PwC's Law Firm Services

Congressional Proposals Requiring Law Firms to Report Taxable Income on the Accrual Method of Accounting

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Executive summary

Proposals in Congress could fundamentally shift how many large law firms must report their taxable income for US federal income tax purposes. Two similar proposals have been introduced that would mandate that certain qualified professional service firms (which encompass law firms) change their overall method of accounting from cash to accrual in order to determine taxable income. Under the proposals, the cash method of accounting would be limited to taxpayers with gross receipts of $10,000,000 or less (inflation adjusted) using an average annual gross receipts test over a three taxable-year period.

The most recent proposal was released by Senate Finance Committee Chairman Max Baucus (D-Mont) on November 21, 2013 as a discussion draft (the Baucus Proposal). Many of the core concepts of this proposal are very similar to the 'small business' tax reform discussion draft issued on March 12, 2013 by Chairman Dave Camp (R-MI) of the House Committee on Ways and Means (the Camp Proposal). The Baucus Proposal expands the earlier discussion draft with more detailed rules that appear to be mainly anti-avoidance in nature.

The practical result of the proposals is that AMLAW 200 law firms would be required to make the switch, causing them to lose the favorable benefits of the cash method. The proposals promise to generate significant complexity for law firms going forward as well as potentially harsh financial consequences. Most notably, the conversion from a cash method to an accrual method for tax purposes likely will generate an unexpected, front-loaded income tax liability that must be paid by law firm partners over a proposed four-year period.

The discussion drafts that contain the Baucus and Camp Proposals are not specifically aimed at law firms – they contain a variety of tax reform proposals affecting many taxpayers. Notwithstanding their negative impacts to law firms, both proposals are touted as a step towards simplifying the US tax rules for small businesses while lessening compliance burdens.

The Camp Proposal contains an effective date for taxable years after December 31, 2013, while the newer Baucus Proposal pushes this date back to December 31, 2014. As neither bill is likely to be adopted outside of tax reform, the effective date for these proposals is in flux. Regardless, law firms should consider preparatory actions now to address the potential impact of these proposals.

In detail

What acceleration of taxable income may result?

A critical consequence of these proposals is the acceleration of taxable income that likely will result when a law firm converts from the cash to accrual method of accounting for tax purposes (hereinafter referred to as the cash method and accrual method respectively). Under the cash method, law firms generally report income when cash is received. But under the accrual method, taxable income may need to be reported much earlier under a host of special rules (described in more detail below.) Most importantly, amounts in accounts receivable (A/R) and work in process will likely shift and become reportable as income for US federal tax purposes.

To lessen the burden of this income all in one tax year, US tax rules allow for a so-called Section 481(a) adjustment that would allow this income to be spread over a four-year period.

The Section 481(a) adjustment is calculated by taking into account all adjustments that affect income and expense accounts, including A/R, work in process, accounts payable, as well as other similar items. The firm's A/R and work in process must be netted against its accounts payable to arrive at its net Section 481(a) adjustment. When changing from the cash to the accrual method, the A/R and work in process generally results in a positive component, while accounts payable will likely be negative. For large law firms, the net amount is likely to be a positive income adjustment.

The proposals also contain a favorable provision which may serve to lower the net Section 481(a) adjustment. The adjustment may be reduced for amounts that would likely be uncollectible by service providers using computations or formulas which, based on experience, should reflect the estimated amount of income that will not be collected.

Who will be allocated income from the conversion?

Partners must report

Law firms operating as partnerships for US federal tax purposes are not subject to income tax; rather, their partners are taxed on their distributive share of income, deductions, gains, losses, and credits. As a result, the law firm partners will unfortunately bear the burden of having to report the Section 481(a) adjustment as income over the four-year period noted above, allocated between partners for the year. The allocation of this income to partners should be governed by the terms of the partnership agreement, assuming it meets US tax allocation rules.

Changes during the adjustment period

What happens if during the Section 481(a) adjustment period, partners leave or retire? Will they continue to be liable for these income inclusions? As a general rule, if a partner reports the first year of income under the Section 481(a) adjustment but then leaves or retires in year two, that partner may not be responsible for the income attributable to the remaining years of the four-year adjustment. However, partners that join the firm in year two may be responsible for reporting his/her share of the Section 481(a) adjustment into income for that year

How will partners finance additional liability from conversion?

The legislative proposals may necessitate new financing decisions by the law firm and/or its partners, which in turn may change the law firm's relationship with its partners. In order to meet the newly created tax obligations, law firms must think ahead and consider if and how they would help partners in paying the additional taxes due on the cash to accrual conversion, as well as payments to partners upon departure from the firm.

Various options may be envisioned. Firms potentially may distribute amounts equal to the estimated tax liabilities on the non-cash income. For some firms this amount could exceed 40% of the net cash to accrual conversion amount spread over four or more years. If a firm chooses to distribute amounts to the partners to help the partners finance the liability, the firm would likely have to borrow. Alternatively, the firm could assist the partners in securing loans on their own or leave the partners to pay the increased tax liability out of their own pocket.

What is the impact on retiring, withdrawing, and new partners?

Capital payouts

Traditionally, law firm partners enter a US partnership, build up capital using after-tax dollars, and exit the partnership with only that capital paid back to them. The partner's share of A/R and work in process typically is not distributed to the partner upon their departure from the partnership, as governed by the partnership agreement. A decision will need to be made regarding how accrued capital attributable to the income recognized for the A/R and work in process partners have paid tax upon should be treated when they depart from the partnership.

The overall capitalization structure of the firm will need to be addressed to help ensure financial stability. Many factors need to be considered, particularly if the firm decides to provide monies to the partners to help with the tax cost of the Section 481(a) adjustment. For example, if the partnership agreement mandates that partners receive distributions equal to their capital accounts when they depart the law firm, firms likely will need to engage in borrowing to meet this corresponding cash obligation. Even if firms leave the financing of the tax liability to their partners, it is likely that they may still need to engage in additional borrowing.

Increased burden on new partners

Law firms also must consider the impact on new partners and their accrued capital. Given that these partners will have increased amounts of non-cash income at the same time they are building capital in the firm there likely will be increased pressure on firms to provide the new partners with some measure of relief. One positive consequence may be the new partner's ability to contribute additional monies to qualified retirement plans due to their increased income levels.

Must the partnership agreement be amended?

Law firms likely will have to review and modify their partnership agreements documenting the changes in their income recognition, tax payment, and distribution policies. Concerns could arise if the partnership agreement mandates that all those partners affected must agree to potential changes.

What time will be needed to work with lenders?

Firms may need to borrow to make distributions to its partners to cover liabilities relating to the conversion as well as capital payouts. New sources of funds will need to be identified and terms negotiated, including loan covenants, for the repayment of the debt. In some cases, firms that previously had little or no debt on their balance sheets may find that the debt and capital structures on their balance sheets become significantly different. This could also trigger the need to re-negotiate current bank covenants for existing debt. In other cases, firms with existing debt will need to seriously consider the burden additional debt and its related cost could cause for the firm itself.

A key item to consider is the time it could take to obtain financing. For many large law firms, it could be a six-month process given the amounts at issue. As a result, it is important that law firms plan ahead and engage financial institutions early to set the groundwork for the financing they may need.

Will greater complexity arise for processes going forward?

Unfortunately, the accrual method of accounting for US federal tax purposes likely will be more complex to manage after the conversion. Analyzing income and deductions using the accrual method (as compared to cash), encompasses a larger spectrum of specialized rules. The following discussion provides a small sampling of the rules that may apply:

Accrued revenue

As a core concept, income is includible in gross income under the accrual method of accounting when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. A fixed right to receive may arise when required performance occurs, payment is due, or payment is received. If the firm has rates agreed upon with the client, then accrued service revenue should be accrued based on the contractual rates. If not, however, it may need to be accrued at standard realization rates.

An area of complexity may arise, for example, as to whether income should be accrued before all performance under a particular contract is completed. In other words, is the contract divisible when consideration under the contract is separately apportioned? The right to receive income from an engagement may not become fixed until the final output (such as an opinion letter) is delivered. However, if the contract delineates progress billing, income may need to be recognized as amounts are billed.

Treatment of bad debts

Under the cash method of accounting, income is not reported until it is received and therefore uncollectible amounts are normally not included in income for US federal tax purposes. Since the income was never included in income, a bad debt deduction cannot be taken for uncollectible amounts. However, under the accrual method, taxable income should include A/R and work in process even if these amounts have not actually been collected and in some cases billed. Thus, law firms using the accrual method may claim a deduction if such amount becomes partially or fully worthless during the tax year.

The allowance of this deduction, while favorable, will likely create additional complexity for law firms. Calculating the bad debt deduction depends upon the method chosen by the taxpayer. Law firms on the accrual method of accounting may be able use the nonaccrual-experience method under which gross income is adjusted downward for uncollectible amounts. Taxpayers may create their own approach to calculate uncollectible amounts but must self-test the approach against their actual experience or adopt one of six safe harbors.

Accrued expenses

The rules governing the treatment of expenses also differ depending upon the method of accounting. For the cash method of accounting, a law firm generally may deduct the allowable item of expense in the tax year the taxpayer makes an actual payment of cash or property. Under the accrual method, an otherwise allowable expense is deductible for the tax year in which 'all events' occur that determine the liability – in other words, the liability must be fixed, rather than contingent on future events or uncertainty and must be an amount determined with reasonable certainty. Moreover, economic performance must also occur, which generally is when the services or property actually are provided.

Many special rules may apply, creating more complications. As an example, for certain liabilities such as rebates, refunds, insurance, service contracts, and taxes, economic performance only occurs when payment is made. Moreover, certain expenses such as rent, deferred compensation, vacation pay, and pension costs have limitations on the amounts that a taxpayer can deduct for the taxable year.

Should process changes be considered?

Given the increased complexity of the rules surrounding the accrual method to determine taxable income, process changes must be considered to ensure compliance – either adding new processes or revamping others. Analyzing the existing portfolio of work to calculate gross income, accrued expenses, and bad debt deductions is likely to take a significant amount of time and resources. For example, different engagements may have varying realization rates as each client may have agreed to different billing rates. Thus, contract terms will need to be reviewed and considered. In addition, system platforms may also need to be adapted to help automate these tasks.

Process change should also be considered in the business development stage. Should firms shift to greater progress billing arrangements when engaging clients? It may also be prudent to review on-going large engagements and determine whether a different billing agreement would be advantageous to ensure a timely match between when cash is received and when income must be reported for tax purposes. Process changes may also need to occur with respect to collection efforts. Law firms could improve their collection of cash in the year the amounts are billed.

How may financial statements be affected?

The conversion from the cash to accrual method for tax purposes will likely have a significant impact on the auditing of law firm financial statements. Additional testing of the A/R and the build-up of work in process will be required including the internal controls established to provide for the accurate statement of these amounts as well as management's estimate of the reserves for these accounts. Moreover, the beginning of the year amounts will also have to be tested.

Similarly, additional work will be required for accrued expenses with both beginning of the year and end of the year amounts subjected to testing. Internal controls established for determining these amounts will also need to be tested. Further changes include the revision and review of footnotes and disclosures. Accordingly, the cost of the audit likely will increase and that increase may be substantial with the cost of the first year likely to be greater than subsequent years.

The takeaway

Anticipated effective date

The implementation date of the Baucus and Camp Proposals is uncertain. The Camp Proposal includes an effective date for taxable years beginning after December 31, 2013. The Baucus Proposal provides a favorable delay by pushing this date back to December 31, 2014. Both discussion drafts are currently in review stages with the drafters seeking comments from the public. While the Camp Proposal does not set a deadline for when comments must be received, Senator Baucus is looking for more immediate feedback from stakeholders by January 17, 2014.

The mandated change from the cash to accrual method is likely only to be considered in the broader tax reform initiative and it is anticipated that it will be significantly based on concepts put forth under both proposals. Although it was previously thought that the time table for tax reform would be implemented as part of the budget conference closer to the end of 2013, it is now anticipated that bills may be released sometime in 2014.

Opposition to the proposal

The American Institute of CPAs (AICPA) has issued comment letters in opposition to the Camp and Baucus Proposals arguing that they would place financial burdens on the affected businesses, especially on their cash flow, and may cause potential hardship on the firms. The AICPA argues that the sum of all these factors would ultimately discourage business growth, which was the stated goal of the House Committee on Ways and Means.

More recently, a bipartisan group of 71 lawmakers issued a letter on November 25, 2013 that urges Ways and Means Committee Chairman Dave Camp to reconsider the ramifications of this proposed change on small businesses and local economies. The letter references concerns from small businesses of having to comply with a more complex accounting system. The letter also states that "mitigating the one-time costs of switching accounting methods would be extremely difficult…" Among other types of businesses, the letter specifically mentions lawyers as an affected group.

If a bill is put forth, stakeholders have also suggested that certain changes be considered. A primary recommendation is that the adjustment period be lengthened beyond the four years that is currently envisioned. Similar to recent proposals for other accounting method changes, a shift to an eight-year Section 481(a) adjustment period would be welcome news to stakeholders. However, a longer adjustment period would not eliminate the need for firms to measure the impact in the first year for allocation over the entire period.

Prepare now

Law firms affected by these proposals should consider the impact to ensure that they are prepared for their potential enactment. An important first step is to quantify what potential Section 481(a) adjustment may be on the horizon. Some firms may be surprised at the size of this adjustment. This analysis should include a detailed review of the balance sheet and the creation of a 'future' balance sheet for management to understand what it will look like after the conversion.

An important consideration is how this change will affect the capitalization of the firm and how the partners will ultimately pay for an increased upfront income tax liability. Depending upon how this issue is addressed, obtaining additional funding from financial institutions should be considered.

Current processes within the law firm should be reviewed as to how they should change to manage this new set of complex rules under the accrual method going forward. The need for new processes and related controls should also be identified. Resource planning and quantifying associated costs should also occur. Resources within the law firm's finance function likely will have to be increased and the skill set of such resources may need to be reexamined.

Finally, monitoring the status of these proposals also is a critical step going forward. The formal submission of comments to Chairmen Baucus and Camp also may be considered so law firms have a greater voice regarding the possible harmful financial consequences of these proposals.

Let's talk

For more information about this issue and how it can affect your business, please contact:

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