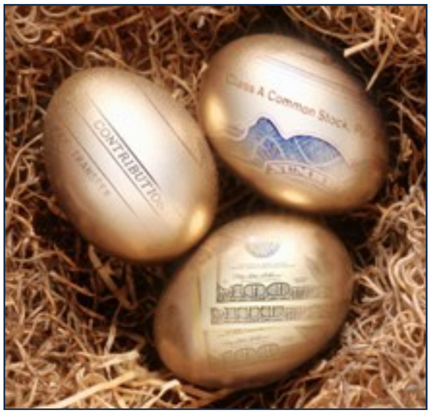
Employee Benefit Services

Retirement Plans for Professional Firms



There have been several developments over the years in qualified retirement plans that have proven uniquely beneficial to professional firms. These developments can apply to both new plan installations as well as the redesign of an existing retirement program.

Advantages of Plan Sponsorship

Tax-qualified retirement plans have long been a key component of overall employee compensation. In a professional firm application, they have also been a method for compensating partners or owners on a before-tax basis, an alternative to taxable bonuses or distributions. In this regard, they have been most widely used as tax-planning devices rather than as a tool to attract and retain employees. While the focus of recruiting efforts by professional firms has traditionally been salary oriented, surveys have shown that employees rank benefits above pay in order of importance. As a key component of a benefits package, qualified retirement plans are the best way to accumulate a substantial retirement fund for long-term employees, as well as for working professional owners or partners. A retirement plan also indicates the willingness of a firm to share in the success of the practice, and to provide for its employees' futures.

The main benefit of qualified plans, for both the employer and the employee, is the deferral of current taxable income. The primary advantage to the sponsoring company is an immediate tax deduction for the amount contributed to the plan for the tax year. Sponsors of non-qualified plans, by contrast, do not receive a deduction until the contributions are included in the income of the employee, usually at retirement.

For the participants of the qualified plan, there are many tax advantages to retirement plan contributions. Participants pay no current income tax on amounts contributed on their behalf. In plans with a salary deferral feature, commonly known as 401(k) plans, the employee may choose between receiving current income and the deferral of that income until retirement. Deferring the compensation allows the employee to lower his or her taxable income, although payroll taxes still apply.

A major advantage of all plans is that the investment earnings of the plan are not subject to current income tax. This permits the accumulation of income and gains on investments without taxation until the funds are withdrawn. This aspect of qualified plans can allow the working owner to accumulate a considerable retirement balance over time through the tax-free build-up of capital. Most 401(k) arrangements allow participants to direct the investment of their own accounts, which has increased the popularity of these plans with employees.

Tiered Allocations

Although qualified plans must not discriminate in favor of highly compensated employees, there are methods that allow for disproportionate contributions to be allocated on behalf of these participants. Through the use of a certain type of profit sharing plan allocation, a professional service employer can designate specific individuals to receive a larger relative share of the contribution than is made for other participants.

These plans, known as “tiered” profit sharing plans (also known variously as “cross-tested,” “super-integrated” or “new comparability” plans), can be designated to meet the specific needs of a professional firm. By providing separate contribution levels (or tiers) for groups of employees, the plan can reflect the structure of the firm in terms of compensation and experience. The tiers can also apply to a specific individual.

Example 1

A law firm establishes a tiered profit sharing plan for the benefits of its partners and employees. The plan provides four tiers of contributions:

Senior partners will receive the legal maximum (currently $56,000 per year); junior partners will receive 12.5% of compensation; associates will be allocated 8% of compensation; and the balance of employees will receive an allocation equal to 5% of pay.

Such an allocation must be tested for discrimination based on IRS regulations, and compensation for the plan purposes is limited to the first $280,000 of pay. The plans generally work for situations where the participants in the higher tiers are relatively older than the lower tiers. These plans are often combined with a 401(k) feature that allows the lower paid employees to increase their retirement accounts at their individual discretion.

In an established plan, switching to a tiered allocation method provides significant advantages over traditional profit sharing plans or Simplified Employee Pension Plans (SEPs), which allocate contributions in proportion to pay. A tiered design can substantially shift the allocation in favor of the older business owner, while lowering the overall cost of retirement program:

Example 2

	Age	Salary	Pro-Rata Method	Tiered Method
Partner	50	$280,000	$56,000	$56,000
Associate	35	$ 90,000	$18,000	$ 4,500
Staff 1	30	$ 45,000	$ 9,000	$ 2,250
Staff 2	25	$ 30,000	$ 6,000	$ 1,500
Total		$445,000	$89,000	$64,450

Defined Benefit Plans

Several developments over the last few decades have increased the utilization of defined benefit plans by professional firms. These include the repeal of the combined plan limitation, increased benefit and compensation limits, and the creation of hybrid plans, known commonly as cash balance plans. As a result, defined benefit plan contributions are available to business owners, regardless of the growth of their defined contribution plan accounts.

Example 3

A 55-year-old attorney earning $350,000 per year had been funding a 401(k)/profit sharing contribution for twenty-five years, which had grown to over $1.5 million by 2018. In 2019, he establishes a defined benefit plan to provide maximum benefits at age 62. His projected annual contribution would be $184,700, with a total accumulation of over $2,000,000 at age 62. He can continue to fund his 401(k) plan, subject to limitations.

Unlike other types of plans, contributions to defined benefit plans are not limited to a set amount per year. The annual contributions to these plans are actuarially determined, based on the retirement benefits to be provided at a specified age. Like tiered profit sharing plans, defined benefit plans work best for older owners with a relatively younger work force, but can also benefit sole practitioners. Due to benefit increases, defined benefit contributions begin to exceed defined contribution limits as low as age 35, assuming sufficient salary.

When employees are involved, defined benefit plans used to be problematic. Due to their short window before retirement age, older employees required significant contributions and often made the adoption of the plan cost-ineffective for owners. This situation has been solved through the use of cash balance plans, usually in combination with a 401(k) plan.

Cash balance plans provide a "hypothetical account balance" that looks to the participant like a defined contribution account. Contribution amounts are specified by employee or groups and the employer guarantees an interest credit on the contribution. This type of plan allows the employer to specify a low contribution amount for their employees, regardless of age, such as $1,000 per year or a benefit equal to 0.5% of pay. The key professionals receive much higher cash balance credits in the plan. Sufficient contributions must be provided in the 401(k) plan to satisfy the nondiscrimination requirements, but this is typically an extremely advantageous arrangement for the business owners, providing them significant contributions at a much lower employee cost than with a traditional defined benefit plan. For professional business owners who wish to fund maximum benefit at retirement, the results can be dramatic, as demonstrated in the following example on the next page.

EXAMPLE 4

	Compensation	Age	Retirement Age	401(k)	Profit Sharing	Cash Balance	Total
partner 1	$280,000	60	65	$25,000	$24,500	$200,000	**$249,500**
partner 2	$280,000	50	62	$25,000	$24,500	$150,000	**$199,500**
associate 1	$175,000	42	62	$19,000	$0	$0	**$19,000**
associate 2	$135,000	35	62	$10,000	$0	$0	**$10,000**
staff 1	$75,000	35	62	$5,000	$5,625	$1,000	**$11,625**
staff 2	$60,000	50	62	$18,000	$4,500	$1,000	**$23,500**
staff 3	$30,000	25	62	$0	$2,250	$1,000	**$3,250**
staff 4	$25,000	22	62	$0	$1,875	$1,000	**$2,875**
Totals	$1,060,000			$102,000	$63,250	$354,000	**$519,250**

In this example, the two partners of a law firm wish to fund sizeable contributions for themselves, but no contributions for their associates. The staff receives the minimum required contribution under the profit sharing plan and a nominal contribution under the cash balance plan to satisfy the minimum participation requirements. The partners represent over 95% of the total employer (non-401k) contribution.

There are other plan concepts and designs that may be of benefit to your professional practice. If you have questions about how we can help you evaluate your retirement plan needs, please contact Therese Cheevers at tcheevers@windes.com or Richard Green at rgreen@windes.com or call us at (562) 435-1191.