

Tax considerations for attorneys who file in multiple states

BY ERIC LAWRENCE, CPA

Partners at law firms face many personal and professional challenges. Due to economic conditions and global competition, law firms have become much larger through mergers and acquisitions resulting in firms that have offices nationally. Today, law firms are required to file tax returns in many states.

Most law firms operate as limited liability partnerships, which are pass-through or flow-through entities created for income tax purposes. Income flows through to the partners – that is, the income of the entity is

treated as the income of the partners. Therefore, it is the responsibility of each partner to report and pay the state tax in each state where the firm files a return.

This article will discuss five tax considerations for attorney-partners required to file in multiple states.

FILE IN THOSE STATES WHERE YOUR FIRM IS DOING BUSINESS

With the downturn in the economy and the recent advances in technology, states are becoming more aggressive in pursuing tax

revenue owed them, and they have the tools to track down non-filers.

The penalties for non-filing can be severe. A firm will advise its partners in which states they should file, the amount of income to report in each state and other relevant reporting information. This is usually reported on an equivalent state Form K-1 that is included in the annual tax package firms provide their partners, including the federal Form K-1. The firm is required to report partners' state tax information to each state. Therefore, if partners do not file the state tax return, the

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state will eventually either send them a notice requiring a return, or file a return and issue a notice to the partners assessing tax, penalty and interest.

REPORT APPLICABLE TAX ADJUSTMENTS TO EACH STATE

Today, state tax returns can be as complicated to prepare as federal tax returns. States avert the loss of revenue from federal tax provisions by “decoupling” – that is, protecting the relevant parts of the state tax code from changes in the federal tax code. The result has significantly increased the complexity of state tax returns.

Partners need to account for these applicable adjustments when preparing their state tax return. Common adjustments or differences between federal and state tax treatment are depreciation, loss on disposal of fixed assets, federal tax credits and tax-exempt interest income. Certain cities such as New York City and Philadelphia impose income taxes, too. If a law firm does business in such cities, its partners will obtain a federal tax deduction, but those taxes are not deductible for state tax purposes. Such firms need to provide the necessary adjustments to their partners to report on their state tax returns.

TEST WHETHER TO JOIN FIRM GROUP STATE TAX RETURN

Many larger law firms offer their partners an opportunity to join in filing a group state tax return. Partners can elect to join the group state tax return or elect out and file their own individual state tax return. The advantage to electing the group option is to reduce the individual attorneys’ time and cost in preparing their personal state tax return. The disadvantage is that the group state tax return may result in more state tax than filing an individual state tax return.

Before electing the group option, partners should test whether there are significant tax savings by filing an individual state tax return. Non-residents of California and New York generally achieve tax savings by filing their own tax returns rather than participating in their firms’ group returns, depending on the amount of firm income apportioned to these states.

CLAIM CREDIT FOR TAXES PAID TO OTHER STATES ON RESIDENT STATE RETURN

Partners are required to report all income to their resident states even if income is sourced to other states and taxes are paid to those states.

To prevent or reduce double taxation, resident states generally allow a credit for taxes paid to other states on partners’ resident state returns. Generally, resident states do not allow a credit for taxes paid to non-resident cities such as New York City and Philadelphia. Partners are permitted to claim a credit for taxes paid to other states on their resident state returns even if they participate in their firm’s group return. Such firms should provide a statement indicating their partners’ share of taxable net income and tax liability in each of the other states.

REPORT NON-RESIDENT STATE TAX PAYMENTS ON FEDERAL TAX RETURN

Non-resident state tax payments are deductible as itemized deductions on partners’ federal

tax returns – that is, on Schedule A of Form 1040 as is done for residents’ state tax payments. Like resident state tax payments, non-resident state tax payments are deducted in the year paid, not incurred.

The same tax treatment is true even when partners file as part of their firms’ group state tax return. The payments made by the firm on their partners’ behalf will be deducted from their draws. Therefore, partners pay state taxes and may deduct those taxes as itemized deductions on their federal tax returns.

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