LAW FIRM MANAGEMENT

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The right PR

IRS FINALIZES RULES FOR PARTNERSHIP REPRESENTATIVES IN AUDITS

The IRS has issued its final regulations for the designation, authority and replacement of a partnership representative (PR) under the new default audit regime for partnerships (including limited liability companies taxed as partnerships). The PR replaces the previous role of the tax matters partner and possesses a broader authority to bind the partnership and all partners in dealings with the IRS. The final regulations are effective for tax years beginning after 2017.

WHAT'S INVOLVED

Under the default audit regime, the IRS will assess tax on an adjustment that increases a partnership's income against the partnership itself, rather than against individual partners from that tax year. A partnership can, however, elect to "push out" the adjusted items to partners from the relevant tax year. Those partners would take their shares of the adjustments into account on their individual tax returns.

When the IRS audits a partnership, the PR has sole authority to act on the partnership's behalf. The PR can extend the statute of limitations, proceed to litigation and make the push-out election — all without any duty to communicate with the firm's partners.

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WHO CAN SERVE AS PR

The proposed regulations allowed a partnership to designate any person with a substantial presence in the United States (meaning, essentially, that the person is available to meet in person with the IRS) and the "capacity to act" as PR. If an entity was designated as PR, the partnership also was required to appoint a designated individual to act on the entity's behalf.

The final regulations make clear that disregarded entities (those that are disregarded as separate from their owners for income tax purposes, such as single-member LLCs) can serve as PRs. Because a disregarded entity would be an entity PR, the partnership must appoint a designated individual to act on the PR's behalf. Both the

WAYS TO LIMIT THE PR'S AUTHORITY

The final regulations (see main article) for partnership representatives (PRs) clarify a proposed regulation that provided that no state law, partnership agreement or other document could limit the PR's authority. According to the IRS, it often expended significant resources under the previous law to determine which state law restrictions might affect who could act for the partnership and under what circumstances. The new partnership audit regime removes this burden.

The IRS emphasizes that this rule applies only with respect to the audit. In other words, the failure to adhere to state law requirements will have no effect on a PR's actions taken within the audit process.

But the IRS notes that the regulations allow a partnership and its PR to enter contractual agreements to define the scope and limits of their relationship. The IRS won't be bound by such an agreement, of course, but a partnership could obtain a remedy under state law if the PR fails to act in accordance with it.

disregarded entity and the designated individual must satisfy the substantial presence requirement. Additionally, a partnership can serve as its own PR if it has a substantial presence in the United States and appoints a designated individual with such a presence to act on its behalf.

The final regulations also eliminated the capacity-to-act requirement altogether to give partnerships as much flexibility as possible in picking their PRs. The IRS may, however, determine that a designation of a PR isn't in effect due to circumstances that would have resulted in the PR not having capacity to act under the proposed regulations. That's because some of the proposed capacity-to-act requirements overlapped with substantial-presence requirements.

HOW TO REPLACE THE PR

The final regulations maintain the proposed rule that a partnership can change its PR only in the context of an administrative proceeding or in conjunction with the filing of a valid administrative adjustment request (AAR). They also revise the proposed regulations to permit a partnership to change the PR when notified that its return has been selected for exam, in addition to when a notice of administrative proceeding (NAP) is mailed.

What about when a PR resigns? The final regulations don't allow that PR to designate a successor. They also prohibit a PR from resigning when the partnership files an AAR. Resignation is allowed only when an NAP has issued.

In contrast, a partnership can revoke a PR's designation (including a designation made by the IRS, provided the agency grants permission) for any or no reason. And anyone who was a partner during the partnership taxable year to which the revocation relates can sign a revocation. Notice of revocation (and of resignation) becomes effective on IRS receipt.

HELP IS AVAILABLE

Notably, the regulations establish that a PR can engage someone — such as a CPA — to act on the PR's behalf under a power of attorney during the administrative proceeding. So your professional advisor can participate in meetings or receive copies of correspondence. •

It costs how much?

HOW A COST RECOVERY SYSTEM CAN BOOST PROFITS

Recovering costs related to clients' legal matters is a standard law firm practice. But to ensure you recover costs effectively, you need a strategic cost recovery policy. Not only is it an important part of your firm's financial strategy, but it's also an important element of a healthy relationship with your firm's clients. If you don't have a cost recovery system in place, now is the time to consider one.

TRACKING EXPENSES

When you think about what your firm does to serve clients' needs, expenses can add up quickly. While copying and faxes don't generate the volume they once did, firms are spending more on scanning, printing and electronic data storage. There are also the costs of legal research and hard costs from vendors for things such as courier service and overnight package delivery. Does your firm bill a flat rate for these items? If so, you may be missing out on potential revenue by leaving some recoverable costs unrecovered.

Tracking office expenses through a cost recovery system helps show you — and your clients — where the money is going. It also enables you to recoup costs without overcharging clients. For example, are your firm's photocopiers, scanners, printers and fax machines equipped with control terminals that require users to input client account numbers before they can be used? They should be. While you most likely won't be able to make 100% of these activities billable, an increase in the percentage of billable activities from, say, 50% to 75% will provide immediate and significant savings.

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SHOPPING FOR SOFTWARE

Cost recovery software — either standalone or integrated with proprietary research databases — is essential for cost tracking, bill-back functions and, most important, client validation. Such software can collect and store information from everything from control terminals to telephones to computers. It enables your IT department and other authorized users to add or delete billing codes and perform other functions as needed.

Systems administrators also can review billing information daily and create customized reports. For example, pop-up screens tied into your client code system will request information from users, such as a client number, before they can begin a search. Any search conducted by a firm member can be dissected in a report that indicates the client, the user, the database accessed, the amount of time spent and other relevant information.

Software and systems vary, so be sure to research your options to make sure you get the features your firm needs. An important question to ask is whether the software you choose is compatible with your other management systems.

STAYING UP TO DATE

To remain competitive and better serve your tech-savvy clients, keep pace with advancing technology. Assess your existing software, ongoing license costs and actual use of the software. Consider upgrading to current versions if your systems are more than five years old. Old software may have compatibility issues with other management systems and lack adequate security and support.

Newer software generally offers better usability and features. For instance, you'll have real-time access, which allows you to see work in progress for any project at any time. This will allow the firm to bill more accurately, helping to cut costs while increasing profitability.

An up-to-date and well-designed system's cost-cutting benefits can free up funds to invest in other technologies that will help your firm run more efficiently and productively. Many software systems now help ensure your firm is in compliance with any federal or state statutes that require extensive financial reporting and electronic record keeping.

BENEFITING CLIENTS

While cost recovery systems are a clear winner for a firm's bottom line, clients may be less enthusiastic about your new or upgraded cost recovery system if they feel the costs are passed on to them. In fact, there has been growing client pushback on fees for electronic legal research and other fees. When meeting with new clients, provide a schedule of rates. When you make revisions to your rates, communicate those changes to existing clients. •

Tips to keep a lid on your overhead expenses

Lower overhead usually means higher profit margins, but many law firms struggle to contain their overhead costs, from rent and administrative expenses to supplies and services. The good news is that you have many avenues to curb overhead from eating into your profits. Your property leasing and staffing costs are two cost areas ripest for reduction.

WHAT ARE YOU PAYING FOR RENT?

Just about every successful private law firm you see depicted on TV is spread out over what seems like acres of square footage. Thanks to Hollywood, many lawyers old and new, as well as clients, have come to see spacious office suites as essential contributors to, and signs of, success.

But every dollar a firm spends on rent means a dollar less of profit. Moreover, technological advances and changing priorities among younger attorneys — who generally appreciate the opportunity to work remotely — make it unnecessary for many firms to occupy as much space as they have in the past. These days, firm members can easily keep in contact using video conferencing, chat apps like Slack and Stride and other cost-effective tools.

And smaller space isn't just for attorneys. The days of large document storage areas are dwindling. Cloud computing slashes the need for storage space.

If a smaller space is impractical for some reason, you may still be able to reduce your rent costs. Review your lease invoices, checking any increases and escalators against the terms of your lease, and don't be afraid to talk to your landlord about renegotiating it.

ARE YOU OVERSTAFFED?

Staffing is another area where law firms frequently can reduce costs. And not just in support staff. Attorney headcount may also merit some re-evaluation.

Let's start with administrative and clerical staff, though. It's easy to fall into a pattern of automatically replacing every administrative employee who leaves the firm. This results in a support staff that never gets smaller (though it may well grow). But given that more and more software solutions are being designed with law firms in mind, you may be able to reduce positions.

Instead of immediately posting a job ad when a staff member leaves, take the time to determine whether you really need a full-time employee to perform that function. Could those duties be split up among other employees or handled with technology? Could they be outsourced at a lower cost? By lowering staff expenses this way, you also may avoid the potential unpleasantness of layoffs down the road.

Does your headcount match the workload you have now, or the workload you hope to have in the future? It should be the former.

Attorney and paralegal staffing also is susceptible to excess. You may find yourself with nonproductive partners or more associates and paralegals than client demand requires. Ask yourself: Does your headcount match the workload you have now, or the workload you hope to have in the future? It should be the former.

WHAT ABOUT COMPENSATION AND BENEFITS?

Take a hard look at compensation, including benefits, for both attorneys and support employees. For example, you might think about shifting from 100% fixed salaries to a hybrid approach with a variable component based on performance.

As far as benefits, conduct a survey of current employees, and review outside research, to determine the perks your attorneys and staff truly value these days. Don't simply stay with the same package you've traditionally offered. You might discover that some of your costliest offerings are rated the lowest by the employees you hope to recruit and retain.

BOTTOM LINE

If your firm seems to bill and collect a good amount yet struggles to grow its profit margins, one of the culprits could be overhead. Reducing overhead and implementing other lean practices can help you contain those costs and boost profits. •

Study reveals hallmarks at top-performing firms

The Legal Executive Institute (LEI) recently released its *2018 Dynamic Law Firms Study*, providing some valuable lessons on how law firms can achieve better financial performance. The study looks at some of the most successful firms from year-end 2015 through year-end 2017 to determine strategies that have the best potential return on investment. The bottom line? Productivity — not billing rates — is critical.

STUDY METHODOLOGY

The study analyzed the three-year compound annual growth rates experienced by law firms included in the Thomson Reuters Peer Monitor sample. It ranked each firm on its individual performance in overall profits, revenue per lawyer and average profit margin.

Every firm was placed in a quartile based on performance. Firms with the highest compound annual growth performances across the three metrics landed in the top quartile and were labeled Dynamic. Those that fell into the bottom quartile were dubbed Static.

PRIMARY FINDING

Dynamic firms placed, on average, an additional 96 billable hours per lawyer into work-in-progress in 2017 compared to Static firms. Notably, this gap trickled down to affect other aspects of financial performance, from a firm's ability to generate additional top-line revenue to the efficacy of its investment strategies.

For example, a drop in productivity hurts a law firm's ability to execute its investment strategies. These strategies often stretch over several years and can take just as long to produce returns. When productivity falls, it shrinks the funds available to carry out investment plans. It's no surprise, then, that Dynamic firms vastly outpaced Static firms when it came to investments in technology improvements and marketing and business development.

LESSONS LEARNED

The study provides several takeaways, including:

Focus on protecting rates rather than hiking them. Practices related to discounts and write-downs negatively affect a firm's billing realization level, in turn hurting collections.

Make money without raising rates. Firms can grow revenues if they increase profit margins, even while holding rates steady. Moreover, increased demand can lead to greater productivity if a firm adds lawyers in proportion to climbing demand.

Beware of productivity losses. Lower productivity means lower bills and lower revenues, thereby undermining longer-term investment priorities. Firms that struggle to increase their rates but still experience standard expense growth will suffer dramatic consequences if their productivity declines.

THE KEY

According to this study, any firm, regardless of size, can improve its financial performance without relying on rate increases. The key is to maintain or boost productivity, resist unnecessary rate discounts and write-downs and improve profit margins. •

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