



S corporation compensation  
The critical question of  
salary vs. distributions

Protect your practice from  
money-laundering schemes

Seeing into the future  
Why law firms should conduct  
quarterly financial checkups

Sales teams can support  
some firms' success

# LAW FIRM MANAGEMENT

WINTER 2026

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## S CORPORATION COMPENSATION

# The critical question of salary vs. distributions

Law firms that elect to be taxed as S corporations face a critical compensation question: How should the practice set salaries *and* allocate profit distributions for attorneys who are both employees and shareholders? Whether your firm is considering such an election or already operates as an S corporation, it's important to consider the tax implications and financial risks. Let's take a closer look.

### TAXATION ISSUES

In S corporations, employee-shareholders (such as attorneys) generally receive a salary and distributions. Salaries are subject to income taxes and federal payroll taxes of 15.3% (split evenly between the employer and employee). Higher-income employees may also owe an additional 0.9% Medicare tax on wages exceeding \$200,000 for single filers, \$250,000 for those married filing jointly or \$125,000 for those married filing separately.

By contrast, distributions aren't subject to payroll taxes because an S corporation's income, gains, losses and deductions pass through to



shareholders, who report the items on their individual tax returns. However, this doesn't mean distributions are tax-free. Shareholders pay income taxes on their shares of the S corporation's income whether it's distributed or not.

One important restriction applies: A distribution can't exceed the shareholder's stock basis in the firm. Any amount distributed in excess of basis is taxed as a long-term capital gain (typically at 15% or 20%, depending on income level).

Given the potential to reduce employment taxes, it's easy to see why some employee-shareholders may prefer to minimize their compensation and maximize their distributions. There's more to the decision, though.

### REASONABLE COMPENSATION

The IRS requires S corporations to pay reasonable compensation to employee-shareholders *before* making distributions. If it determines compensation is unreasonably low, the tax agency may reclassify distributions as wages, triggering payroll tax liabilities, penalties and interest.

When assessing whether an attorney's salary is indeed reasonable, the IRS likely will consider the individual's training, experience, duties and responsibilities, as well as time and effort devoted to the firm. An investigator will also look at practice-specific factors such as the firm's:

- Dividend history,
- Payments to nonshareholder employees,
- Timing and structure of bonuses, and
- Compensation agreements and formulas used to determine pay.

In addition, the IRS will compare the practice's compensation to that of similar legal practices.

## BUILDING THE CASE FOR REASONABLE COMPENSATION

If your law firm is an S corporation — or considering making the election — you'll need to address the reasonable compensation requirement for employee-shareholders. (See main article.) That means documenting how various factors were considered, including your practice's:

**History.** A newer firm might justify lower salaries.

**Size.** Smaller firms may lack the financial capacity of larger ones.

**Location.** Urban or certain suburban firms may need to pay higher salaries.

**Profitability and growth.** Stronger earnings generally support higher compensation.

Additional influences include the state of the economy and local labor market conditions. Supporting documentation may include data from the U.S. Bureau of Labor Statistics, compensation surveys from bar associations or recruiting firms, and competitors' job listings or industry benchmarks. It's also advisable to maintain a formal compensation policy approved by a governing body or compensation committee that keeps written minutes of its meetings.

### KEY TO SUCCESS

Generally, the key to establishing reasonable compensation is determining what the employee-shareholder actually does for the S corporation and where the firm's gross receipts come from. The tax agency looks at three major sources of gross receipts: 1) the shareholder's personal services, 2) the services of nonshareholder employees, and 3) capital and equipment.

If most of the practice's income stems from the shareholders' personal legal services, a shareholder's earnings should be classified as wages subject to payroll taxes. On the other hand, if income is generated primarily through nonshareholder employees or the use of capital and equipment, those earnings may be more appropriately treated as distributions.

An employee-shareholder's administrative or management work — for example, that of a managing partner who no longer directly bills clients — should also generally be compensated as wages. This is because such duties contribute to the firm's operations.

Comprehensive documentation is your best defense. Be prepared to show how you determined compensation levels and how they reflect each employee-shareholder's role, time and contribution to practice income. Maintain records that demonstrate a thoroughly documented compensation-setting process, comparable salary data for similar firms, and a well-reasoned rationale behind the balance of wages and distributions. (For more information, see "Building the case for reasonable compensation" above.)

### PREPARATION IS PARAMOUNT

If your firm's profit distributions significantly exceed its wage payments, the IRS may take a closer look to ensure compensation isn't being misclassified. This could result in a time- and resource-consuming audit at the very least — and liability for back taxes, penalties and interest in a worst-case scenario.

Work closely with your CPA to establish defensible, tax-savvy compensation policies and maintain compliance with IRS rules and expectations. •

# Protect your practice from money-laundering schemes

Money laundering may not be the first threat that comes to mind when assessing risks to your law firm. However, in recent years, several firms have been implicated in laundering money through client accounts. As criminals grow more sophisticated, your firm should regularly evaluate its exposure to potential money-laundering risks — especially in relation to its client base. The most effective safeguard is a proactive system for identifying and assessing risks so your firm can prevent being used for illicit activity before it occurs.

## LAWS AND GUIDELINES

The American Bar Association (ABA) has long opposed anti-money laundering (AML) legislation targeting attorneys. Many argue that such laws would be burdensome and undermine confidentiality and attorney-client privilege. But the ABA supports the guidelines developed by the Financial Action Task Force (FATF), an inter-governmental body whose recommendations are recognized as the international standard for AML and counterterrorist financing.

The FATF has identified several legal activities that are particularly susceptible to money laundering, including:

- Buying and selling real estate or business entities,
- Managing client money, securities or other assets,
- Managing bank, savings or securities accounts,
- Organizing contributions for the creation, operation or management of companies, and
- Creating, operating, or managing legal persons or arrangements.

Conducting these activities across borders may intensify vulnerability.

## A COMPREHENSIVE ASSESSMENT

According to the FATF, the cited activities should be subject to a comprehensive risk assessment. The assessment typically considers three types of risks.

First, there's country or geographic risk. It relates to the location(s) of the client, the transaction, and the source of the wealth or funds. Higher risks are generally associated with countries that support terrorist activity, have high levels of organized crime or corruption, or are subject to international sanctions (for example, those imposed by the United Nations).

Client risk factors are the second type of risk. The FATF has developed a lengthy list of the characteristics of clients whose activities might pose a higher risk. These include politically exposed persons (PEPs), clients who maintain unusual or complex structures that obscure ownership, and those who operate cash-intensive businesses. Unusual client relationships or payment methods may also raise red flags.

Third, there are service risk factors. The FATF's list of these is also long. It includes services



where an attorney may effectively vouch for the client's standing, reputation and credibility — without an appropriate knowledge of the client's affairs. Other examples include engagements in practice areas where the attorney lacks expertise or real estate transfers occurring in unusually short time frames.

*The attorney should evaluate whether assisting the client might involve money laundering by conducting a risk assessment and reviewing any red flags or inconsistencies.*

#### DUE DILIGENCE PROCEDURE

To help attorneys mitigate money-laundering risks, the ABA, International Bar Association, and Council of Bars and Law Societies of Europe jointly developed a multistep client due diligence procedure. This process begins at client intake.

An attorney should first identify and verify the identity of the client and the beneficial owner. It's

also important to understand the client's background, business and financial activities based on information gathered during the normal course of engagement.

Next, the attorney should evaluate whether assisting the client might involve money laundering by conducting a risk assessment and reviewing any red flags or inconsistencies. If the attorney decides to proceed, ongoing monitoring is essential — especially when dealing with PEPs or clients from high-risk jurisdictions.

If the attorney believes that criminal proceeds are being used in a transaction or to engage legal services, he or she should, as required or permitted, file a Suspicious Transaction Report (STR) with the appropriate authority. The attorney must also take care to avoid tipping off the client about the STR.

#### ON YOUR RADAR

To enable your firm's attorneys to provide best-in-class legal services to clients, keep the risk of money laundering on your radar. Your CPA can help identify vulnerabilities, refine internal controls and ensure compliance with widely accepted AML standards. •

## Seeing into the future

### WHY LAW FIRMS SHOULD CONDUCT QUARTERLY FINANCIAL CHECKUPS

Running a legal practice comes with plenty of moving parts. There are clients to serve, cases to manage and deadlines to meet. For these reasons and others, regular reviews of firm financials may fall toward the bottom of your to-do list.

The problem is, if you wait until year end to scrutinize the numbers, unpleasant surprises become highly likely. Conducting quarterly

financial checkups helps keep your firm's money matters in clear view all year long, giving you time to address possible issues before they turn into major problems.

#### 4 KEY AREAS

Quarterly financial checkups don't dig into every detail of every transaction. Rather, they look at whether key indicators are pointing in the right

direction. Done properly, a checkup will help you and your partners spot patterns earlier, make quicker adjustments, and avoid the stress of unexpected cash flow crunches or surprisingly high tax bills. Here are a few key areas to keep an eye on each quarter:

**1. Realization rates.** As you know, not all billed time turns into collected revenue; your realization rate shows how much of your work actually ends up as income. A dip in that number can signal issues, such as excessive write-downs, delayed invoicing or clients who consistently push back on fees. Catching these trends early gives you time to address them before profits take a hit.

**2. Partner draws and distributions.** Partner compensation can present distinctive problems for law firms. Many practices get into trouble when more money is taken out than cash flow can comfortably support. This often happens in busy months that look profitable on paper but don't bring in revenue as quickly as expected. Regularly reviewing draws against actual earnings helps prevent shortfalls later. Moreover, it keeps tax season from becoming a scramble to cover under-withheld income.

*Regularly reviewing draws against actual earnings helps prevent shortfalls later.*

**3. Accounts receivable aging.** Most legal practices encounter clients who are slow payers. But if that list is growing longer each quarter, your working capital may be silently shrinking.



Looking at an accounts receivable aging report every quarter can highlight problematic clients and indicate whether your billing process needs tightening.

**4. Tax projections.** As you've likely experienced, firm revenue can rise and fall throughout the year depending on caseload and outcomes. Without updated tax estimates, it's easy to underpay and face penalties — or overpay and slow down cash flow. Running a quarterly projection helps ensure your payments stay aligned with your practice's actual income and expenses, keeping your overall tax plan for the year on track.

#### INSIGHT INTO ACTION

Quarterly financial checkups are powerful only if you act on what you learn. Trendlines spotted early can guide smarter decisions about staffing, technology investments, partner compensation and even client mix. This kind of proactive financial management keeps your legal practice stable, nimble and confident — no matter what the next quarter brings.

And don't feel like you have to go it alone. Your CPA can help you interpret the numbers, benchmark performance, and develop strategies that strengthen cash flow, manage tax liability and better ensure annual profitability. •

# Sales teams can support some firms' success

Law firms' traditional business model is increasingly under scrutiny as practices adapt to rapid technological shifts and changing client expectations. For example, historically, attorneys have been the unquestioned rain-makers for most firms. But many practices are now exploring the concept of establishing a dedicated sales team to provide much-needed support for bringing in new business.

## MULTIPLE BENEFITS

At some firms, the old guard has long resisted the idea of using nonattorney salespeople. But even those who have traditionally opposed the notion may reconsider when they realize their firm can enjoy greater revenue — and they can devote more time to what drew them to the profession: practicing law.

Sales professionals know how to make attorneys look good, too. For instance, they can coach attorneys when preparing for and making pitches. Although attorneys should handle the legal content in pitch meetings, a sales pro can help manage the engagement process and close the deal.



Moreover, clients generally appreciate having someone who can quickly connect them with the right attorney for their case. Salespeople often get to know the firm and its services better than individual attorneys working within their practice silos.

Bear in mind, though, that these perks don't come cheap. Qualified sales professionals are typically paid a base salary plus a revenue-based bonus. Depending on the size and structure of your firm, a sales pro could eventually make as much as some partners.

## REPORTING STRUCTURE

When hiring, look for candidates who have previously met revenue expectations and, preferably, have contacts in your target markets. Look for salespeople who are collaborative; they'll need to work well with your attorneys and your wider staff.

Once you hire someone, implement an appropriate reporting hierarchy. Generally, sales professionals shouldn't report to marketing, as marketing typically supports sales. It's usually best for salespeople to report to the managing partner or another high-level partner.

Finally, be patient. No matter how talented, sales pros need time to learn about your firm and its clients, as well as develop relationships in the market. Some may need six months to a year to get fully up to speed and for you to see the results in quarterly revenue.

## A POTENTIALLY FRUITFUL IDEA

A dedicated sales team can provide a boost to your firm's top line and free up attorneys to focus on what they do best. But they may not be a good fit for every practice. Ask your CPA for help identifying the costs, projecting the numbers and assessing your potential return on investment. •



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