
# Qualified Retirement Plan Designs for Law Firms

By Andrew E. Roth

## I. INTRODUCTION

A discussion on retirement can be a difficult one to start. Qualified Retirement Plans have become an important part of the employee benefit programs offered by professional practices, but partners typically tend to focus on their clients rather than their retirement program. While retirement may indeed be years away, Qualified Retirement Plans can provide practices with substantial tax savings today. Law firms, in particular, can use Qualified Retirement Plans to maximize retirement savings for partners in a tax-efficient manner. Plan contributions are immediately tax-deductible and enjoy tax-deferred growth until they are withdrawn during retirement. Taxation may be further delayed by partners and employees alike by rolling the proceeds of the plan over to an individual retirement account (IRA). Plan assets also have the unique benefit of being unreachable by creditors of the individual plan participants as well as creditors of the firm, with very few exceptions.

This article briefly discusses certain techniques law firms can use to maximize the substantial tax benefits of Qualified Retirement Plans.

## II. DEFINED CONTRIBUTION PLANS

### A. 401(k) Plans in General

Many law firms offer 401(k) Plans, technically known as Cash or Deferred Arrangements (CODAs). Employees of the firm, including partners, may elect to defer a portion of their salary or draw as a plan contribution. These contributions are generally made pre-tax, where the funds grow and are not taxed until withdrawal at separation from service or retirement. Alternatively, participants may choose to forgo the immediate tax deferral in favor of after-tax contributions that grow, and may be withdrawn, tax free (known as a Roth 401(k)).

Employees may choose to make traditional (pre-tax) 401(k) contributions, Roth (after-tax) 401(k) contributions or a combination of the two – provided that the total does not exceed the annual Internal Revenue Service (IRS) limit ($18,000 for 2017). Employees who have turned age 50 by year-end may make an additional $6,000 "catch-up" 401(k) contribution, increasing their effective 401(k) limit from $18,000 to $24,000. Both the $18,000 401(k) limit and the $6,000 "catch-up" limit are subject to annual cost-of-living increases.

In general, contributions to a 401(k) Plan are subject to an annual nondiscrimination test, called the Actual Deferral Percentage Test (ADP Test). This numerical test separates the eligible employees into two categories – Highly Compensated Employees (HCEs) and Non-Highly Compensated Employees (NHCEs) – and compares the average 401(k) contribution for each group. HCEs include any employee who (a) earned more than the compensation threshold for the *prior* year (earned more than $120,000 in 2016 for the 2017 plan year) or (b) owned directly or by attribution more than 5 percent of the ownership interests in the employer. When the HCEs contribute, on average, significantly more than the NHCEs, the HCEs must receive taxable refunds of those contributions.

### B. Safe Harbor 401(k) Plans

Rather than risking potential taxable refunds each year, many professional employers have added a safe harbor component to their 401(k) plans. Safe harbor plans are exempt from the annual ADP Test, allowing the HCEs to maximize their 401(k) contributions without relying on significant participation by NHCEs. The sponsor of a safe

**Andrew E. Roth**, J.D., LL.M. (taxation), is a partner of Danziger & Markhoff LLP, with over 30 years of experience as an ERISA attorney. He received his Bachelor of Arts degree from New York University, his Juris Doctor degree from Brooklyn Law School, and his LL.M. from New York University School of Law. Andy is a frequent lecturer in the areas of pension, profit-sharing, and employee benefits law. He has substantial experience in designing and implementing qualified plans for business owners that maximize deductible contributions on their behalf. He is admitted to practice before the U.S. Tax Court and the Federal District Courts for the Southern and Eastern Districts of New York, and is a member of the New York State Bar Association. Andy can be reached at 914-948-1556. *Special thanks to Mark T. Hamilton, Esq., and Alex P. Nahoum, EA, MAAA, for their contributions.*

harbor plan must inform its employees that the firm will be making a contribution on their behalf for the upcoming year. This is done through an annual notice that must be distributed at least 30 days prior to the beginning of the plan year.

There are two types of Safe Harbor plans:

1. **Safe Harbor Non-Elective**: The employer makes a contribution equal to 3 percent of each eligible employee's compensation for the plan year. These contributions are made whether or not the employee actually makes a 401(k) deferral for the year. The Plan may provide that the 3 percent contribution is allocated to all eligible employees or to eligible NHCEs only.
2. **Safe Harbor Match**: The employer makes a matching contribution, generally equal to (a) 100 percent of the employee's first 3 percent of compensation contributed as a 401(k) deferral, plus (b) 50 percent of the employee's next 2 percent of compensation contributed as a 401(k) deferral. This contribution ends up capping out at 4 percent when the employee's 401(k) deferral is at least 5 percent of their compensation for the year. Unlike the Safe Harbor Non-Elective contribution, an employee must make a 401(k) contribution to be eligible to receive a Safe Harbor Matching contribution. Therefore, if NHCE participation is very low, a Safe Harbor Match may be attractive. In our experience, however, NHCEs at law firms tend to see the obvious benefit of participation in such a plan and are more likely than some other types of businesses to make the elective deferrals necessary to receive the Safe Harbor Match.

### C. Profit Sharing 401(k) Plans

In addition to 401(k) elective deferrals and employer safe harbor contributions, most professional employer plans include a profit sharing feature. Profit sharing contributions may be made by the employer on behalf of each employee and can increase a partner's total allocation under the plan to as much as $54,000 per year ($60,000 if including the $6,000 401(k) "catch-up" contribution). These additional profit sharing allocations can be skewed toward the partners in the plan through age-weighted nondiscrimination testing (called "new comparability" testing).

New comparability testing separates the employees into the same two categories as the ADP test: HCEs and NHCEs. However, since new comparability is age weighted, higher paid employees who are closer to retirement can receive a much larger portion of the contribution while lower paid employees who are further from retirement receive a much smaller portion of the contribution. This allows the partners of the firm to receive a maximum contribution allocation while limiting the contributions going to the staff to a modest and manageable number.

### D. Top-Heavy Plans and Split Plan Design

As noted above, many law firms utilizing these types of Qualified Retirement Plan designs tend to maximize contributions for the partners while limiting the outlay for the staff. This strategy often results in the plan becoming "top-heavy." A top-heavy plan is a plan where at least 60 percent of the total balances belong to the firm's partners. When a law firm partner wants to contribute to a top-heavy plan, the firm must provide all eligible active non-partner employees with a minimum allocation of 3 percent of their salary. This allocation must be provided to non-partner HCEs and NHCEs alike. This can get expensive when the firm employs highly paid professionals who are not partners, like law firm associates. The firm is faced with the difficult decision to either make the top-heavy minimum contribution or exclude these associates from the plan entirely (preventing them from even making their own 401(k) deferrals).

An alternate approach would be to set up a plan solely for the associates and any other highly paid professionals. The firm can then exclude them from the "primary" plan (the plan containing the partners and lower paid staff employees) and avoid the top-heavy minimum contribution for associates and highly paid staff. As long as none of the partners participate in this second "associates-only" plan, no top-heavy minimum contributions would be required in that plan. Participants in the "associates-only" plan are then able to make 401(k) contributions without any need for the firm to make any employer contribution on their behalf. This type of "Split Plan" design is very common with professional practices that have non-owner or non-partner highly paid employees.

Firms with a large number of employees can use a different type of "Split Plan" design. Plans that provide for employer contributions are generally required to provide a minimum contribution level for all eligible staff employees. As the number of staff employees increases, this minimum contribution level can get more and more expensive. While the partners may be receiving the maximum contribution allocation under the plan, they may be on the hook for a considerable cost to the staff. In these situations, firms have split their plan in two. Plan 1 benefits the partners of the firm and half the eligible staff employees. Plan 2 also benefits the partners of the firm but includes the other half of the eligible staff employees. The result is a lower contribution level for the staff employees, while allowing the partners to increase their percentage of the total contribution. This is not a design that necessarily works for all professional practices, since there are a number of nondiscrimination testing requirements, but it can be a cost-effective solution in the right circumstances.

## III. DEFINED BENEFIT PLANS

### A. Defined Benefit vs. Defined Contribution

Through a combination of 401(k) deferrals, employer safe harbor contributions and employer profit sharing contributions, partners of a law firm can make annual deductible contributions up to the statutory limit of $54,000 ($60,000 if over age 50 for 2017). However, Qualified Retirement Plans are not limited to just defined contribution plans. Defined benefit plans can yield tax-deductible contributions far in excess of the $54,000 or $60,000 annual defined contribution limit. This is because the tax code limitations on defined benefit plans apply to the amount an employee can withdraw at retirement, rather than what an employee can fund today. For example, an individual age 62 who has participated in a defined benefit plan for at least 10 years may withdraw approximately $2.7 million. Funding to that number could allow the firm to contribute and deduct over $200,000 per year for that individual.

While defined contribution plans provide employees with an account balance that fluctuates with the market, defined benefit plans instead provide employees with a guaranteed benefit at retirement. Traditional defined benefit plans express these guaranteed benefits in the form of a life annuity payable at the plan's normal retirement date. The larger the guaranteed benefit is under the benefit formula, the larger the tax-deductible contributions may be to fund those benefits.

### B. Cash Balance Plans

Many law firms sponsor a type of defined benefit plan known as a cash balance plan. Cash balance plans often allow partners to supplement their profit sharing 401(k) plan with an additional deductible contribution for themselves at a modest increase in staff costs. A cash balance plan is subject to all of the funding requirements and operational and benefit limitations as a traditional defined benefit plan but looks and feels very similar to a defined contribution plan. Benefits in a cash balance plan are expressed as a guaranteed account balance, increased each year by a "contribution credit" and an "interest credit."

Contribution credits may be a percentage of salary formula or a flat dollar formula (or a combination of both), and may be different for different classes of employees. Law firms may want to give one contribution credit formula to partners of the firm and another (usually much lower amount) to staff employees. Cash balance plans may even be designed to give different contribution credit amounts for each individual partner. Contribution credits are usually fairly close if not equal to the actual plan contributions funded by the firm.

Interest credits are given as a guaranteed rate of return by the employer. These are generally either a flat rate or a rate indexed on a bond yield (like the return on the 30-Year Treasury). If the plan assets consistently underperform the guaranteed rate the employer may need to make additional contributions to compensate. However, if plan assets consistently outperform the guaranteed rate, employers may be able to reduce their contributions in subsequent years.

### C. Past Service Plans

Cash balance plans generally rely on level funding, where the contribution amount is consistent from one year to the next. This allows firms to rely on a consistent deductible contribution each year. On the other hand, it would typically not allow a firm to make a significantly higher contribution in a year with a substantial windfall. Rather than setting up "level-funded" (also referred to as "accumulation") plans, firms seeing a one-time influx of cash may be looking for alternative designs to shield that income.

Defined benefit plans and cash balance plans are essentially funding toward a target in the future. There can be a number of different paths to get to that same target. For example, a law firm with a single employee wants to design a plan that will result in a lump sum of $300,000 at retirement, which is three years away. A level-funded plan design may yield an annual contribution of around $100,000 per year over the three-year period, culminating in the $300,000 goal. However, since that employee is close enough to retirement, the plan may be designed to allow the firm to be able to contribute $200,000 in the first year on their behalf with a modest $50,000 per year thereafter. Under the right circumstances, the contribution could potentially amount to as much as $300,000 in the first year, with no further funding requirement over the two succeeding years.

The exact funding requirements and deduction limits on these types of plans are based on the demographics of each firm (and, in part, on plan experience), but this example illustrates how this strategy could allow the firm's partners to shelter non-recurring (or "windfall") income from taxes without the need for a substantial cash commitment in future years. This can be very valuable for law firms whose income stream is unpredictable (e.g., irregular contingent fee revenue at the conclusion of successful litigation) but do not have the cash flow for level funding over a period of years.

## IV. CONCLUSION

Properly designed Qualified Retirement Plans can have substantial benefits for professional practices, and law firms are no exception. Partners can shield substantial income from taxation through their working years and enjoy the results of a tax-deferred "nest egg" upon retirement. These plans can also have the ancillary benefit of functioning as a retention tool for valuable employees by using delayed plan eligibility and vesting provisions. Often, law firms and other professional practices already maintain Qualified Retirement Plans, but do not take advantage of some of the unique design options available to them. Or, plans are set up but not adjusted as the needs of the firm change. As the firm evolves, so should its retirement program. Law firms should look to review their current plan design with a pension expert to ensure they have the best fitting design for the firm as well as its partners. ■