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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Law Partners Could Pay For Tax Code Change: Experts

By **Keith Goldberg**

Law360, New York (February 23, 2012, 10:46 PM ET) -- Lawyers could pay stiffer prices for seats at the partnership table if U.S. business partnerships were taxed more like traditional corporations under the Obama administration's corporate tax reform proposal, but there are still ways for law firms to preserve their current tax status if the changes come to pass, experts say.

While the administration's proposal, unveiled Wednesday, wasn't long on specifics, it called for "greater parity between large corporations and their large noncorporate counterparts."

Partnerships, as opposed to traditional corporations, aren't subject to corporate taxes, so all profits are passed through to the partners. Typically, law firms collect money, pay out wages to employees, then distribute what's left to partners, who pay individual income tax and self-employment tax on their shares of the profits.

But taxing law firm partnerships like traditional corporations could lead to higher taxes for partners because the nature of their work means they would be wearing two hats — employee and owner, according to Allen & Overy LLP tax partner Jack Heinberg.

"In the classic corporate model, the equity partner gets a dividend," Heinberg said. "Now, a partner will be taxed on ordinary income, the corporation will be taxed and partners will be taxed on dividends. From a tax perspective, that would increase the cost of being a partner."

In the most extreme case, paying corporate taxes, taxes on income and dividends could nearly double the tax rate partners would have to pay as part of a corporation as opposed to a partnership, according to Douglas Eckert, a tax partner at accounting firm Brown Smith Wallace LLC.

"Effectively, they would have to double their billing rates in order to make the same amount of money, which puts pressure on costs," he said. "There's less incentive to be an owner."

However, there would be a simple way for law firms to get around paying taxes on corporate profits, according to Elliot Freier, a tax attorney of counsel at Irell & Manella LLP. Law firms could simply distribute all their profits to their partners in the form of salaries or bonuses at year's end, thereby reducing the firm's corporate taxable income to zero.

"It's a service business. The vast majority of the income is derived from people providing services," Freier said. "You either pay that to them as salary or not."

Unlike other partnerships such as private equity firms, real estate development or energy partnerships, law firms don't make capital investments to increase their value, Freier said. The only way law firms can do that is by increasing the amount of work done by its lawyers.

Law firms rent office space and purchase technology in order to be able to do their work, but ultimately, “we invest in people,” added David Scott Sloan, chair of estate planning in the private wealth services department of Holland & Knight LLP.

“Even in [law firm] mergers, you're still acquiring people,” Sloan said. “People aren't depreciable.”

But it's hard to know what a corporation's exact profit is on the last day of the year, according to Arnstein & Lehr LLP tax partner Robert McKenzie.

“If the estimated profit is $100,000 and it is distributed by salary before year's end, all is fine,” McKenzie said. “What if profit is underestimated by another $50,000? Then those profits would face double taxation.”

And simply distributing all profits to partners as salary or bonuses and zeroing out corporate income could raise red flags with the Internal Revenue Service and other agencies because it raises questions over whether such compensation is reasonable, Heinberg says.

Courts have previously held that attempts by corporations — especially family-held ones — to distribute all profits to majority shareholders as salary were unreasonable, according to Heinberg.

“The argument is that you're the shareholder and you're the employee. You're in complete control,” Eckert said. “The IRS would say, 'A normal corporation, would it distribute its entire profit to all its officers? The shareholders will revolt.'”

Making the matter more complicated is the fact there's no bright-line test as to what is reasonable compensation, Heinberg said.

“I don't think you can simply say, 'Don't worry, we'll just pay it out as salary,'” Heinberg said. “If there was going to be this kind of change, there would have to be something that takes into account compensation on one hand and sharing of profits on the other. Otherwise, it would be a very difficult balance because the goal would be clearly to zero out your corporate tax.”

Freier says reasonable compensation is a valid question, but believes it would be difficult for the IRS to tell law firms — as well as other professional service providers — that their partner compensation is unreasonable, given the way their billing rates are structured and the fact that their clients have already agreed to pay those billing rates.

“When a law firm creates an hourly rate, it includes the labor of the attorney and the overhead,” Freier said. “How is someone going to say it's unreasonable for this lawyer to be paid $300 an hour [in salary], when you're actually charging the client $500 an hour for his work?”

With so many businesses now organizing themselves as partnerships — from private equity firms to real estate development firms and energy companies — experts doubt that the tax changes sought by the Obama administration will ever come to pass.

“You look across all the industries that find this [partnership option] to be an attractive device, there's going to be pushback, even with a reduction in corporate tax rates,”

McKenzie said. “I would think the real estate industry and law firm industry would make enough [political] donations to prevent it.”

--Editing by Jocelyn Allison and Andrew Park.

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