LAW FIRM MANAGEMENT

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PASS-THROUGH ENTITY TAXES

How law firms can manage the SALT deduction limit

Many high-income taxpayers were upset when the Tax Cuts and Jobs Act of 2017 (TCJA) imposed a $10,000 limit on the federal income tax deduction for state and local taxes (SALT). In response, at least two dozen states and New York City have implemented pass-through entity taxes (PTETs) that provide a workaround for those eligible. What do such taxes mean for law firm partners, members and shareholders? Read on.

PTET APPROACH

The SALT cap has proven especially painful for owners, members and shareholders in pass-through entities. These taxpayers historically have seen their entities' state-level taxes "flow through" to them individually. Notably, these taxpayers may be on the hook for SALT in *every* state where their businesses earn income. As a result, they can easily surpass the $10,000 deduction limit without even taking into account state and local property and sales taxes or income taxes on other sources of income.

> *PTETs generally allow covered pass-through entities to pay a mandatory or elective entity-level state tax on business income with an offsetting owner-level benefit.*

PTETs take advantage of the fact that the SALT cap applies only to individuals, not businesses. The particulars of the various PTETs vary by jurisdiction (see "California, New York laws illustrate the differences," on page 3), but they generally allow covered pass-through entities to pay a mandatory or elective entity-level state tax on business income with an offsetting owner-level benefit. The benefit usually takes the form of a full or partial credit, deduction or exclusion. The entity can deduct the full amount of the state tax as a business expense.

IRS RESPONSE

PTETs aren't the first workaround to pop up at the state level to circumvent the SALT cap. Earlier strategies quickly ran into a wall, though, as they were shot down by the IRS. For example, the

CALIFORNIA, NEW YORK LAWS ILLUSTRATE THE DIFFERENCES

The pass-through entity tax (PTET) laws in California and New York provide examples of the potential variations in various states' PTET laws. While both generally allow a pass-through entity to pay tax at the entity level with a corresponding credit at the individual tax level, significant differences exist.

For example, California's PTET is 9.3% of the entity's net income, which includes only the distributive shares of those partners, members or shareholders who consent. In New York, though, the taxable income includes the income of all partners, members or shareholders, regardless of whether they consent. The PTET calculation also differs between partnerships and S corporations in New York.

The California credit is nonrefundable but can be carried over up to five years. In New York, the excess credit over tax due is treated as an overpayment and credited or refunded. These are just some of the differences between the two states' approaches to PTETs. And other states will have even more variations. Do some research before taking the leap.

agency explicitly rejected initiatives in states like New York and New Jersey to allow taxpayers to donate to state-sponsored charitable funds in exchange for credits against their state taxes.

To the surprise of some, the IRS gave its approval for state PTETs in 2020. It clarified that SALTs imposed on the income of partnerships or S corporations are deductible by the entity and not subject to the SALT limit for partners and shareholders who itemize their deductions. (The IRS has indicated it intends to issue proposed regulations with further guidance, but such regulations hadn't been published at the time this article was drafted.)

NEXT STEPS

Many law firms are well positioned to take advantage of the PTET approach, but you'll need to do some planning. States, for example, have deadlines for when an entity must make its annual election. In addition, you must obtain consent from — or at least notice to — owners, members and shareholders.

It's also worth considering that the election won't necessarily help every owner; in fact, it could be detrimental to some. An attorney might, for instance, live in a state that doesn't allow credits for PTET paid in another state, which would reduce the election's benefit — and create a double-taxation situation for the attorney. Another question is whether the PTET requires estimated tax payments. If so, that will affect the firm's cash flow.

Law firms considering this option should consider where the owners, members or shareholders live and their other income sources, as both of these factors could affect how an election plays out. Evading the SALT limit may not prove worth it in light of other effects on federal and state tax liability.

PROMISING BUT COMPLEX

Variations among the state PTETs abound, with differences in everything from eligible entities and how individual taxpayers are credited to election requirements and deadlines. Contact your tax advisor to make sure you both minimize your tax liability and comply with all of the applicable requirements. •

It’s time to review your client trust account practices

Handling client money happens daily in every law firm. State ethics rules require most attorneys to use trust funds to segregate client funds from firm funds. Maintaining these client trust accounts (CTAs) while meeting your state’s ethics rules can be onerous, but following the rules is better than sanctions or potential disbarment. CTA rules vary by state, but let’s look at ways you can monitor your CTA practices.

TIMING PAYMENTS

You sometimes may be tempted to help clients out by disbursing settlement funds before the funds have cleared, especially if your firm has a single account that holds all client funds instead of individual CTAs. After all, you know the account has sufficient funds to cover the disbursement and will be reimbursed. But you’ll likely violate the rules because you’re paying one client with another client’s money.

You also might risk making premature payments to the firm, particularly when you take fees paid in advance. These funds generally are a liability that you owe until you earn them, at which point you can transfer them to your operating account.

Some states allow flat or other fees paid in advance to be deposited in a firm’s operating account in certain circumstances. When in doubt, place them in the CTA until you obtain some clarification of the applicable rules. In addition, make sure credit card payments of advances aren’t directed to your operating account if they aren’t permitted.

GOING NEGATIVE

Many people have at some point written a check against funds they haven’t deposited or that haven’t yet cleared their consumer banking account, resulting in what’s known as a negative balance. Odds are, they reason, the funds will clear before the check recipient deposits it.

CTAs generally can’t have negative balances without violating the rules. A CTA can have either a positive balance (meaning it’s holding client funds) or a zero balance (because all client funds have been paid out). A negative balance signals, at best, negligence and, at worst, misappropriation.

This is a problem, even if the account has automatic draft protection. Depending on whether the arrangement covers only the exact overdraft amount or automatically deposits a flat amount, firm funds could commingle with client funds. “Instant credit” arrangements — where the bank agrees to immediately credit accounts for deposits while it waits to collect the funds from another financial institution — carry a similar risk because the credit essentially is a loan to the firm.

MAINTAINING RECORDS

CTA rules generally require you to hold on to bank statements and canceled checks. It’s advisable to also keep deposit receipts, checkbook stubs and copies of client checks for a complete audit trail. (Check your local rules for the required retention period.) Don’t make the mistake of relying on your bank to keep the requisite records and provide copies when needed. This negligence alone could constitute a violation. Plus, banks fail, merge or undergo other changes that could jeopardize the availability of years-old checks and other documentation.

Most states also expect attorneys to keep their own records explaining transactions depicted in the bank's documents. Maintain a detailed ledger that records the transactions for each client with the:

- Date, amount and purpose of each deposit, and
- Date, amount, payee, purpose and client name for each disbursement.

Keep an account journal that tracks each transaction through each CTA. Record every deposit and disbursement to the client ledger and account journal within 24 hours so nothing falls through the cracks.

COMPLYING IS CRITICAL

Violations of your state's rules, whether the product of intentional acts or mere negligence, can have dire consequences. Even small missteps that undermine your CTA compliance could lead to disciplinary action. Therefore, regularly review your CTA practices to ensure you're in compliance. •

Investing in alternative business structures

ABA ETHICS OPINION SETS OUT RULES

The American Bar Association (ABA) opened the door to attorneys' passive investments in so-called alternative business structures (ABSs) with a 2021 formal ethics opinion. But the permission comes with significant limitations that attorneys should take into account before — and after — making such investments.

THE GENESIS OF THE OPINION

ABA Formal Opinion 499 was prompted by changes in Arizona and Utah to their versions of ABA Model Rule 5.4, which has been adopted in nearly every U.S. jurisdiction. The rule prohibits attorneys from sharing legal fees with a nonlawyer or practicing in a law firm in which a nonlawyer owns an interest or serves as an officer or director.

In 2020, Utah launched a pilot program under which court-approved entities could include nonlawyer owners in law firms. The following year, Arizona eliminated Rule 5.4, replacing it with a system whereby Arizona law firms with nonlawyer owners or investors can be certified by the state Supreme Court as ABSs. These changes, according to the ABA, raised the question of whether an attorney practicing in a jurisdiction that adheres to Rule 5.4 can acquire a passive investment interest in an ABS in a jurisdiction that doesn't adhere to that rule.

THE OPINION IN A NUTSHELL

The ABA opinion concludes that an attorney who makes such an investment doesn't violate Rule 5.4 if:

- The investment is made with the goal of receiving a monetary return on investment,
- The investing attorney doesn't practice law through the ABS or manage or hold a position of corporate or managerial authority in it and isn't otherwise involved in the daily operations of the ABS, and
- The investment attorney doesn't have access to protected information without the ABS client's informed consent.

It emphasizes that investing attorneys must ensure that the ABS doesn't identify them as lawyers or hold them out as lawyers associated with the ABS. They also should exercise due care to avoid exposure to confidential client information as part of their investing due diligence. Failure to do so could result in a determination that the investing attorney is part of the ABS "firm."

THE CONFLICTS QUESTION

The opinion acknowledges that investing attorneys might have conflicts of interest that arise from their own practices. It distinguishes, though, between conflicts that exist at the time of the investment and those that subsequently arise.

If the investment itself would create a personal conflict of interest under Rule 1.7(a)(2), the attorney must refrain from the investment or appropriately address it under Rule 1.7(b). The *potential* for conflict, however, doesn't bar the passive investment — although it does require the investing attorney to address conflicts that later materialize.

The opinion cautions that investing attorneys should consider the possibility of "concurrent conflicts" that could arise from their representation of clients in the attorneys' jurisdiction. Such a conflict would likely exist, for example, if the attorney represented a person with interests adverse to an ABS client when the attorney made the investment. In that case, the investment could create a significant risk that the attorney's representation of the client would be materially limited.

While the conflict would preclude the investing attorney from representing the client, though, other members of the firm could probably assume the representation without a conflict because personal interest conflicts generally aren't imputed. The opinion also notes that a passive investment doesn't create an "of counsel" relationship where conflicts are imputed to other attorneys.

KNOW — AND AVOID — THE RISKS

Financial advisors generally steer investors to diversify their portfolios. However, if you're thinking about diversifying by investing in an ABS you should proceed with caution. The investment may be "passive," but if you don't actively avoid confidential information and conduct ongoing conflicts analysis, you could run afoul of Rule 5.4. •

Midsize firms poised to profit from growing demand

The latest edition of the Thomson Reuters Institute's *Report on the State of the Midsize Legal Market* paints a generally "bullish" picture for midsize law firms — with the average midsize firm outperforming its Am Law 100 counterparts in demand growth (1.7% vs. -0.2%) in the first half of 2022. It cautions, though, that multiple challenges remain. The report is based on data from 168 U.S.-based firms, including 45 Am Law 100 firms, 50 Am Law Second Hundred firms and 73 midsize firms.

THE GOOD NEWS

The report finds that midsize firms are in a better position relative to the market than they were just a few years ago. It notes global changes and pandemic-related events prompted clients to turn to larger firms in search of safety and solidity.

But the climate in 2022 — including increased inflation and fears of recession — caused clients to pursue more cost-effective solutions to their legal problems without sacrificing quality. The result has been a sort of "reversal of fortunes" for many midsize law firms.

The report cites several fundamental markers that appear positive for these firms. For example, they generally have fared well when it comes to attorney attrition. An earlier report from the Thomson Reuters Institute indicates that midsize firms represent a disproportionate percentage of so-called "stay" law firms with lower rates of turnover — meaning they're perceived as desirable places to work. With midsize firms typically providing lower associate pay scales and smaller raises, their impressive "stay" stats suggest that, for some attorneys, a satisfactory work environment involves more than simply money.

THE BAD NEWS

It's not all good news, though. The report states that other trends, such as skyrocketing overhead expenses and higher associate compensation have been a drag on the financial results of midsize firms. Productivity fell in these firms, too, but by less than in their peers — 1.8% versus 2.3% for the average firm across the market. Negotiated rates lagged behind the market, highlighting the importance of collections.

And large salary increases in international law firms have required midsize firms to raise salaries to stay competitive. The report advises firms with lower pay scales to create firm cultures that provide satisfaction in forms other than monetary.

A favorable work culture can possibly overcome the draw of a higher salary, the report says. The absence of that culture, though, makes it more likely that higher pay will be sufficient for competitors to poach talent. Attorney attrition is particularly worrisome in a tight labor market where the costs to fill vacancies have escalated dramatically. The report found a 117% increase in recruiting expenses over the previous 12 months.

CAUTIOUSLY OPTIMISTIC

Overall, though, the report finds that midsize firms are on a favorable footing going forward. We can help firms of all sizes build a sustainable foundation for the future. •

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