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What every law firm Schedule K-1 packet generally should (and should not) have

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Tax season is in full swing and your law firm's partnership tax returns and Schedules K-1 are undoubtedly being prepared. The 2017 U.S. partnership tax filing deadline for calendar-year taxpayers is March 15, 2018, and most law firm partners will receive their K-1 packets around that time. Included in these packages will be a wealth of information which is needed for law firm partners to accurately file their federal and state income tax returns, and also take advantage of every deduction available to them. Please note this article addresses information for 2017. There could be changes to this list for 2018 and forward. Here are 10 areas that should be considered with your Schedule K-1 packets:

1. **Composite tax return liabilities** – It's become the norm for law firms to practice in states where they are not physically located. States have made tax compliance easier for law firm partners by allowing them to participate in composite or group returns, where your nonresident tax filing obligation is satisfied by the partnership filing such return. Your share of the composite tax liability may be taken as a credit on your resident state tax return. To claim this credit, make sure you receive with your K-1 packet your share of the composite tax return income as well as your share of the composite tax liability for every state in which you participated.

   One thing to make sure is not included is a share of Washington, D.C., unincorporated business taxes, or a reference to a Form D-30, the return on which these taxes are assessed. A law firm's income is not subject to tax as an unincorporated business in the District of Columbia. If you receive a share of Washington, D.C., taxes paid, consult your tax advisor regarding why these taxes are being remitted.

2. **State taxes paid during 2017** – Your 2017 composite tax liability doesn't necessarily match up with nonresident state tax payments made on your behalf during 2017. If you itemize your deductions for federal income tax purposes, you can include all state tax payments made by the partnership on your behalf from Jan. 1, 2017, through Dec. 31, 2017. Make sure you're being provided this information, ideally broken out by state. This information may include:

   a. 2016 Q4 payments made in January 2017
   b. 2016 tax balances due in March or April 2017
   c. 2017 Q1 payments made in April 2017
   d. 2017 Q2 payments made in June 2017
   e. 2017 Q3 payments made in September 2017
   f. 2017 Q4 payments possibly made in December 2017

   Note that in 2018, the recently passed Tax Cuts and Jobs Act capped the itemized deduction for state taxes at $10,000. Therefore, your deduction for state taxes paid during 2018 may be limited.

   Make sure this information doesn't include state, municipality and city taxes such as Texas, Ohio's Commercial Activity Tax, Washington's Business & Occupation tax, Philadelphia, and New York City. These are entity-level taxes for which the partnership itself is liable, and the law firm should be reducing its ordinary income by any payments toward these tax liabilities.

3. **Nonresident state Schedule K-1 when not included in the composite** – Some law firm partners automatically default to participating in all nonresident state composite returns given they are relieved of their nonresident filing obligations as a result. They also believe it saves them money because they don't have additional tax preparation costs. But what they may not realize is they could end up having a larger nonresident tax liability by participating in a composite return than they would if they filed their own nonresident state income tax return. If the additional tax liability from participating in a composite exceeds the tax preparation costs of filing a nonresident state income tax return, then it's worth reconsidering your participation in the composite.

   The rate of tax in your resident state must also be considered. Even if the composite tax is greater, if you will receive a full credit on your resident return, then participating in the composite return will not cost you any additional tax.

The classic case is when a law firm has revenue from California sources and also has California nonresident partners. California's composite tax rate is 12.3 percent – the highest in the U.S. California's top individual rates – for most nonresident partners – may be lower, generally from 8 to 10.3 percent.

If your tax advisor can prepare a California nonresident state income tax return for less than the tax savings from filing outside of the group return, then it's worth considering opting out of the composite. New York state is another jurisdiction with high individual tax rates (up to 8.82 percent), for which the above analysis should be considered prior to participating in a group return.

If you opt out of a group return, make sure you have an understanding of when you are required to make estimated tax payments and the nonresident withholding rules. Your partnership may be required to remit the nonresident withholding on your behalf.

4. **Retirement contributions** – If you made contributions to your firm's qualified retirement plans, your contributions may be reported on Line 13R, Line 13W, in the footnotes of your Schedule K-1 or some combination of these. This amount can include a variety of deferral plans such as 401(k), IRA, KEOGH and cash balance plans. The amount deferred may be deductible on your federal income tax return.

   Ensure that any contributions made to a Roth retirement account are not included. Roth plans are funded through post-tax contributions, meaning you cannot take a current-year deduction for individual income tax purposes.

5. **Health insurance** – Included in Line 13M, Line 13W or in the footnotes of your Schedule K-1 is the cumulative amount paid for health insurance premiums as a self-employed individual. The premiums paid for you, your spouse and your dependents may be deductible on your federal income tax return. These premiums may include:

   a. Medical insurance premiums
   b. Dental insurance premiums
   c. Vision insurance premiums
   d. Long-term care insurance premiums

   Special rules apply when you are eligible to be covered by your spouse's plan or if you purchase individual coverage instead of through the firm. If either case applies, please discuss with your tax advisor.

   What should not be included on this line are nondeductible life insurance and disability insurance premiums. Contributions to health savings accounts typically are on Line 13W or in the footnotes of your Schedule K-1.

6. **Foreign taxes** – If your firm has operations in a foreign country, you may be eligible to take a credit for taxes paid to that country. Make sure your Schedule K-1 includes the following information either on Line 16 or in the footnotes of your Schedule K-1:

   a. Name of country
   b. Amount of taxes paid
   c. Date paid
   d. Type of income – either general or passive
   e. Foreign gross income
   f. Foreign deductions

   This information should not be lumped as consolidated amounts from several different countries. The amounts should be broken out by country, as there may be limitations at the individual level depending on the country where the tax was paid.

7. **Self-employment earnings** – As a law firm partner, your ordinary business income and guaranteed payments may be subjected to the self-employment tax at the individual level. Generally, any earnings from the active practice of law should be classified as self-employment earnings and will subject a law firm partner to self-employment tax on their individual income tax return.

   Additionally, your self-employment earnings can be reduced by any amounts attributable to your activities as a lawyer that are paid by you personally outside of the firm, including interest on loans used to make capital contributions into the partnership and unreimbursed partnership expenses.

8. **Resident state decoupling adjustments** – For your individual income tax return, many states start with federal adjusted gross income and make adjustments from there to arrive at state taxable income. These decoupling adjustments vary by degree and by state, but the most common are depreciation and, in a few cases, entity-level state and local taxes deducted on the federal return. Make sure you're receiving what your resident state's depreciation expense would be. If the partnership has historically taken any section 168(k) bonus depreciation or section 179 depreciation, then more likely than not the partner will either have an addition or subtraction adjustment on their resident state tax return.

   One adjustment that could also be overlooked is entity-level state and local taxes. These are deductible at the federal level and flow through as a deduction against your ordinary business income. In most states there is no adjustment, but in a few instances your share of entity-level state and local taxes paid may need to be added back to your resident state return. Please discuss with your tax advisor.

9. **Quarterly earnings** – Law firm revenues and therefore profits are often earned in an uneven fashion throughout the year and frequently heavily weighted toward the latter half of the year. The Internal Revenue Service (IRS) and most states allow law firm partners to annualize their individual estimated tax payments based on the actual timing of their earnings. Therefore, you could likely pay the majority of your estimated tax liabilities in the third and fourth quarters if you used the annualized method to pay your estimates.

   To avoid penalties on underestimation, every law firm partner needs to know the percentage of profits earned during each quarter. This information then can be used to complete federal Form 2210, which documents for the IRS what payments were required on a quarterly basis. This information may reduce any underestimation of tax penalties. A similar approach is used by most states.

10. **Nondeductible expenses** – Included in Line 18C or in the footnotes of your Schedule K-1 is the cumulative amount of nondeductible expenses for income tax purposes. Common nondeductible expenditures are meals and entertainment, political contributions, gifts, club dues, key man life insurance, jurisdictional fines and penalties and luxury suite stadium boxes. The cumulative amount reported on your Schedule K-1 is already factored in determining your share of the partnership's ordinary income; therefore, you should not report this amount separately on your individual income tax return. Instead, this informational item should be utilized to track your tax capital account balance. Your share of nondeductible expenses reduces your tax capital account in the partnership.

    This article is meant as a high-level guide to help you understand the various information you may need to help you prepare your individual income tax return. This information is often contained in the Schedule K-1 package you receive from your law firm. It is not intended to give you tax advice on the deductibility of any amounts. We recommend you consult your tax advisor regarding the information included within your Schedule K-1 packet.

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