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What Should Law Firms Do When the 401(k) Plan Is Not Enough?

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If you've heard grumbling lately, it may be the sound of your partners complaining about their 401(k) profit sharing contributions. Many partners who desire to put additional money into their retirement plans on a tax deferred basis cannot do so because they have already put in the maximum amount.

The maximum 401(k) plan contributions can be as much as $20,500 for 2007. For law firms interested in permitting partners to defer additional taxable income in the form of tax-favored contributions to a retirement plan, a profit-sharing plan can provide another $29,500. However, once the maximum contribution has been reached ($50,000 for those 50 years of age and over and $45,000 for those under 50 years of age), then 401(k) profit sharing plan participants can no longer defer income or contribute to their retirement plans.

There is a solution. Contributions to Cash Balance Plans, the law firms' next 401(k) plan, can be as much as $200,000 per year. A Cash Balance Plan is a defined benefit plan that specifies the amount of contribution to be credited to each participant and guarantees the investment earnings on those contributions. Each participant has an individual account that resembles the accounts in a 401(k) profit sharing plan. All participant accounts are maintained by the plan actuary who generates annual participant statements.

The account grows annually in two ways. First, a company contribution that is determined by a formula specified in the plan document. It can be a percentage of pay or a flat dollar amount. Second, the account grows with an annual interest credit. This guaranteed rate of return is spelled out in the plan document and is not dependent on the plan's investment performance. The rate of return changes each year and for many plans is equal to the yield on the 30-year Treasury bond, which in recent years has been around five percent. Once participants terminate employment, they will be eligible to receive the vested portion of their account balance, which is determined by the plan's vesting schedule. Law firms typically make certain that partner accounts are 100 percent vested.

The advantage of the Cash Balance Plan over the traditional defined benefit plan is that each partner knows what is going into the plan on his or her behalf and what will come out when he or she leaves.

Because they are not profit sharing plans under which contributions can vary year to year depending upon profitability, Cash Balance Plans have to be amended to permit different contribution levels. Employers can designate different contribution amounts for various participants. However, there is a restriction on the frequency of amendments to change benefits unless there is a valid economic reason. For example, if a firm's profit is not expected to support the Cash Balance Plan contribution, the plan can be amended. A Cash Balance Plan can also be frozen or terminated.

Tax deductions for contributions made on behalf of non-partners are taken on the partnership return. Tax deductions for contributions made on behalf of partners are taken on their personal or corporate tax returns. However, to be sure that the amount deducted for tax purposes by a partner as shown on schedule K-1 is the same as the amount contributed on behalf of the partner, the partnership agreement must permit this method of allocation. Typically, partnerships that adopt the Cash Balance Plan do not want the partners' contributions allocated like most other firm expenses – in proportion to ownership. Either the partnership agreement or internal policy should

Continued on page 20

Law Firms

Continued from page19

assure that each partner is allocated an appropriate share of the plan's cost.

Law firms that are good candidates for Cash Balance Plans have one or more of the following characteristics:

1. Partners who desire to contribute more than $45,000 per year. Many attorneys may neglect their personal retirement savings while they are building their practices. Consequently, they need to catch up on their retirement savings. Adding a Cash Balance Plan allows for acceleration of savings on a tax-favored basis. Pre-tax contributions of $100,000 to $200,000 annually are not unheard of in a law firm's Cash Balance Plan.

2. Firms that have demonstrated consistent profit patterns. Because a Cash Balance Plan is a pension plan with required contributions, a consistent cash flow and profit is important.

3. Firms already contributing three percent or more to employees' plans or those willing to do so. While Cash Balance Plans are often established for the benefit of partners and other highly compensated employees, other employees also benefit. The plan normally provides a minimum contribution of five to seven percent of pay for the firm's staff.

4. Partners over 40 years of age who desire increased tax deferrals or wish to catch up on their pension savings. The maximum amount allowed in a Cash Balance Plan is age dependent. Therefore, the older the participants, the faster they can accelerate their savings.

To determine an individual's maximum contribution to a Cash Balance Plan, go to: www.cashbalancedesign.com.

For the partners that have reached the limit for maximum contributions into 401(k) and/or profit sharing plans, the Cash Balance Plan provides a significant opportunity to increase contributions into a qualified retirement plan as well as defer taxable income. ■

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