Who, me? Law firm partners, profits and payroll taxes

By Robert W. Wood

These days, being a partner in a law firm may not mean what it used to mean. Perhaps that's true in some other professional fields too, like accounting. But in law firms, at least, being named "partner" may not mean ponying up capital.

It may not involve a stake in the firm's equity or profits. It may not come with much authority to sign for the firm either. But when it comes to taxes, partners are taxed differently than employees and that can matter to the partner, to the firm, and to taxing authorities.

Federal income tax withholding applies to wages. That is why employees get 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 a whole host of other confusing labels, including the of counsel or senior counsel variety.

In all of these cases, how firms and lawyers handle taxes can be sensitive, for the lawyer, the firm, and the government. Even for full equity partners that are supposed to do their own taxes, some law firms help partners take care of their taxes. After all, the firms do not want to risk having a partner who fouls it up, which is easy to do.

Uniformity is important too, and more than one state is sometimes involved. Taking care of taxes usually means both federal and California, and sometimes other states. But what about local taxes?

You might think those don't matter, but they can add up. Take San Francisco's payroll tax that hits law firms in the city with a 1.5 percent tax on all 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 piece. Still, it can be a surprisingly big number. What about the pay of partners? That has been a controversial issue.

Indeed, 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 San Francisco eventually wised up and 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 a couple of different hats.

Often, law firm partners are paid some money for working in the firm. Hopefully, the partners also get some money for sharing in the profits of the firm. Such tasks as bringing in business to be handled by others is arguably services too, but there are different ways of looking at such things.

In any case, receiving a cut of the firm's profits rather clearly could not be treated like payroll. Yet the factual issues seemed tough so the law following Proposition Q included a rule some find arbitrary. There is a safe harbor so 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, and there were some lawsuits filed.

Notably, in *Coblentz Patch Duffy & Bass LLP v. City and County of San Francisco et al.*, A135509 (Cal. App. 1st Dist., Dec. 24, 2014), one 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. In the overall scheme of taxes, one can argue that a 1.5 percent payroll tax is not the biggest problem. We 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. In some cases, a good part of the decision can come down to taxes.

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