

YEAR END TAX PLANNING FOR LAW FIRMS



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Agenda

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- Managing the tax planning process
 - ▣ Align tax planning with goals of the firm
 - ▣ Tools and techniques
 - ▣ How tax planning may impact bank covenants
 - ▣ Gross income and advanced client costs

- Tax planning opportunities:
 - ▣ Deferral of invoicing / collections
 - ▣ Opportunities for deductions
 - ▣ Prepayment of expenses
 - ▣ Pension plan strategies
 - ▣ Capital spending
 - ▣ Ideas to mitigate the impact of last minute surprises



Agenda

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- Other Year end considerations
- Looking forward – potential changes in tax rates
- Capitalization:
 - ▣ Importance of retaining partners' capital
 - ▣ Developing a capital retention plan
- Outlook for 2010 and beyond
 - ▣ Budgeting
 - ▣ Where is growth going to come from?





Managing the tax planning process

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Align Tax Planning with the Goals of the Firm

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- Consider all the constituents in the process:
 - ▣ Partners or shareholders
 - ▣ Tax strategy
 - ▣ Financial reporting goals
 - Bank financial covenants
 - ▣ 2009 and long-term business goals

- A current tax saving may be a great idea in isolation, but not when considering other long-term strategies or how it may affect the financial statements

- Decisions must be in all the partners' / shareholders' best interest



Tools and Techniques

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- Close November 30 books

- Projection of book income at December 31:
 - ▣ Cash Receipts for December
 - ▣ Payroll for December
 - ▣ Operating expenses for December
 - ▣ Potential bonuses – employees / shareholders
 - ▣ Depreciation adjustments

- Make sure you are aware of cash flow commitments



Tools and Techniques

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- Three column approach

- Critical to track these three amounts during the tax planning process:
 - ▣ Taxable Income
 - ▣ Cash / Line of Credit balance
 - ▣ Bank Covenant

- Need to be informed to avoid:
 - ▣ Leaving the firm with no cash in January
 - ▣ Defaulting on a bank covenant



TAXABLE INCOME PROJECTION				Taxable Income	Cash Balance	Line of Credit
	Net Income at November 30		\$	-		
	<i>Cash / LOC Balance at November 30</i>				\$	-
	Depreciation Adjustments (not already booked)					
	Section 179		\$	-		
	Regular depreciation		\$	-		
	Projection to Dec 31:					
	Cash Receipts - December		\$	-	\$	-
	Payroll - December		\$	-	\$	-
	Operating Expenses - December		\$	-	\$	-
	Bonuses - December		\$	-	\$	-
	Expenses that can be prepaid:					
	Rent		\$	-	\$	-
	Other		\$	-	\$	-
	Other		\$	-	\$	-
	Accounts payable to pay down		\$	-	\$	-
	Expenses incurred on Credit Card		\$	-		
	Fixed asset purchases (cash) (within S179 limit)		\$	-	\$	-
	Accrued Profit Sharing		\$	-		
	Partners Draws / Distributions				\$	-
	Payment of client costs				\$	-
	Receipts from client costs				\$	-
	Drawdown line of credit				\$	-
	Expected Net Income to December 31		\$	-		
	Expected Cash and LOC balance at 12/31				\$	-
	Non-deductible items:					
	Meals & Entertainment		\$	-		
	Keyman Life Insurance		\$	-		
	Penalties		\$	-		
	Expected Taxable Income		\$	-		
	Target Taxable Income			\$100,000		

Covenant Calculation - Example

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<u>Covenant Calculation:</u>			
Debt Service Coverage Ratio:			
Expected Net Income		\$	-
Addback:			
Depreciation			
Interest expense			-
Taxes			-
Deduct:			
Unfinanced capital expenditures			-
Distributions			-
Numerator		\$	-
Interest expense			
Current maturities of LTD			-
Denominator		\$	-
Debt Service Coverage			
Required			1.25:1
Excess (Shortfall)		\$	-



TAXABLE INCOME PROJECTION				Taxable Income	Cash Balance	Line of Credit
	Net Income at November 30			\$ 800,000		
	<i>Cash / LOC Balance at November 30</i>				\$ 350,000	\$ -
	Depreciation Adjustments (not already booked)					
	Section 179			\$ (20,000)		
	Regular depreciation			\$ -		
	Projection to Dec 31:					
	Cash Receipts - December			\$ 600,000	\$ 600,000	
	Payroll - December			\$ (250,000)	\$ (250,000)	
	Operating Expenses - December			\$ (100,000)	\$ (100,000)	
	Bonuses - December			\$ (580,000)	\$ (580,000)	
	Expenses that can be prepaid:					
	Rent			\$ (50,000)	\$ (50,000)	
	Other			\$ (40,000)	\$ (40,000)	
	Accounts payable to pay down			\$ (20,000)	\$ (20,000)	
	Expenses incurred on Credit Card			\$ -		
	Fixed asset purchases (cash) (within S179 limit)			\$ (10,000)	\$ (10,000)	
	Accrued Profit Sharing			\$ (250,000)		
	Distributions				\$ (30,000)	
	Payment of client costs				\$ (20,000)	
	Receipts from client costs				\$ 30,000	
	Drawdown line of credit				\$ 150,000	\$ (150,000)
	Expected Net Income to December 31			\$ 80,000		
	Expected Cash and LOC balance at 12/31				\$ 30,000	\$ (150,000)
	Non-deductible items:					
	Meals & Entertainment			\$ 15,000		
	Keyman Life Insurance			\$ 5,000		
	Penalties			\$ 1,000		
	Expected Taxable Income			\$ 101,000		
	Target Taxable Income			\$100,000		

Bank Covenants

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- Be certain you understand calculation of covenants
- Re-read loan documents and discuss any unclear terms with bank
- Quarterly / annual covenant compliance certificate
- Banks are not as inclined to grant waivers as in previous years:
 - ▣ Waiver approval may have to go to credit committee
 - ▣ Default may result in a higher interest rate and/or a “waiver fee”
 - ▣ Ultimately, the bank could pull the line of credit



Bank Covenants

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- If you think the firm will be in default of the covenant:
 - ▣ This may be more important than the tax planning strategy
 - ▣ Strategize what can be done to avoid this
 - ▣ Hold partner draws if necessary
 - ▣ May impact decision to prepay expenses
 - ▣ Could elect out of accelerated depreciation

- Contact the bank:
 - ▣ Banks don't like surprises!



Gross Income Issues

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- General
- Gross income types
- Cash reporting
- Retainers
- Client trust accounts
- Non-cash sources



Advanced Client Costs

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- Definition
- Preferred method
- Changing method
- Strategies
- Other issues





Tax Planning Opportunities

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Deferral of Invoicing / Collections

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- If you defer the cash collected, then it will not be taxable income

- You may have to defer invoicing so collections are deferred properly

- Watch out for “constructive receipt” problem
 - ▣ If you collect cash and just do not deposit it, it is still considered cash received for income tax purposes

- Wire transfers – monitor cash receipts to Dec 31.



Opportunities for Deductions

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- Pay down accounts payable
 - ▣ Prioritize operating expenses, not client costs

- Prepayment of expenses

- Section 179 expense and bonus depreciation

- Pension plan deduction

- Consider goals of the company first

- Align the tax strategies with goals



Prepayment of Expenses

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- Consider how this will affect Q1 of 2010
- Start by considering prepaying expenses that you would normally incur in Q1 of 2010
- Ordinary and necessary
- “12 month” rule
 - Cannot prepay expenses beyond 12 months
 - For example can prepay rent Jan-Dec 2010 only
- Examples:
 - Rent
 - Check with landlord, negotiate a discount
 - Insurance
 - Make sure if contract is ending you intend to renew with that vendor



Prepayment of Expenses

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- Examples:
 - Leases (Operating leases only)
 - Under which you have current obligations
 - Payroll that is going to get paid on January 1st or 2nd
 - Be careful doing this as you do not want to affect others individual tax planning
 - Give the software company or other consultant a prepayment on Q1 maintenance contract or professional services



Pension Plan Strategies

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- Deduct employer contributions to a pension plan if paid for by the due date of the tax return, with extensions:
 - **No extension:**
 - The payment would be due by 3/15 for corporations or 4/15 for partnerships
 - **With extension:**
 - The payment would be due by 9/15 for corporations and partnerships
- Be careful to review your pension plan document to make sure your plan does not say you need to fund the employer contribution earlier



Pension Plan Strategies

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- Profit Sharing Plan
 - Employer contribution is a way to defer tax and give an incentive to employees
 - Employee contributions
 - Employer Contributions
 - 401(k)matching
 - Additional discretionary contribution
 - Possible required contribution if “Top Heavy”
 - Know your plan



401(k) / Pension Plan limitations

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Limits Table	2009
Elective Deferrals	\$16,500
Catch-up contribution	\$5,500
Def Ben \$ Max	\$195,000
DCP Annual Additions	\$49,000
Compensation Limit	\$245,000
Highly Comp EE Limit	\$110,000



Credit Cards

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- Expenses incurred on Credit card balances before Dec 31 but unpaid at this date can still be deducted
- Credit cards are like debt
- Must be qualifying business expenses



Uncollectible Client Costs

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- Review capitalized Client Disbursements Receivable for any costs which may be uncollectible
- If uncollectible then these costs can be written off as a deduction
- Document efforts made to collect A/R balance (to support the deduction)



Other Risk Areas and Opportunities

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- Non-Deductible Expenses
 - ▣ Country club dues
 - ▣ Sky box license fees
 - ▣ Sports tickets in excess of fair value
 - ▣ Penalties
 - ▣ Political contributions
 - ▣ Personal expenses
 - ▣ S Corp Shareholder fringe benefits – should be added to W2
 - ▣ Officers' life insurance



Meals and Entertainment

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- Meals & entertainment
 - Tax documentation

 - Exceptions to 50% rule
 - Expenses treated as compensation
 - Reimbursed expenses
 - Recreational expenses for all employees
 - Items available to the public
 - Entertainment sold to customers
 - Expenses includible in income of persons who are not employees.

 - Extravagant – non-deductible

 - Company wide events – 100% deductible



Capital Spending

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- Section 179 Depreciation
 - Dollar limitation - \$250,000
 - Investment limitation – \$800,000
 - Passenger autos - \$8,000; SUVs - \$25,000

- Amounts for future years:
 - 2010 - \$133,000
 - 2011 - \$25,000



Capital Spending

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Bonus Depreciation:

- Allows a bonus first year depreciation deduction of 50% of the adjusted basis of qualified property

- Qualified property
 - ▣ MACRS property with recovery period of 20 years or less, computer software or qualified leasehold improvement property
 - ▣ Original use of the property must begin with the taxpayer
 - ▣ Purchased and placed in service during 2009 (set to expire 12/31/09)



Capital Spending

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- Consider any purchases you may make in early 2010
- Can any of these purchases be accelerated to 2009 to take advantage of Section 179 ?
- Qualifying asset must be “placed in service” before Dec 31, 2009



Capital Spending

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Qualified Leasehold Improvements for 15 years:

- Placed in service prior to 2010
- Placed in service more than 3 years after building
- Nonresidential real estate
- Lease cannot be between related parties
- Improvement made to interior portion and not:
 - ▣ Improvements that enlarge the building
 - ▣ Elevators or escalators
 - ▣ Improvements that benefit a common area



Ideas to Mitigate the Impact of Last Minute Surprises

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- Such as:
 - ▣ Wire transfers / last minute receipts on Dec 31

- Strategies to reduce taxable income:
 - ▣ Prepay more rent
 - ▣ Prepay more operating expenses
 - ▣ Keep some accounts payable – just in case
 - ▣ Charge more expenses on credit card
 - ▣ Depreciation
 - ▣ Pension plan contributions

- Make sure that the proper approval process is in place based on firm governance



Summary of Year End Strategies

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- Goal of year end
- To reduce taxable income:
 - ▣ Defer income/cash receipts
 - ▣ Accelerate expenses/primarily cash disbursements
 - ▣ Maximize section 179 deduction
 - ▣ Maximizing pension contribution while balancing future cash flow needs
 - ▣ Review client costs that are uncollectible
 - ▣ Pay bonuses or accelerate payroll
 - ▣ Evaluate and control non-deductible items
 - ▣ Manage cash flow to goals of company
 - ▣ Be aware of “phantom income” that could trigger taxable income
 - ▣ Look at taxable income, not just changes in cash
 - ▣ Have partners do individual tax planning with accountant



Other Year End Considerations

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- ❑ Personal use of auto
- ❑ Group term life insurance
- ❑ Add shareholder benefits to W-2s (including Health Insurance)
- ❑ Officer's life and disability
- ❑ Form W-4
- ❑ Independent contractor reporting
- ❑ Pension distribution
- ❑ Employer-owned life insurance policies
- ❑ Sales and use tax compliance
- ❑ Abandoned property compliance



Looking Forward - potential changes in tax rates

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- Sunset of EGTRRA tax rate decreases in 2011:
 - ▣ Individual tax rates
 - most brackets increase 3%, top rate goes up to 39.6%
 - ▣ Qualifying dividend tax rate
 - ▣ Long term capital gains rate

- Healthcare reform bills – *possible* tax increases
 - ▣ 5.4% surtax on >\$500,000 single / \$1m MFJ (House)
 - ▣ Increase in Medicare by 0.5% on income > \$200,000 single / \$250,000 Married (Senate - *proposed*)
 - ▣ Tax on “Cadillac” health plans (Senate - *proposed*)
 - ▣ Penalties for insufficient health insurance coverage of employees





Capitalization

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Capitalization

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Firms with a strong capital position can:

- ❑ Make better business decisions
- ❑ Work through the unexpected loss of a client or sudden unanticipated expenditures
- ❑ Can consider strategic investments

Firms with the following need to retain more capital:

- ❑ Ambitious hiring objectives / growth plans
- ❑ Substantial out-of-pocket expenses on behalf of clients;
- ❑ Significant unevenness of cash collections;
- ❑ Contingent-fee practice;
- ❑ High dependency on a small number of large clients;
- ❑ Upcoming retirements of senior partners in the next few years



Capital

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The firm should strive to achieve the following:

1. Positive equity in the firm
 2. Have Equity to Debt ratio of 2:1
 3. Have no debt
 4. 2 months of Operating Expenses in Capital
-
- Retain Earnings and don't distribute all income every year
 - Avoid pitfalls of recently restructured or dissolved firms
 - S Corps should only make distributions to pay taxes on allocated income until the firm has built sufficient capital
 - Retain capital for rainy day – purpose of loan covenants for capital requirements





Outlook for 2010 and beyond

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Outlook for 2010 and beyond

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- 2010 Budget
 - Have you prepared a budget?
 - Budget Revenue:
 - Capacity – Attorneys Hours X Rates X Realization
 - Sales Analysis:
 - Existing Clients
 - New business needed
 - Set origination targets
 - Budget Expenses
 - Budget Cash Flow
 - Seasonality of Cash
 - Partner / Shareholder distributions
 - Debt Covenant Projections



Outlook for 2010 and beyond

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- Where is growth going to come from?
- Where are new clients going to come from?
 - ▣ Origination targets
 - ▣ Business development activity
- Track billing rates on top clients
 - ▣ When was the last time you asked for a rate increase?
- People:
 - ▣ Hiring requirements
 - ▣ Attorney raises – stay ahead of expectations
 - ▣ Reward the superstars – future partners
 - ▣ Make the difficult decisions on excess capacity
- Space considerations



ANY QUESTIONS?



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