YEAR-END TAX PLANNING FOR LAW FIRMS

K. Jennie Kinnevy
Director

Neil F. Scullion
Director

Agenda

- Managing the tax planning process
  - It's never too early to start
  - Sharing some tools and techniques
  - Ideas to mitigate the impact of last minute surprises

- How tax planning impacts
  - Annual financial statements
  - Banking relationship / loan covenants
  - Business opportunities / funding growth

- Opportunities for deductions
  - Pension plan strategies
  - Capital spending
  - Uncollectible client costs
  - Types of expenses to pay (and not pay)

Agenda (continued)

- Planning for the new tax law and potential change in rates
  - Tax savings strategies
  - Tax traps for the unwary
  - Compliance with IRS rules

- Outlook for 2012
  - Budgeting
  - Where is growth going to come from?

Managing the Tax Planning Process

- It's never too early to start
- Sharing some tools and techniques
- Ideas to mitigate the impact of last minute surprises

It's Never Too Early To Start

- Set taxable income goals for the year:
  - Projected cash basis net income for the year
    - Revenue / Expenses / Profits
    - Depends on type of entity
      - Corporations –Taxable Income
      - Partnerships – Allocable Income
  - Potential book adjustments
    - Depreciation
    - Write-off uncollectible client costs
    - Investments
    - Information needed from other sources (K-1, pension)
  - Review tax adjustments for 2011:
    - Meals and entertainment
    - Non-deductible items (life insurance, penalties)

Align Tax Planning with the Goals of the Firm

- Must consider all the constituents in the process:
  - Partners or shareholders
    - Decisions must be in all (most) partners' / shareholders' best interest
    - Must meet their expectations
  - Financial reporting goals
    - Meeting budgets
    - Bank financial covenant compliance
  - 2012 and long-term business goals
    - Firm goals – 2012 and beyond
    - Cash availability
    - Capital accounts
  - Does tax strategy meet all of the above goals?

- A current tax strategy may be a great idea in isolation, but not when considering other constituents

Tools and Techniques

- 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 (is book same as tax?)

- Make sure you are aware of cash flow commitments for next year
- Communications with management and/or partners

Tools and Techniques

- 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	$ -		
Cash / LOC Balance at November 30		*$ -*	*$ -*
Depreciation Adjustments (not already booked)			
Section 179	$ -		
Regular depreciation	$ -		
<u>Projection to Dec 31:</u>			
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 Corporate Taxable Income	**$100,000**		
Target Partnership Allocable Income	**$4,100,000**		

TAXABLE INCOME PROJECTION

	Taxable Income	Cash Balance	Line of Credit
Net Income at November 30	$ 800,000		
Cash / LOC Balance at November 30		*$ 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 Corporate Taxable Income	**$100,000**		
Target Partnership Allocable Income	**$4,100,000**		

Ideas to Mitigate the Impact of Last Minute Surprises

- Such as:
  - Wire transfers / last minute receipts on Dec 31
  - Date of last payroll
  - Client intake procedures – avoid year-end scams

- Strategies to manage 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
  - If "C" Corp – shareholder bonuses
  - Sponsorships vs. charitable contributions

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

Managing the Tax Planning Process - Summary

- ✓ Manage expectations with partners / shareholders
- ✓ Consider long term goals as well as tax savings
- ✓ Monitor cash receipts to avoid surprises

How Tax Planning Impacts…..

- Annual financial statements
- Banking relationship / loan covenants
- Business opportunities / funding growth

Annual Financial Statements (Balance Sheet)

- How does tax planning affect Balance Sheet?
- Target financial statement income number but maintain a health balance sheet
  - If financial statements are on income tax basis
  - Corporation – avoid negative equity
  - Partnership – retain sufficient capital
    - To fund tax distributions owed
  - 1st Quarter Cash Flow
- What are accrual basis results?
  - Working Capital needs
- 5-year profitability trend
  - Partner / shareholder compensation

Bank Covenants

- 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 inclined to grant any waivers unless comfortable with:
  - Firm (management)
  - Partners (retention)
  - Financial outlook (profitability and future covenant compliance)
- 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
- Be aware of material change clauses

Covenant Calculation - Example

Covenant Calculation:		
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)	$	-

Bank Covenants

- 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 (last resort)
  - May impact decision to prepay expenses
  - Could elect out of bonus depreciation
  - May need to contribute capital
- Contact the bank:
  - Banks don’t like surprises!

Business Opportunities / Funding Growth

- If you pay out all the cash now to reduce taxable income – what will implications be?
- Capital retention
- What do cash flow projections look like for first 3 months of 2012?
- Investment in fixed assets in 2012
- Prepayment of expenses – helps to mitigate cash impact in early 2012
- Upcoming retirements of senior partners, unfunded plans

How Tax Planning Impacts Different Goals - Summary

- ✓ Manage your whole Financial Statements – Balance Sheet as well as P&L
- ✓ Manage expectations with partners / shareholders and their expected comp.
- ✓ Monitor impact on bank covenants and compliance
- ✓ Make sure you will have enough cash flow in early 2012

Opportunities for Deductions

- Pension plan strategies
- Capital spending
- Uncollectible client costs
- Types of expenses of pay (and not pay)

Pension Plan Strategies

- 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
  - For example – a match that must be paid with each payroll

Pension Plan Strategies

- 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"
      - Safe harbor
      - Defined Benefit plan
  - What you need to know about your plan
    - Your plan features
    - Changes in limitations
    - Changes in laws and your fiduciary responsibilities
  - Prepare projections based on current comp
  - Accrue throughout the year based on current comp to avoid big year-end adjustment
  - What other types of Plans do people have?

401(k) / Pension Plan limitations

Limitations	2011	2012
Elective Deferral	$16,500	$17,000
Catch-Up Contributions (50+)	$5,500	$5,500
Def. Benefit $max	$195,000	$200,000
Def. Contrib. $max	$49,000	$50,000
Compensation Limit	$245,000	$250,000
Highly Comp EE Limit	$110,000	$115,000

Capital Spending / Depreciation

- Compare actual expenditures to original budget for 2011
  - Additional depreciation may be required
  - Matching depreciation with cash outflow for expenditures or debt repayment
- Section 179 Expensing for 2011
  - Dollar limitation - $500,000
  - Investment limitation – $2,000,000
  - Qualified Leasehold Improvements – up to $250,000 can be expensed
- Expectation for 2012 – reverts back to $125,000 (indexed for inflation) – estimate might be $139,000
- Unlimited carry forward to offset future taxable income (subject to $ and income limitations in existence in the year it will be taken).
- Planning technique for Corporations
- Passenger autos - $11,060; SUVs - $25,000
  - Remember business use rules

Capital Spending / Depreciation

Bonus Depreciation (calendar year 2011)

- When to use and not to use
- Federal vs. Massachusetts rules
- Allows a bonus first year depreciation deduction of 100% of the adjusted basis of qualified property through 12/31/11
- 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 (new property only)
  - Purchased and placed in service during 2011 (set to expire 12/31/11)

Capital Spending / Depreciation

Qualified Leasehold Improvements for 15 years:

- Placed in service more than 3 years after new 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

Uncollectible Client Costs

- 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)

Deferral of Invoicing/Collections

- 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 do not deposit it, it is still considered cash received for income tax purposes

- Wire transfers – monitor cash receipts to Dec 31.

Types of Expenses to Pay (and not pay)

- Payments before year-end that reduce taxable income
  - Certain accounts payable
  - Prepayment of expenses such as rent, benefits, professional fees
  - Employee bonuses

- Payments before year-end that do not reduce taxable income:
  - Balance sheet items
    - Pension plan – deduction
    - Hard costs
    - Partners draws / shareholder distributions
    - Principal payments on debt
    - Credit card balances (expense when incurred)
    - Payroll withholdings

- Consider goals of the company first and align the tax strategies with goals

Prepayment of Expenses

- Consider how this will affect Q1 of 2012
- Start by considering prepaying expenses that you would normally incur in Q1 of 2012
- Ordinary and necessary
- "12 month"
  - Cannot prepay expenses beyond 12 months
  - For example can prepay rent Jan-Dec 2012 only
  - Business purposes

Prepayment of Expenses

- Examples:
  - Rent
    - Check with landlord, negotiate a discount
  - Insurance
    - Make sure if contract is ending you intend to renew with that vendor
  - Leases (Operating leases only)
    - Under which you have current obligations
  - Give the software company or other consultant a prepayment on Q1 maintenance contract or professional services

Credit Cards

- 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

Opportunities for Deductions - Summary

- ✓ Funding pension plan
- ✓ Align depreciation with goals
- ✓ Deductible expenses to pay or prepay

Planning for Potential Change in Tax Rates

- Tax savings strategies
- Tax traps for the unwary and year end considerations
- Uncollectible client costs

Potential Changes in Tax Laws

- November 23 report of the Joint Select Committee on Deficit Reduction – watch this space
- Changes in Tax Rates
- Changes in Pension Laws
- Changes in Depreciation
- Changes in Charitable Deductions
- Changes in Tax Credits

Credits

Federal:

- Retained Worker Credit (HIRE Act)
  - Worker must have been hired after 2/3/10 and before 1/1/11 and retained for 52 weeks
  - Maximum credit $1,000 per eligible employee
- Differential wage payment credit
  - Less than 100 employees
  - Credit for a portion of excess wages paid while employee is on active military service

Massachusetts:

- Hiring Incentive Training Grant Program
  - $2,000 per employee and up to $30,000 per company
  - Training costs of newly hired employees that are out of work for 6 months or more

Year-End Tax Saving Strategies

- Goal for year-end
- To monitor taxable income to meet targeted goals:
  - Defer income/cash receipts
  - Accelerate expenses/primarily cash disbursements
  - Pay bonuses or accelerate payroll
  - Maximizing pension contribution while balancing future cash flow needs
  - Maximize section 179 deduction
  - Review client costs that are uncollectible
  - Charitable gift strategy (C Corporations, sponsorships)
  - 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
  - Eligibility for tax credits

Tax Traps For The Unwary

- Income Issues:
  - Gross income types
  - Cash reporting
  - Retainers
  - Client trust accounts
- Expense Issues:
  - Unexpected pension costs
  - Pension – must pay by due date / eligibility
  - Life insurance
  - Federal taxes paid (C Corps)
  - Section 179 you cannot use (C Corps)
  - Charitable contributions limitation (C Corps)
  - >2% shareholders (S Corps)
  - Partner benefits (P-ships)
  - Increasing Meals and Entertainment add-back
- Balance Sheet Issues:
  - Advanced client costs
  - Negative Capital Accounts (Partnership)
- Last minute surprises (slide 11)

Advanced Client Costs

- Definition
  - Costs paid on behalf of a client
- IRS required method
  - Treated as a loan to client until reimbursed
- Changing methods
  - Is your firm compliant?
  - Four year phase-in of change if made voluntarily
- Strategies
  - Retainers from clients to cover costs

Negative Partner Capital Accounts

- Partnerships should look at individual partner capital account balances
  - Consider impact of negative partner capital accounts

- Partners draw in excess of basis could be taxable absent a Deficit Capital Restoration Obligation in the Partnership Agreement

Meals and Entertainment

- 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

Other Risk Areas

- Non-Deductible Expenses
  - Country club dues
  - Sky box license fees
  - Sports tickets in excess of fair value
  - Penalties
  - Political contributions (should not be paid through the firm)
  - Personal expenses
  - S Corp Shareholder fringe benefits (should be added to W2)
  - Officers' life insurance

Typical Employee Benefits to Add to W2's

- Group term life insurance
  - Coverage over $50,000 (except >2% S Corp SH)
- Long term care insurance
- Personal use of company-owned auto
- Personal use of leased vehicles
- Officer's life and disability
- >2% S Corp. Shareholder Benefits:
  - Group Term Life
  - Health Insurance
  - Long term care insurance
  - Life Insurance and disability benefiting EE or spouse

- Partnerships - All of these benefits are non-deductible for partners in a partnership
  - Some flow-through to 1040 and are deductible

Other Year End Considerations

- Independent contractor reporting – 1099-Misc / 1096
- Pension distribution
- Employer-owned life insurance policies – reporting
  - Material changes to post-1986 policies
- State income taxes – nexus in new states?
- Sales and use tax compliance (next slide)
- Abandoned property compliance
- City of Boston Form of List
- Are IOLTA accounts fully reconciled?
- Annual Reports
- 5500 Filings (Benefits, 401(k))
- Changes to Shareholder / Partnership Agreements
- Payroll Reconciliations
- Capitalization Policy

Use Tax Compliance

- If you make purchases which are subject to Sales tax and the vendor does not charge Sales tax – you are responsible for calculating Use Tax and remitting with Use Tax return

- Massachusetts Dept. of Revenue auditing law firms for Sales and Use Tax
  - Non-filers – exposure for 6 years
  - Filers – exposure for 3 years (under S/O/L)

- Firms should have a process in place for identifying invoices that may be subject to Use Tax

- We recommend you self audit last 3 years – even if you are filing Sales and Use Tax Returns timely

Use Tax Compliance

- Areas of exposure could include:
  - Property and equipment purchases / computer software
    - Particularly vendors out of state / on-line
  - Leases
    - Sales tax on lease for computers, copiers, postage machine, vehicles, etc.
  - Books and Periodicals
    - Some non-profits (such as MCLE) do not charge sales tax – law firm must pay use tax
    - Lawyers diaries
    - Office supplies
    - Out of pocket costs paid on behalf of a client which client reimburses (such as flip-charts)
    - Items (tangible) purchased through employee expenses accounts that are reimbursed to employees
  - On line / out of state / catalog purchases
  - Software maintenance contracts

Tax Year-End Strategies and Potential for Change in Rates

- ✓ Review year-end strategies to match goals
- ✓ Ensure compliance with risk areas and compliance requirements – IRS, payroll, pension
- ✓ Conduct a self-audit for sales and use tax compliance

Outlook for 2012

- Budgeting
- Where is growth going to come from?

2012 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

2012 Budget

- Obtain "Buy-In" to Budget
  - Partners agree with revenue growth targets
  - Billing Attorneys to meet billing and collection targets
  - Attorneys to meet hours and realization targets
  - Tie in new business development to the marketing plan
  - The more strongly the budget is approved and accepted, the more likely it is to be achieved
  - Align to business objectives, capital retention and tax planning needs

- Monitor
  - Budget to actual on a monthly basis
    - Expenses, revenue and seasonality
  - Compare actual figures, line by line against budget
  - Cash collections
  - Variance analysis & explanations on a monthly basis

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:
  - Capacity and hiring requirements
  - Attorney raises – stay ahead of expectations and monitory marketplace
  - Reward the superstars – future partners
  - Make the difficult decisions on excess capacity
- Space considerations

QUESTIONS?

Upcoming Seminars

Year-End Payroll Issues Seminar

Friday, November 18, 2011 | 8:30am - 11:00am

Feeley & Driscoll Conference Center

Presented by:

K. Jennie Kinnevy

Neil F. Scullion

Jennie Kinnevy, a director at Feeley & Driscoll, has more than twenty-five years of experience in public accounting, the majority of which have been as an auditor and tax and business advisor to privately held businesses. Jennie has a BS in Economics from the Wharton School of the University of Pennsylvania and a MS in Taxation from Bentley College. She is a member of the Massachusetts Society of Certified Public Accountants, the American Institute of Certified Public Accountants. Ms. Kinnevy leads the Professional Service Firm Group at Feeley & Driscoll working with senior management to improve profitability and working with financial teams to provide GAAP, OCBOA and ERISA audits. She has also published several articles on law firm strategic and financial management issues and lectured at seminars to managing attorneys and firm administrators. Ms. Kinnevy is a contributing writer and editorial board member of Accounting and Financial Planning for Law Firms, published by American Lawyer Media.

Neil F. Scullion, CPA, ACA is a director at Feeley & Driscoll, P.C. concentrating on Law Firms. Neil has more than fourteen years experience providing accounting, auditing and consulting services. He has published articles on law firm management issues and lectured at seminars to firm administrators. Mr. Scullion grew up in Hampshire, England, and holds a Bachelor of Science degree in accounting from the University of East Anglia in Norwich, England. As well as being qualified as a Certified Public Accountant, he is a Chartered Accountant in England and Wales. Mr. Scullion is currently pursuing a Master of Science in Taxation from Northeastern University.