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LAW FIRM MANAGEMENT

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Opting out of the new partnership audit regime

The Bipartisan Budget Act of 2015 (BBA) changed how partnerships are audited. Proposed IRS rules for partnership audits under the law apply to taxable years beginning after December 31, 2017, but some partnerships can choose to opt out. If your law firm is organized as a partnership, here's what you need to know.

NEW AUDIT RULES

The proposed regulations provide a default audit regime under which the IRS will assess tax on any tax adjustment that increases a partnership's income against the partnership itself, instead of against the individual partners from that tax year. In other words, the economic burden will hit the partners in place when the audit adjustment is finalized, not those in place during the tax year that income was underreported.

Eligible partnerships that wish to opt out should make the election on their timely filed tax returns for the tax year to which the election applies.

Alternatively, a partnership can elect to “push out” the adjusted items to the partners from the relevant tax year. Those partners would take their shares of the adjustments into account on their individual tax returns. (Separate proposed regulations provide rules addressing how partners that are pass-through entities, such as limited

partnerships or limited liability companies, take into account pushed-out adjustments.)

OPT-OUT ELIGIBILITY

The BBA generally allows certain partnerships to opt out of the BBA rules entirely. This means they and their partners would be audited under the rules applicable to individual taxpayers. If a partner is a partnership or limited liability company, though, the overall partnership can't elect out of the rules.

In early 2018, the IRS issued final regulations that clarify which partnerships can opt out and how. They provide that partnerships with 100 or fewer qualifying partners can opt out as long as the partners are:

- Individuals,
- C corporations,
- Foreign entities that would be treated as C corporations if domestic,
- S corporations, or
- Deceased partners' estates.



FINDING THE RIGHT PARTNERSHIP REPRESENTATIVE

Proposed regulations for partnership audits (see main article) create the new role of partnership representative (PR). This person replaces the tax matters partner under the former regulations.

The PR has sole authority to act on behalf of the partnership. He or she wields broad authority to bind the partnership and all partners, including the ability to waive the statute of limitations, proceed to litigation and make the push-out election — all without any duty to communicate with the partners regarding an audit. And if the partnership fails to designate a PR, the IRS has the power to do so.

Thus, choosing a PR is very important. Be sure to review how your partnership agreement covers this role and make necessary amendments. Because the PR has more authority than the former tax matters partner, simply doing a “global replace” in your partnership agreement isn’t enough. Remember, the IRS will be dealing solely with your PR, so it may be prudent to require in the agreement that that person notify you of any communications he or she does have with the IRS.

Eligible partnerships must furnish 100 or fewer Schedules K-1, “Partner’s Share of Income, Deductions, Credits, etc.” Spouses count as two partners, and persons who hold a partnership interest on behalf of another person don’t qualify as eligible partners. If an eligible partner is an S corporation, the S corporation’s shareholders are taken into account when determining whether the partnership must furnish 100 or fewer statements, as is the statement issued to the S corporation itself.

ELECTION PROCESS

Eligible partnerships that wish to opt out should make the election on their timely filed tax returns for the tax year to which the election applies. Elections are irrevocable without IRS consent. Partnerships must notify each partner of the election within 30 days of making it, using the form and manner the partnership chooses.

The election must include each partner’s name, tax identification number and federal tax classification. In addition, the partnership

must include an affirmative statement that the respective partner is an eligible partner, along with any additional information the IRS requires in forms, instructions or other guidance. If an eligible partner is an S corporation, the partnership must provide the name and Social Security number of every shareholder in the S corporation.

If the IRS determines that an election is invalid, it will notify the partnership in writing. The new partnership audit procedures will apply, and any adjustments and penalties will be collected at the partnership level.

DECISION TIME

Merely being eligible to opt out isn’t reason enough to do so — your firm could have good reasons to stick with the new audit regime. And it’s worth noting that the IRS has made clear that opting out won’t reduce the likelihood of audit. Consult with your CPA to determine the best course forward for your circumstances. •

Get the most bang from your social media

Trolls, hackers, public relations nightmares — the risks of social media are highlighted frequently. Nonetheless, platforms like Twitter, Facebook, Instagram and LinkedIn have become the 21st century equivalent of the Yellow Pages. That means law firms that aren't "listed" are likely to miss out on potential referral sources, clients and job candidates.

WHY YOU CAN'T IGNORE IT

A Pew Research Center survey conducted in early 2018 found that the typical American uses at least three of the eight major social media platforms (Facebook, YouTube, Instagram, Pinterest, Snapchat, LinkedIn, Twitter and WhatsApp). And it's not just younger people who are on these channels — 64% of respondents ages 50 to 64 use social media.

With social media so embedded in our lives, it has come to play a critical role in branding. Before social media took off, many law firms spent a lot of time optimizing their website content for search engines, researching keywords and crawling over

Google Analytics™. But social media makes it much easier to build your name recognition. You can use multiple channels to repeatedly and consistently communicate who you are, what you do and for whom you do it. Your postings can convey your areas of expertise and position you as a thought leader in those areas.

Give users a reason to follow you and, going forward, pay attention to your posts.

Your postings also provide a prime tool for networking. They help you stay top of mind with your existing referral sources and introduce you to new sources. Social media lets you quickly find and connect with business leaders, media and others. Of course, you'll need to put in some face time in real life with such people — virtual connections alone usually won't cut it.

HOW TO MAKE THE MOST OF IT

You also need to do more than simply post profiles on the popular platforms. When it comes to social media success, content is king. Don't make the mistake of just sending out links to articles and press releases. Text has increasingly limited appeal, as evidenced by the fact that, according to Pew, 73% of U.S. adults use YouTube.



Develop videos to convey what you've previously gotten across with text. For example, you could create or share clips on topics of interest to prospective clients and post day-in-the-life-of-the-firm videos for job candidates. If you post only promotional materials, you won't get far. You must give users a reason to follow you and, going forward, pay attention to your posts. Likewise, pay attention to the comments you get in response, and actively engage with your followers.

And whatever you end up posting, be sure to do so on a regular basis. The best way to ensure this happens is to have a posting schedule (including both the days and the specific times to post) and stick to it.

Show them the money

COMPENSATING YOUR MANAGING PARTNERS

All law firms have them: the partners who spend the bulk of their practice managing the firm. But if the firm focuses on compensating only rainmakers and large revenue generating partners, they may lose those best qualified for the job. Properly compensating partners who perform the seemingly mundane, but critical, work will keep your firm running profitably.

WAYS TO PAY

Many law firm managing partners perform the job full-time and don't do client work, making compensation fairly straightforward. But what about part-time managing partners, who've given up at least some client work to perform nonbillable management tasks? Compensating these partners can be tricky. It doesn't make sense to compensate such individuals based solely on billable hours, revenue generated or other methods used to evaluate full-time practicing partners.

As far as where to post, resist the temptation to hop on every available platform. Instead, narrow your social media platforms according to whom you want to reach. Identify the demographics of your target audience(s) and select the three or so platforms most likely to reach them. For example, LinkedIn is especially popular with college graduates and those in high-income households.

MAKE THE INVESTMENT

While social media accounts are free, effective use of them requires a significant investment of non-billable time and attention that might not produce obvious or immediate results. But the costs of staying off of social media probably are even higher. •

Instead, consider a flat fee plus percentage. Here, your firm pays a set amount for management duties, such as \$90,000. Then you can add a percentage of profits based on hours, revenues, client origination and other metrics.

Another way to compensate part-time managing partners involves a mix of objective and subjective criteria. This method considers the partner's management *and* client-related contributions. Compensation is based on a variety of factors, depending on what your firm values, the percentage of time spent managing vs. working with clients, and how successful the partner is at meeting personal and firm objectives. Everything from your firm's financial health to the managing partner's business origination could be a factor. This second option generally works best because it allows firms to reward their managing partner not only for doing the job, but for doing the job well.

OBJECTIVE FACTORS

To ensure everyone knows what to expect, your managing partner should work with your compensation committee to allocate percentages to nonbillable management and billable client work. For example, the partner may decide he or she needs to devote 75% to management and 25% to clients. In this case, the 25% would be evaluated the same as the client work of other practicing partners. The remaining 75%, however, would be assessed on a variety of factors.

Objective criteria might include your firm's financial performance, as measured by per partner performance or revenue growth, and achievement of goals, such as implementing an IT upgrade or recruiting a lateral partner to head up a new practice area. Ask the partner to set goals that align with your firm's strategic objectives to help make this assessment easier.

SUBJECTIVE FACTORS

Most criteria, however, are likely to be subjective. For example, effective leaders usually are credited with having "vision" and inspiring confidence — neither of which is easy to measure.

Depending on your firm's priorities, your managing partner may be responsible for business and



marketing strategies, including growth via mergers and geographic expansion. Other responsibilities may include:

- Client satisfaction,
- Public relations and business and legal community outreach,
- Internal operations, loss prevention, internal controls and ethics,
- Manager and partner performance,
- Human resources and employee benefits, and
- Firm morale and productive relationships between attorneys and staff.

Put managing partner responsibilities in writing, recognizing that they may change over time as the partner adjusts to the role.

Put such responsibilities in writing, recognizing that they may change over time as the partner adjusts to the role. Everyone should be on the same page about which duties are considered "part of the job" and which reflect extraordinary performance (usually financial achievements). In the case of the latter, you may want to pay a performance bonus separate from regular compensation.

STRIKE A BALANCE

Fairly compensating your managing partners doesn't mean you have to pay them more than your top rainmakers. You'll need to find the right balance for your firm. By providing the right incentives, you'll attract those who are able to successfully balance managerial duties with client representation. •

What now? Responding to the improved economy

After a long recession and slow recovery, the economy seems to be headed back to more stable ground. Just as the weak economy required law firms to make some changes in strategy, so, too, does the improved situation. These three steps can position your firm to make the most of the upturn.

1. HELP YOUR CLIENTS GROW

The most cost-efficient route to sustained profitability is through the retention of profitable clients. And the clients most likely to stick around are grateful clients.

Demonstrate your expertise by identifying and bringing existing clients growth opportunities they can pursue, within their own industries or beyond. Not only does this show them that you're in their corner and understand their needs — it also opens the door to cross-selling of additional firm services.

2. RECONSIDER YOUR PRACTICE AREAS

Many firms responded to the recession by focusing on volume. In better times, though, you should emphasize profitability when deciding which practices to continue, add or drop.

In addition to evaluating your practice areas to determine which are the strongest, survey the legal landscape in general to get a sense of which areas are expanding and shrinking. Practices that may have thrived during the downturn — such as those handling loan workouts, foreclosures and bankruptcy — probably have seen a drop-off in activity. Others are vulnerable to automation or commoditization.

On the other hand, depending on location and other factors, you could see an increased demand for merger and acquisition, construction, real estate, private equity, technology and regulatory



work. The sweeping changes in the Tax Cuts and Jobs Act should translate to escalated activity in tax practices. The spreading legalization of cannabis is creating new legal industries in certain states (although these largely tap existing expertise in, for example, tax and regulatory matters), too.

3. ADJUST YOUR FEES

The recession led to a “race to the bottom” in terms of fees for struggling firms. Reassess your fees and look for places where you can boost them. Don't increase your fees across the board, but do raise them for your star attorneys or those in high-demand or specialized areas.

Think about reining in any steep discounts you felt pressured to offer. In current conditions, discounts should be extended only where you stand to benefit, such as when you're guaranteed a large volume of work. Continuing unnecessary discounts for highly profitable clients out of a fear of rocking the boat undermines your value.

EYES ON THE PRIZE

Regardless of the economy, the driving goal for law firms should be long-term profitability. To achieve this, make sound, data-driven decisions and avoid the temptation to chase the next hot, but all-too-often fleeting, practice area. •



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