Andy's Accounting Lecture

Depreciation/Amortization
If permanently affixed, then it's a leasehold improvement and it is amortized over 39 years.
If it can be taken with you, it's a furniture or fixture, and it is depreciated over 5-7 years.

When spend money on leasehold improvement, amortize over 39 years, but if move sooner, write off the balance the year that the premises are abandoned.

Operating Lease - at end of term, the firm does not own it. It's just like renting space, you pay as you go.

Capital Lease - must meet one of following terms.

- if you own the equipment after the term.
- if you have a bargain purchase option
- if the lease term covers 75% of the useful life
- if the PV of payments = 90% of the value of the equipment

If install equipment worth $400,000 financed through capital lease, $400,000 is added to assets, as does liabilities. No effect on equity.

For federal income tax purposes, a Limited Liability Company (LLC or LLP) is treated like a partnership, but more flexible in operation.
Professional corporation is treated like a corporation.
S corporation is also a corporation

- not publicly traded
- no more than 75 shareholders
- no foreign ownership
- distributions must be pro-rata at same time.
- files a corporate return with K-1.

Partnership v. professional corporation.
In PC, the entity must withhold taxes for shareholders, as if they were employees.
In partnership, each partner is responsible for filing income taxes.

Income of a PC is taxed, whether withdrawn or not, just as in partnership.
Shareholders and partners pay income taxes at individual rates.
Capital contributions to a PC or a partnership are pre-tax basis, meaning that they are not tax deductible.

Modified cash basis financial statements reflect: (only items related to cash such as prepaid expenses and accrued fringe benefits on the balance sheet. Not fees receivable and accounts payable, not unbilled time, and not bad debt expense on the income statement.

Depreciation - three methods

Using an example of a $10,000 asset over a life of 10 years

Straight line - equal amount each year over the life of the asset - $1,000/year.
Double declining (accelerated) - results in more rapid depreciation under the theory that the asset looses more value in the earlier years, so more closely "matches" revenue with expenses.
First year, $1,000 x 2 = $2,000
Second year, $8,000/10 years x 2 = $1,600
Third year, $6,400/10 years x 2 = $1,280
Sum of the digits - denominator becomes sum of digits of year of live.
e.g. over five year life, 5+4+3+2+1 = 15
First year 5/15 x $10,000 = $3,333.33
Second year 4/15 x $10,000 = $2,666.67
Third year 3/15 x $10,000 = $2,000.00

Modified Accelerated Cost Recovery System (MACRS)

- 3 years - N/A
- 5 years - autos, trucks, computers & phone systems
- 7 years - office furniture and fixtures
- 10 years - N/A
- 39 years - leasehold improvements

Forms of Ownership

Form	Taxes	Liability	Continuity	Comments
Sole Proprietor	Schedule C to Form 1040	Unlimited	Limited Life	Just one person, not incorporated. Simple to create, easy to discontinue.
Partnership	Partnership files an information Form 1065, and K-1s filed with partner Form 1040.	Unlimited	Limited Life	
Corporation		Limited	When shareholder leaves, corporation continues.	
	C Corporation, taxes paid at corporate level, double taxation.	Limited		
	S Corporation, same as partnership. 1065/K-1.	Limited		Disadvantages: -limited to 75 shareholders. -U.S. Citizens or residents. -distributions must be taken by all at the same time. Out of favor now.
Limited Liability Company	Same as partnership, 1065/K-1	Members not personally liable.		Hybrid between partnership and corporation. In vogue now.
Professional Corporation	Can be S or C.	Shareholders not personally liable.		Shareholders paid salaries and receive dividends. No longer in vogue. Changing from C to S causes built in capital gains.

Financial Statement Summary

Report	Alternate Name	Date/Period	Formula
Balance Sheet	Statement of Financial Position	Point in Time	Assets= Liabilities + Equity Assets - Liabilities = New Worth Resources = Claims against them from creditors and owners.
Income Statement	Profit/Loss, P&L, Earnings Statement	Period of Time	Revenue - Expenses = Net Income Revenue - Expenses = Bottom Line
Cash Flow Statement	Statement of *Changes* in Financial Position	Period of Time	Shows sources and uses of cash from: operating, financing and investing activities.
Statement of Changes in Partner Equity	Partner Capital Note: in a corporation, partner equity is retained earnings.	Period of Time	Beginning balance + income + additional contributions - withdraws = ending balance

Income Statement provides roadmap link between balance sheet dates.
The income goes to the partner equity statement, and the net of that goes to the balance sheet.

Cost Accounting

Financial accounting accumulates and measures costs for the *entire firm* in the format required for financial statements or tax returns.

Cost accounting assigns or allocates costs to specific services, products, organizational units, or functional activities in order to (1) facilitate and enhance management planning, control and decision-making, and/or (2) satisfy some external reporting requirement.

Two principal reasons for cost accounting:

- determine the profitability of various services.
- determine the costs of internal activities.

Typical accounting systems segregate billings and receipts by practice area, but not expenses.

Costs are defined as expenses incurred to accomplish an end. They include (1) cash expenditures such as salaries and wages, supplies; (2) periodic charges such as depreciation and amortization; and, (3) cost of partners.

Costs behave as:

- *Fixed* Costs: expenses which tend to remain relatively constant in any given year, regardless of changes in the level of business activity. Significant changes in fixed costs occur only as a result of a major change in a firm's size or operational methods. They include occupancy, depreciation, amortization, insurance, telephone equipment expense, equipment leases.

- *Discretionary* Costs: Expenses that are basically operational. They are incurred in a firm's discretion, but once incurred, become fixed for a time period. Before commitment, they are controllable, so they should receive special attention. They include salaries, professional memberships, subscriptions, repairs and maintenance. When defined functionally, they are client development, recruiting, office administration activities.

- *Variable* Costs: Expenses that vary with the level of business activity. In manufacturing, they are labor and materials. In a law firm, supplies, for example are minimal, and labor is discretionary. Therefore, pure variable costs are relatively few in a law firm. Exceptions are overtime salaries, taxes on gross receipts (UBT), supplies, and some utilities such as OT HVAC.

Two ways to measure a profit center's contribution to overall profits:

- *Marginal Contribution:* deduct *direct* costs from revenues and is used to measure the controllable performance of a profit center.
- *Net Contribution:* deduct *all* costs from revenues and is a measure of the overall performance of the firm or the profit center.

80-20 Rule says that 80% of the activity on a given area results from relatively few items, say 20%. Thus, a firm can exercise substantial control over its operations by giving attention to these vital few items.

In cost accounting, care should be given that the complexity of a system may be more burdensome than the an aid in controlling costs and planning for profits.

Disbursements

Hard Costs Those advances which are incurred by actual direct disbursements of funds to outside third parties. They are booked as receivables when paid on behalf of clients, with subsequent reimbursement of such costs merely reducing the balance sheet receivable. Therefore, the firm does not get the timing benefit of a deduction for such costs when incurred with deferral of income recognition when repaid.

Soft Costs Those that are captured and billed to clients using manual systems or technology to assess the charges directly into the client billing records. E.g., facsimile and photocopies. The firm deducts the underlying costs as incurred, and realizes taxable income when such amounts are subsequently paid by the client.

The IRS penalizes firms that expense hard costs when incurred by disallowing the expense, and still requiring that the income be realized.

State Taxation of Partnerships and Partners

Most states follow the basic federal tax structure governing income taxation of partners and partnerships, that is, partnerships are treated as conduits and are not themselves subject to tax, but partners are directly taxable with respect to their distributive shares of partnership income.

Resident Partners - Most states tax resident partner on their entire distributive shares of partnership income regardless of the source of such income or the state to which it is attributed.

Nonresident Partners - are taxed on their share of partnership income derived from property, business operations or other activities of the partnership in the state. The focus, therefore, is on the source or attribution of the income to the state in the hands of the partnership. The allocation and apportionment rules that generally apply are the same as those that apply to corporations. The theory is that the partnership is an aggregation of individuals, rather than an entity separate and distinct from their owners, as in a corporation. It follows that partners who actually conduct the business of the partnership within the taxing state act as agents for the nonresident partners. It is sometimes said that there is sufficient *nexus* for states to tax nonresident partners.

To ease filing requirements, most states allow composite returns for nonresident partners, but the taxes must be paid at the highest marginal rate, each partner must consent in writing, deductions by partners are not allowed unless related to the partnership operation, and it must represent the only in-state income for that partner.

Intra-office allocation of revenue for foreign offices is based on people, revenue or occupancy costs.

icut residence in 1976 [before the taxpayer became a resident of Massachusetts].[286]

The results reached in the cases have a good deal of merit as a matter of tax policy, since they hold the gain taxable by the state in which the property was located and in which the appreciation in its value took place. However, the holding of the Massachusetts Appellate Tax Board that the state of the taxpayer's new residence lacks the constitutional power to tax the gain is open to question,[287] for the decision collides with the established principle that the state of a taxpayer's residence may tax all his income from whatever source derived. (See supra ¶ 20.04[1].)

The peculiar quirk in the case lies in the fact that, as a tax relief measure, the federal and state income tax statutes defer the tax on the profit realized from a sale of the taxpayer's principal residence in order to enable him to reinvest the proceeds in a new home. That wholesome tax accounting rule should not diminish the power of the state of residence to tax the profit on the sale in the later year in which the income is recognized under the relief provision. To be sure, it has been held by a number of state courts that a person who moves into the state during the course of a taxable year is not taxable by that state on income received earlier in the taxable year before he became a resident that was derived from work done, activities carried on, or property located outside the state.[288] Nevertheless, the rule enunciated by the Appellate Tax Board would be inconsistent with other existing widely applied income tax rules. As noted earlier, it is established practice in many states, when a taxpayer changes his residence, for the state of the new residence to tax him on income thereafter recognized, even though it was received for work done, or business con-

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[286] Id. The Maryland Tax Court appears to have embraced these views, suggesting that, with respect to gain that Maryland residents earned from the sale of their Pennsylvania residence while Pennsylvania residents, "Maryland may collect tax only on the part of the Petitioners' ... gain which occurred while they were residents of Maryland." Clifford v. Comptroller, Md. Tax Ct., May 15, 1992, Dkt. No. Income Tax 4599. The holding of the case, however, was that the Maryland residents were not entitled to a credit against Maryland taxes for gain that they recognized for federal tax purposes when they purchased a second Maryland residence that cost less than the Maryland residence they purchased upon leaving Pennsylvania. Because the gain then recognized for federal purposes was less than the appreciation in the first Maryland residence, the taxpayers had not, in the court's view, ever been required to include any of the deferred gain from the Pennsylvania sale in their Maryland income.

[287] The following discussion of the constitutional power of a state to tax the gain realized by a resident taxpayer while a nonresident of the taxing state, but recognized after he had become a resident, reflects the views of the senior author of this treatise (J. Hellerstein). For the contrary views of the junior author, W. Hellerstein, see Smith & Hellerstein, "State Taxation of Federally Deferred Income: The Interstate Dimension," 44 Tax L. Rev. 349, 370–373 (1989).

[288] See supra note 268.

items normally retain their character when passed through to the partners as though realized directly by the partners from their source.[293]

Some states, however, treat partnerships in whole or in part as separate taxable entities. Illinois levies a special "personal property replacement tax" on the net income of all business organizations with activities in Illinois, including partnerships.[294] Michigan imposes its Single Business Tax on all persons with business activities in the state, including partnerships.[295] New Hampshire assesses a Business Profits Tax on the income of partnerships to the extent of the proportion of such income equal to the aggregate percentage interests of the resident partners.[296] In addition, both the District of Columbia and New York City impose unincorporated business taxes on partnerships conducting business within their jurisdiction.[297]

[1] Taxation of Resident Partners

Most states tax resident partners on their entire distributive shares of partnership income regardless of the source of such income or the state to which it is attributed.[298] This is an application to partnership income of the general principle that residents are taxable on their income from whatever source derived.[299] Although there are cases holding that resident partners are not taxable on income (and may not deduct losses) from out-of-state partnerships, these cases arose under state statutes that did not tax residents, or resident partners, on partnership income derived from sources outside the taxing state.[300]

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[293] Colo. Rev. Stat. § 39-22-202(2); Mass. Gen. L. ch. 62, § 17(c); RI Gen. Laws § 44-30-15(b).

[294] Ill. Ann. Stat. ch. 120, § 2-205(b).

[295] Mich. Comp. Laws Ann. § 208.6(1).

[296] NH Rev. Stat. Ann. § 77:14.

[297] DC Code Ann. § 47-1808.1; NYC Code §§ 11-502(a), 11-503.

[298] See, e.g., Cal. Rev. & Tax. Code § 17041; NJ Income Tax Reg. § 18:35-1.14(b)(2); Pa. Personal Income Tax Reg. § 107.2(b); Bechert v. Commissioner of Taxation, 221 Minn. 65, 21 NW2d 101 (1945).

[299] See supra ¶ 20.04.

[300] Freidell v. Commissioner, 220 NW2d 763 (Minn. 1978) (losses allocated to Minnesota resident partner of a South Dakota partnership were not Minnesota source items and thus could not be deducted on the resident's Minnesota return); Ellis v. South Carolina Tax Comm'n, 280 SC 65, 309 SE2d 761 (1983) (income and losses passed through to a resident partner from an out-of-state partnership not includable in South Carolina taxable income, since the source of such income and loss was the partnership's activities outside the state); but see Sweitzer v. Wisconsin, 65 Wis. 2d 235, 222 NW2d 622 (1974), in which the court held that a Wisconsin resident may deduct losses from a New York limited partnership, even though Wisconsin did not generally tax residents on income from sources outside the state, on the theory that the losses were derived from the resident's in-

tually conduct the business of the partnership within the taxing state act as agents for the nonresident partners.[304]

Although these principles have been well established for some time,[305] they have been challenged in recent years in a series of cases involving nonresident partners of New York law firms. Nonresident partners practicing in the Washington, D.C., office of a New York law firm argued that New York lacked jurisdiction under the federal and state constitutions to tax their shares of partnership income earned by the firm in New York. The taxpayers claimed that all of their own legal work was performed in Washington rather than New York and the income distributed to them by the partnership should not, therefore, be treated as derived from New York sources. The New York courts dismissed these arguments, noting that the partnership's substantial New York practice provided sufficient nexus to permit the state to tax their nonresident partners' distributive shares of partnership income apportioned to New York, regardless of whether the partners were themselves present in New York.[306] The New York court, however, rejected a contention of the State Tax Commission that a Washington, D.C., partner of a New York firm with a branch in Washington was taxable on his entire income from the partnership. It was held that the partner was taxable only on his share of partnership income attributable to New York.[307]

In another case involving a Washington, D.C., partner of a New York law firm, the court considered the contention that the partner's share of partnership income taxable by New York should be apportioned to the state by the number of days the taxpayer spent in New York engaged in legal work, rather than on the basis of his share of the partnership income apportioned to New York by reference to the partnership's in-state and out-of-state activities.[308] That is the method New York employs in attributing the income of a nonresident employee to the state.[309] The court rejected the claim, noting that "it is the portion

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[304] These theories were articulated by the New York courts in the leading case of People ex rel. Badische Anilin & Soda Fabrik v. Roberts, 11 AD 310, 42 NYS 502 (1896), 152 NY 59, 46 NE 161 (1897). In that case, a German corporation whose only tie to New York was its ownership of a limited partnership interest in a New York partnership was held to be subject to New York tax. The court reasoned that, while a shareholder of a corporation does not conduct the business of that corporation and does not directly own the corporation's property, a partner in a partnership "is doing business as such, as though he were solely engaged in the same business for his sole profit." Id., 11 AD at 312, 42 NYS at 503. See also Chapman v. Browne, 268 AD 806, 48 NYS 2d 598 (3d Dep't 1944), motion for leave to appeal denied, 286 AD 836, 50 NYS2d 461 (1944).

[305] See supra note 297.

[306] Weil v. Chu, 120 AD2d 781, 501 NYS2d 515 (3d Dep't 1986), aff'd, 70 NY2d 783, 515 NE2d 908 (1987), appeal dismissed, 485 US 901, 108 S. Ct. 1069 (1988).

[307] McCauley v. State Tax Comm'n, 67 AD2d 51, 415 NYS2d 118 (3d Dep't 1979).

[308] Debevoise v. State Tax Comm'n, 52 AD2d 1023, 383 NYS2d 968 (1976).

[309] NY Personal Income Tax Reg. § 131.18.

whether the partnership is carrying on its business within the state.[313] A few states, however, have recognized limited exceptions to the general rules governing the taxation of nonresident partners for certain limited partners. Massachusetts exempts from tax nonresident limited partners on income earned by Massachusetts partnerships from dealing in securities for the account of the partnership and not as brokers.[314] Prior to 1988, Wisconsin provided that nonresident individual limited partners were not subject to Wisconsin tax with respect to income earned by such partnerships in that state.[315] In an analogous situation involving *corporate* limited partners, the New York State Tax Commission has ruled that a foreign corporation's ownership of a limited partnership interest in a partnership doing business in New York will not subject the corporation to the state's franchise tax on the ground that it is doing business in the state through the partnership.[316]

[3] Sale of Partnership Interest

Because resident partners are normally taxable on all of their income whatever its source, they are subject to tax on the gain on disposition of their partnership interests regardless of the source of the gain. When a nonresident realizes gain from the sale of a partnership interest, the states usually treat the transaction under the general rules governing taxation of income from intangibles, that is, the income is taxable by the state of the partner's domicile under the principle of *mobilia sequuntur personam* unless the intangible has acquired a business situs in another state.[317] Thus, administrative tribunals in California

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[313] Compare Ausbrooks v. Chu, 66 NY2d 281, 496 NYS2d 969, 487 NE2d 879 (1985) (nonresident filing New York personal income tax return could not deduct losses as limited partner in partnership engaged in out-of-state real estate development because partnership was not engaged in business in New York) with Vogt v. Tully, 53 NY2d 580, 444 NYS2d 441, 428 NE2d 847 (1981) (nonresident filing New York personal income tax return could deduct losses as limited partner in partnership engaged in leasing of railroad cars in New York). See also CRIV Invs., Inc. v. Department of Revenue, Ore. Tax Ct., April 23, 1997, Dkt. No. 4046 (nonresident corporate limited partner in Oregon real estate partnership subject to tax on distributive share of partnership income).

[314] Mass. Gen. L. ch. 62, § 17(b); but see Neese v. Commissioner of Revenue, supra note 305 (applying general rule).

[315] See former Wis. Stat. § 71.07(1g)(b)(2), repealed by 1987 Wis. Laws, Act 399. The rule was confined to those partners who do not participate in the management of or act on behalf of their partnerships. Id. In fact, under the Uniform Limited Partnership Act, a limited partner who participates in management becomes liable for its debts. Uniform Limited Partnership Act § 7.

[316] See Advisory Op., TSB-M-88(5)(C) (Mar. 10, 1988), discussed in Chapter 6. But see supra note 306 (citing cases in which the New York Court of Appeals applied the rules applicable to nonresident general partners to nonresident limited partners).

[317] See supra ¶ 20.05[6].