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Tax Considerations for Maryland Attorneys Who Become Partners

By Eric J. Lawrence

Congratulations! You have achieved your professional goal of becoming a partner in your law firm. Perhaps that achievement came after years of working in an established firm. Or it may have come when you started your own firm. Regardless, in addition to the many professional and personal requirements that you have now taken on upon achieving partner status, your individual federal, Maryland, and other state tax requirements and filings will now require additional time and attention.

Since most law firms operate as limited liability partnerships you will no longer receive a W-2 to report your income. Law firm limited liability partnerships are pass-through or flow-through entities for income tax purposes, where income "flows through" to the partners; the income of the entity is treated as the income of the partners. Therefore, it is the responsibility of each partner to report his/her share of income and pay his/her corresponding federal, Maryland and other state income taxes.

Economic conditions and global competition have caused law firms to become much larger through mergers and acquisitions, resulting in firms that have offices nationally and internationally. Due to these trends, law firms are often required to file tax returns in many states.

This article will discuss how these changes and growing complexities affect tax considerations for attorneys who become partners.

Federal Income Tax Requirements

You will receive a federal Schedule K-1 rather than a W-2 to report your income and deductions. The K-1 will separately state each item of income and deduction and you are responsible for accurately reporting these on your individual forms and schedules. Unfortunately, the K-1 is very complicated and will require several IRS forms and schedules including:

- Schedule E - This schedule reports your ordinary income and guaranteed payments.
- Schedule SE - This schedule reports self-employment tax that you are required to pay. These taxes are the social security and Medicare taxes previously withheld for you as an employee.
- Form 1116 - Many law firms operate globally and have international offices. Your firm may have to pay foreign income taxes and you will be eligible to claim a credit for these against your federal taxes on this form.

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Layton's Chance, Vienna, MD
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Section Open Meeting: Strategies in Mediation and Arbitration: From Contract Clauses to Implementation
Monday, November 18, 2013 | 6:30pm
Join us for a lively panel discussion and light refreshments.
Bond Street Social, Baltimore, MD
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YLS Bowling
Wednesday, November 21, 2013 | 5:30pm – 8:30pm
Mustang Alley's, 1300 Bank Street,Baltimore, MD 21231
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- Schedule B - This schedule reports your allocable share of interest and dividends earned by your law firm on its investments.
- Schedule A - This schedule reports various deductions including charitable contributions and state income taxes paid by your law firm.

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In addition, if you participate in your firm's pension and health insurance plans, those deductions will appear on your K-1 and be reported on your Form 1040, page 1, lines 28 and 29.

As an employee, you had applicable federal and Maryland taxes withheld from your paycheck. Now, as a partner, you are responsible for paying these taxes on a quarterly basis. Estimated quarterly payments are generally due April 15, June 15 and September 15 of the current year and January 15 of the following year. You will need to determine your income for each quarter and remit the appropriate amounts.

Maryland and Other State Income Tax Requirements

In addition to the federal return, you may be required to file state tax returns other than for your resident state of Maryland. Your firm will inform you in what states you should file and provide you with the amount of income to report in each state as well as other relevant information. This information is usually reported on an equivalent state Schedule K-1 that is included in your annual tax package from your firm that includes your federal Schedule K-1. With the downturn in the economy and advances in technology, states are becoming more aggressive in tracking down non-filers and have the tools to do so. The penalties for non-filing can be severe. Your firm is required to report your state tax information to each state. Therefore, if you do not file the state tax return, the state will eventually either send you a notice requiring a return or file a return for you and issue a notice assessing tax, penalty and interest.

Today, state tax returns can be as complicated to prepare as federal tax returns. States, including Maryland, avert the loss of revenue from federal income tax provisions by "decoupling." Decoupling protects the relevant parts of a state's tax code from changes in the federal tax code. The result has significantly increased the complexity of tax returns in many states, including Maryland. You will need to account for these applicable adjustments when preparing your Maryland and other state tax returns. 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 and Philadelphia impose income taxes as well, and if your firm does business in such cities you will obtain a federal tax deduction, but those taxes are not deductible for Maryland tax purposes. Your firm will need to provide the necessary adjustments for you to report on your Maryland tax return.

Many larger law firms offer their partners an opportunity to join in filing a group state tax return. The partner can elect to join the group state tax return or opt out and file his/her own state tax return. The advantage of electing the group state tax return is to reduce your time and cost in preparing your own return. The disadvantage is that the group return may result in more state tax than an individual return. Therefore, before electing the group return, you should test whether there are significant tax savings to be gained by filing your own state tax return. Non-residents of California and New York generally achieve tax savings by filing their own tax returns rather than participating in the firm's group return, depending on the amount of firm income apportioned to these states.

You are required to report all income to your resident state of Maryland even if income is sourced to other states and you pay tax to those states. To prevent or reduce double taxation, Maryland generally allows a credit for taxes paid to other states on their state returns. However, Maryland does not allow a credit for taxes paid to non-resident cities such as New York and Philadelphia. You are permitted to claim a credit for taxes paid to other states on your Maryland return even if you participate in the firm's group return. Your firm should provide a statement indicating your share of the taxable net income and the tax liability in each of the other states.

Non-resident state tax payments are deductible as an itemized deduction on your federal tax return on Schedule A of Form 1040 like your resident state tax payments. Like resident state tax payments, non-resident state tax payments are deducted in the year paid, not the year incurred. The same tax treatment is true even when you file as part of the firm's group state tax return. The payments made by the firm on your behalf will be deducted from your draws. Therefore, you have paid the state taxes and may deduct those taxes as an itemized deduction on your federal tax return.

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