate discussion beyond the scope of this article. Additionally, while box 3 indicates taxable income, box 10 is more informational as it represents gross proceeds, not necessarily taxable income.*

- **1099-NEC –** Use this form if your business is paying an attorney or law firm for its legal services provided to you. This includes co-counsel arrangements, fee splitting, or expert witness fees.

Who is responsible for reporting?

A key reason for the overreporting of Forms 1099 is that the IRS is unlikely to penalize anyone for issuing more 1099s than required. Generally, the defendant (whether person or, entity) or its insurer, not the plaintiff's attorney, is responsible for determining whether payments are taxable and need to be reported on a 1099. All payments are presumed reportable on a 1099 unless a specific taxability exemption applies, such as physical injuries. Given that law firms are often intermediaries of legal settlement payments, some possibility of being considered the payor exists and may not always be clear in either the guidelines or, regulations. The tax regulations are not incredibly clear in defining the oversight and management functions that would make the law firm the payor. Thus, many tax advisors look to be conservative and advise that a 1099 be issued when in doubt, especially in cases where it is uncertain to the defendant if, and to whom, the 1099 will be issued and unless there is a clear exemption from taxability. If duplication does occur, then it can always be corrected via subtraction on the recipient's return rather than the issuance of a corrected 1099.

	1099-NEC	1099-MISC
General Notes	The IRS reintroduced these forms in 2020 to better manage self-employment income reporting.	This form serves as a catch-all for payments not covered by the 1099-NEC.
Law Firms	NEC stands for nonemployee compensation. Your firm needs to issue this form to jury consultants, co-counsel, investigators, expert witnesses, and other professionals who were paid over $600 to assist in a case. These forms help substantiate the deductions on your business tax return.	Clients should *typically* receive this form from the payor, not your firm, for all taxable settlement payments reported in Box 3. Your firm should also *typically* receive this form from the payor for the gross settlement proceeds from the case reported in Box 10. Many law firms choose to issue their own 1099-MISC for all settlements, because the IRS regulations sometimes consider an attorney a "payor" if they play a significant role in the management and oversight of clients' settlement money. Your law firm also needs to issue this form to any client who receives a refund from the firm's direct income, rather than the trust account.
Clients	Any clients who paid $600 or more for your **legal services** while running their business should provide you with this form. This income is included on your business tax return.	Any clients who paid you $600 or more for **nonlegal services** while running their business should provide your firm with this form.
Due date	1099-NEC forms must be provided to recipients and filed with the IRS by January 31, 2024.	The deadline for furnishing 1099-MISC forms to **recipients** (if amounts are reported in boxes 8 or 10) is February 15, 2024. Meanwhile, 1099-MISC forms must be filed with the **IRS** by February 28, 2024. The due date is March 31, 2024, if filed electronically.

Law Firm Start Ups: Choice of Entity Considerations – Which Entity Makes the Most Sense for your Firm?

The choice of entity is among the most important decisions facing taxpayers when starting a new law firm. Choosing the appropriate type of entity is a complex analysis and is generally dependent upon many factors: type of legal practice, state nexus considerations, cash flows, and capital requirements. The TCJA included many changes that affected this analysis. One of the headline changes was the top C corporation tax rate “permanently” decreased from 35% to a flat 21%. Taxpayers should keep in mind that current tax proposals could raise tax rates and make other changes to the federal income tax system for corporations and high-wealth individuals. These proposals should be monitored, and their potential effects should be considered when evaluating the short and long-term benefits of a particular entity choice.

C Corporation: While the TCJA reduced the federal corporate rate from 35% to 21%, it did not change the tax rate on distributions from a corporation to its shareholders. Qualified dividends received by non-corporate taxpayers are still taxed at a maximum rate of 20% (plus an additional 3.8% for taxpayers subject to the net investment income tax). The combined effective federal tax rate for non-corporate shareholders on distributions classified as ordinary (non-qualified) dividends from a C corporation is 40.8%.

Pass-Through Entity Deduction: The TCJA also provided a rate reduction for non-corporate taxpayers on income from flow-through entities. Income of flow-through entities is not taxed (federally) at the entity-level but is instead included by the owners on their respective income tax returns. The TCJA reduced the top non-corporate tax rate on ordinary income from 39.6% to 37% while also providing a 20% deduction (via Section 199A) for certain business income for non-corporate taxpayers that own flow-through entities. This 20% deduction reduces the effective federal tax rate on flow-through income from 37% to 29.6%. To the extent the owners of a flow-through entity have included these amounts as taxable income, the cash can generally be distributed from the flow-through entity without additional tax. Note that there are various other factors that need to be weighed when planning for the 20% deduction such as the payroll and property basis limitations. In addition, not all pass-through income is eligible for the 20% deduction – law firms are considered to be a specified service trade or business (“SSTB”) which if the taxpayer has too high a level of income, the 20% deduction does not apply. Therefore, taxpayers should consult their tax advisors to verify, discuss and analyze. Individual partners in a law firm may also be subject to self-employment (SE) taxes. Note - some retiree arrangements may avoid SE tax. In addition, shareholders of S corporations who work in the business are required to pay themselves reasonable compensation, which is taxable at ordinary income rates and subject to FICA & Medicare taxes. W-2 compensation (along with partners guaranteed payments) is not eligible for the 20% deduction. The S corporation is responsible for paying half of the employment taxes, and the S corporation shareholder pays the other half.

Accordingly, the effective rate of tax on income from a flow-through entity will depend on several factors.

***Practice Tip:** When modeling this out and comparing different effective tax rates, entity distributions should be considered. If a business plans to reinvest all of its after-tax proceeds and not make any distributions, a C corporation would likely provide a greater opportunity for growth because the after-tax proceeds (which are subject to federal tax at a 21% rate) generally are higher than those of a flow-through entity (assuming the flow-through entity makes distributions to enable its owners to pay taxes). Conversely, if a business plans to distribute all of its income, a flow-through entity may be more efficient.

***Caution:** Major issues can arise under various state and local tax and/or foreign country tax systems that would need to be factored into any choice of entity analysis. It is also important to note that a C-corporation cannot avoid paying shareholder distributions (dividends) without having a reasonable business need to retain the cash. Otherwise, it risks becoming subject to a 20% Accumulated Earnings Tax (AET). Such reasonableness of anticipated cash needs should be assessed based on facts existing at the close of the tax year and, because the burden of proof rests with the taxpayer, proper documentation is recommended.

***Reminder: Net Operating Losses (NOLs):** The TCJA eliminated the carryback of net operating losses (NOLs) for individuals and corporations for tax years ending after December 31, 2017. Starting January 1, 2021, NOLs arising in tax year 2021 and beyond may only be carried forward indefinitely. In addition, for tax years 2021 and beyond, a NOL may not exceed 80% of taxable income computed without regarded to the NOL deduction.

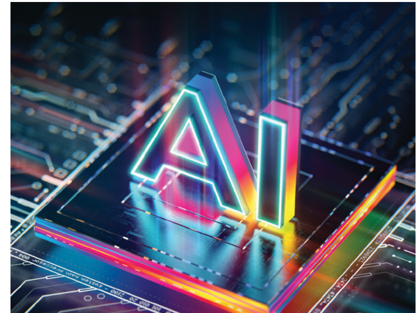
IRS Audits and Tax Enforcement Update

On September 8, 2023, the IRS Commissioner announced the rollout of a coordinated enforcement strategy that will involve audits of tax returns filed by 75 of the largest partnerships and partnerships with over $10,000,000 of assets operating in the United States. This follows the implementation of the Centralized Partnership Audit Regime ("CPAR") initiated to facilitate easier collection of tax from partners relating to partnership audit adjustments. Other enforcement efforts will focus on compliance issues involving digital assets, as well as continued emphasis on reporting of offshore accounts and collection of back taxes owed by high wealth individuals. Behind much of the new strategic effort is the use of GenA.I. and other investments made possible by the long-term funding approved by Congress through the Inflation Reduction Act of 2022.

With both compliance audits (500 compliance audits anticipated and field examinations - 75 field examinations anticipated) of large partnerships, the IRS is demonstrating that it is committed to improve the quantity and quality of its partnership audits. Compliance audits will require partnerships to substantiate return items (e.g. - reconciliation of balance sheet items to the tax return) and could evolve to full-scale field audits depending on the findings. Field examinations will be similar to research audits and involve a detailed and multi-year review of the partnership's operations and tax positions.

***Anchin Observation:** Taxpayers targeted by this audit initiative should expect that the IRS has conducted a thorough risk analysis prior to issuing the notice of selection for examination, most likely aided by GenA.I. These partnerships should anticipate that information document requests ("IDR's") will reflect a more strategic, targeted approach than previously has been the norm in partnership audits. While it is still early in the process, to date we have seen indications that there is national coordination of large partnership audits.

Other Considerations: GenA.I.'s Impact on Law Firms



Law firms face the uncertainty of how to address and implement GenA.I. with some considering early adoption, and others taking a wait-and-see approach. Some firms are even considering banning it altogether, but that may impact lateral and first year talent acquisition as law schools create programs around it. This policy could create even more risk as attorneys will look to use it even if off-line without having been educated on the privacy and copyright concerns as well as other issues exacerbating risk and, therefore, without having the proper "guardrails in place" to mitigate such. Regulatory legislation is on the horizon, including President Biden's recent executive order and the European Union's Generative A.I. Act. Historically, those types of technology issues such as privacy, copyright and risk of errors tend to resolve themselves over time as the technology evolves and widespread adoption occurs. For example:

- eDiscovery was originally done by external vendors before moving in-house; and
- When the "Cloud" entered our consciousness, clients at first were insistent that their data and work product not be stored in the cloud. Several years later, they insisted that everything be handled within the cloud.

GenA.I is already here and needs to be incorporated into law firms' current, three and five-year strategic plans. Lawyers must be educated on how to construct queries, the associated risks, risk mitigation and how to effectively utilize Generative A.I. within their firm's practice model. Most GenA.I. vendors emphasize that ***the human factor*** remains essential as unreviewed work product isn't acceptable under any professional standards. However, the efficiencies gained from handling massive amounts of data, drafting briefs, reviewing documents and even in M&A transactions already exist. These efficiencies will severely impact firms adhering to a traditional billable hour model versus alternative fee arrangements ("AFA's"). Consider the following:

- What happens to the legal workforce as thousands or tens of thousands of highly concentrated hours are replaced with minutes of computer time and hundreds of review hours?
- Does the law firm model migrate from a pyramid or cylindrical shape into more of a diamond shaped organizational structure?

- If the mundane tasks are replaced by GenA.I., legal continuing education needs to adapt to prepare attorneys today to become the reviewers and critical thinkers of tomorrow who will provide value that clients are willing to pay for!
- Think of the cloud – what happens when your clients begin to require your firm to use GenA.I. in its work?
- Who will you need to hire to manage/implement the use of GenA.I. within the firm. Will you be competing for GenA.I. engineering talent and how will you conduct those interviews?

These are some of the GenA.I. issues and management considerations that law schools and law firms need to address today to ensure their continued success as many of the above concerns will most likely be resolved within the next few years.

Conclusion

Business and tax planning is complex. Proactive planning involves more than just a focus on lowering your taxes for the current and future years. There are many things to think about and rules to navigate when it comes to tax planning. The various items and planning opportunities discussed in this guide are general in nature and may not apply to each taxpayer's situation. However, in most, if not all situations, multi-year modeling may be required to try to maximize the best tax results today and in future years. This guide cannot cover every tax planning opportunity that may be available to you and your firm. Therefore, we urge you to meet with your tax advisors, who should be able to provide you with a comprehensive review of business and tax-saving opportunities appropriate for your firm. As we continue to monitor the prospect of regulations, guidance, and potential new tax legislation, and as the year-end approaches, you should consider the aforementioned opportunities as you review your tax picture. If you would like to discuss any of these techniques or planning ideas, please contact any member of Anchin's Law Firm Group at your earliest convenience. We stand ready to help you plan effectively and to navigate through the various tax rules that may apply to your firm.

About Anchin

Anchin is a leading accounting, tax and advisory firm, specializing in the needs of privately-held companies, investment funds and high-net-worth individuals and families.

The firm has remained independent and partner owned for a century, allowing it to invest in a values-driven approach to client service and its great workplace culture. The full-service firm, with a team of 500, including more than 65 partners, provides a wide range of assurance, financial reporting, tax and advisory services, including tax strategies and compliance, tax credits and incentives; state and local and international tax strategies; family office strategies management and succession advisory; growth, transition and exit strategies; transaction advisory; client accounting advisory services; cybersecurity and digital risk solutions; and litigation support, forensic accounting and valuation services. Anchin has offices in New York City, Uniondale, New York, and in Boca Raton, Florida, and is an independent member of BKR International, a network of more than 160 firms with over 500 offices in over 80 countries around the world. Discover what's possible by visiting us online at www.anchin.com.

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