PERSPECTIVE

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Sometimes, Law Partners Are Actually On The Payroll

By Robert W. Wood

Should law partners be subject to payroll taxes in the same way as employee wages? The question itself may sound like heresy. Yet it is being asked more frequently today and by an increasing number of jurisdictions, including by cities such as San Francisco. The setting for the question is rich in history.

A partnership is classically a sharing of risk and reward. Partners may be full and equal partners, limited partners, equity partners, income partners, or partners in name only. Not all of these types of partners are treated the same by law firms or other types of partnerships. Accounting, private equity, hedge funds and various other types of businesses may have their own nomenclature and their own customs.

Some partners may have capital they have invested, although being named "partner" does not always mean ponying up capital. Being named a partner may mean a stake in the firms' profits, which can boil down to the services of partners and employed lawyers.

When it comes to taxes, however, partners are taxed differently than employees. That can matter to the partner, to the firm, and to taxing authorities. Federal income tax withholding applies to wages. That is why employees receive a payroll check with income and employment taxes taken out. Not so for partners.

Partners are supposed to get a draw from the firm, with no taxes taken out, and then are to take care of their *own* taxes. Of course, some firms treat some partners as salaried income partners, like employees. There can be income partners, limited partners, and various other confusing labels. Of counsel and senior counsel lawyers may be employees for tax purposes, may be proprietors, or may even by taxed like partners.

General partners are owners and therefore generally have personal liability for the debts and obligations of the partnership. If a law firm has employees, the law firm is required to withhold and transmit the withheld tax money to the Internal Revenue Service and to the state. If the law firm fails to pay over the taxes, partners can be personally liable.

With these big tax issues, you might think that local taxes do not matter. They may seem to be a drop in the bucket, but they can add up. An example is San Francisco's payroll tax.

It hits law firms with offices in San Francisco with a 1.5 percent tax on the firm's payroll. For every employee of every type, you add up their wages and pay 1.5 percent of that amount to the city. If you can prove what portion of the workers' pay was for work done outside of San Francisco, you avoid the tax on that portion of their compensation.

Whether the pay of partners should be subject to this 1.5 percent payroll tax has been a controversial issue. Many highly compensated people in San Francisco, including law firm partners, do not show up on payrolls. For many years, the firms quietly got away with not paying payroll tax on their partners. That made sense, since they really were not on the law firms' payroll.

But the city of San Francisco became concerned that partnership distributions were really like payroll, so the city went to the voters. In 2008, San Francisco voters approved Proposition Q, extending the city's payroll tax to "certain partnerships and other businesses." The proposition recognized that partners were really wearing several different hats when they were paid.

Law firm partners may be paid for working and personally performing services for their firm. The partners may also receive some pay that really amounts to sharing in the profits of the firm. Bringing in business to be handled by others is arguably services too, but there are different ways of looking at such things.

Receiving a cut of the firm's profits would not seem to be payroll for performing services. However, to avoid arguing about the facts of a particular case, Prop. Q included a safe harbor. Under it, partnerships can elect to treat a portion of their partner income as compensation subject to the city payroll tax.

If the firm elects, it can pay city tax on 200 percent of the compensation of the top quartile of employees. The upside of this safe harbor, of course, is that the balance of the partner's "pay" can escape the city's 1.5 percent payroll tax. Not everyone was happy with this compromise. Indeed, there were many lawsuits filed in San Francisco County Superior Court. *See, e.g.*, *Orrick Herrington & Sutcliffe LLP v. City and County of San Francisco et al*., 14-541986; *Arnold & Porter LLP v. City and County of San Francisco et al.*, 14-541923; *Pillsbury Winthrop Shaw Pittman LLP v. City and County of San Francisco et al*., 13-535043.

Notably, in *Coblentz Patch Duffy & Bass LLP v. City and County of San Francisco et al.,* 233 Cal. App. 4th 691 (Cal. App. 1st Dist. 2014), the firm sued to recover $194,903 of payroll taxes paid on the compensation of its equity partners. Some simple math suggests that the amount being split up between partners was considerable. They argued that equity partner compensation should only be subject to the payroll tax if it was guaranteed.

That "guaranteed" term has a technical meaning in the partnership tax law, under federal tax law at least. And it is a logical argument if you are talking about federal income taxes. Just how relevant that was to city tax law was an open question.

The federal tax law says guaranteed payments (pay that does not hinge on partnership profits) are deductible to the partnership and taxable to partners. Ultimately, the court found that the federal and state income tax rules about guaranteed payments did not bear on the applicability of the San Francisco's payroll tax. The court found that the city was really taxing compensation for services in partnership profit distributions.

To the court, a portion of the firm's profit distributions were for the partners' services, and the tax applies to it. On April 22, the state Supreme Court denied review of the case. That suggests law partners are mostly stuck with the 1.5 percent tax.

Of course, we already have federal income taxes at 39.6 percent, California income taxes at 13.3 percent, and Social Security tax at 15.3 percent. The latter alone is a big issue for law firms. That 15.3 percent is borne half by the employer and half by the employee on wages.

There are some wages that escape most of these taxes, once the wage base of $118,500 is exceeded. In the case of partners, the self-employment tax is 15.3 percent, and it is borne by the partner. Law firms are getting increasingly sophisticated how they classify and treat their partners.

Payroll and income taxes are a feature of every business. So are property taxes, and for many businesses, so are sales and use taxes. San Francisco seems to have won the payroll tax war, but at least there is not yet a California sales tax on legal services. Not yet…