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LAW FIRM MANAGEMENT

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How to pump up retirement savings

CASH BALANCE PLANS MAY BE THE ANSWER FOR YOUR LAW FIRM

Cash balance plans provide a vehicle for high earners who regularly contribute to their employers' 401(k) plans at or near the limits to put more money away for retirement on a tax-deferred basis. In conjunction with 401(k) plans or on their own, cash balance plans are well suited for law firms.

THE ADVANTAGES

Technically, a cash balance plan is a defined benefit plan (sometimes known as a pension plan). It's often referred to as a "hybrid plan," though, because it shares some features with a defined contribution plan, such as a 401(k).

Specifically, cash balance plans combine the higher contribution limits of defined contribution plans with the higher maximum benefits and deduction limits of defined benefit plans. Because the contribution limits increase with age, participants approaching retirement can quickly juice their retirement savings.

Both a law firm and the participants reap tax benefits. The firm enjoys larger deductions for its contributions than it could with a 401(k) plan. It also might be able to deduct fees paid for a plan administrator.

Cash balance plans combine the higher contribution limits of defined contribution plans with the higher maximum benefits and deduction limits of defined benefit plans.

The participants can accumulate significantly more tax-deferred retirement savings than with a 401(k) plan. For example, in 2023, the maximum combined employee-employer contribution to a 401(k) account for a 55-year-old is $73,500 (including catch-up contributions of $7,500). But a firm can contribute up to $241,000 to a cash balance plan, on top of the 401(k) contribution.

Cash balance plan contributions may affect attorneys' personal federal taxes, too. They can reduce the hit from Medicare and net investment income taxes, for example.

The investment risk is borne entirely by the firm (see below), which owns and directs the plan assets. Market fluctuations don't change the amount of the ultimate benefits payout to participants, and plan assets are protected from creditors.

A cash balance plan is a powerful tool for recruitment and retention, too. The plans can help even associates burdened with big student loan payments to begin to save.

SECURE 2.0 EASES CASH BALANCE PLAN ADMINISTRATION

The Setting Every Community Up for Retirement Enhancement (SECURE) 2.0 Act signed into law in late 2022 brings a welcome change to cash balance plans (see main article). Such plans are subject to "backloading" rules that prohibit a participant's benefit accrual rate for a year from exceeding the rate in the previous year by more than a prescribed amount.

The IRS has required that the backloading test apply the most recent interest crediting rate for future years — but some plans use variable rates for interest credits. If the variable rate for the preceding year was low or 0%, it was difficult to satisfy the backloading test.

SECURE 2.0 eliminates the requirement that plans use the most recent interest rate as the projected rate when determining compliance with the backloading rules. Rather, they can use a reasonable projection of the future rate, up to 6%. As a result, plans can provide higher benefits to older participants with less risk of noncompliance.

THE MECHANICS

A cash balance plan must be sponsored by a business, but it can be a one-person business. That means the plan can work for solo practitioners.

The plan establishes a theoretical account for each participant, which is maintained by an administrator. The administrator credits the account with annual contributions (known as "pay credits") — typically a percentage of a participant's compensation (for example, 4%), a fixed amount or a combination. Whatever the formula, the pay credit generally is the maximum allowable.

These accounts are also credited with interest based on a rate stated in the plan (see "SECURE 2.0 eases cash balance plan administration," above). The rate usually is a fixed percentage or based on the yield of an index (for example, the 30-year Treasury), rather than based on the actual returns on the plan assets. Participants receive a lifetime annuity or a lump sum payout that generally can be rolled over into an IRA.

Cash balance plans aren't without their complications. For example, you'll need to retain the services of an actuary because they're subject to minimum funding obligations, which may or may not be satisfied solely by investment returns. If returns fall short for a given year, the law firm must make up the difference. The firm must obtain an annual certification from an actuary that the plan will meet its obligations.

In addition, a cash balance plan must pass nondiscrimination testing to ensure that the contributions made by and for rank-and-file employees are proportional to those made for highly compensated employees. The main effect is that the firm will likely need to increase contributions to non-highly compensated employees if it wishes to boost the amounts their highly compensated colleagues receive. The firm will require the assistance of an actuary here, as well.

WORTH CONSIDERING

A cash balance plan could be a valuable tool for increasing a firm's current-year tax deductions while accelerating retirement savings. The plans are more complex than 401(k) plans, though, so do your research before taking the plunge. We can answer any questions you have. •

It's time to review your partnership agreement

If your law firm is like many others, you probably don't refer to your partnership agreement until a partner is leaving the firm — but that could be a mistake. A lot can happen after a law firm creates its partnership agreement: new partners may enter, while existing partners exit. Your firm may have seen leadership transitions or made equity adjustments. An out-of-date agreement can throw your firm into tumult at the worst possible moment. Let's take a look at some areas to consider.

DETERMINING PARTNER STATUS AND RIGHTS

The agreement must identify the current partners and lay out the process for the admission of new partners, including how to decide to bring on new partners; voting rules; rights and obligations of different partnership tiers (if applicable); and buy-in requirements. If new partners must satisfy a buy-in requirement, your agreement should describe how the buy-in amount will be determined.

Next it must detail the decision-making and voting process. Will action require a majority, supermajority or unanimous vote? Will votes be granted on a per-capita or weighted interest basis? Try not to designate a single approach for all matters, but instead base the voting protocol on the type of issue. For example, require a supermajority vote on issues too important to hinge on a difference of one vote, such as admitting a new partner or merging with another firm.

Your partnership agreement should address the return of capital (including fixed capital and undistributed earnings) and equity interests to retiring partners.

List reasons for expulsion, such as disbarment, criminal conviction, bankruptcy and/or malpractice. Detail the expelled partner's rights and state whether your firm will return capital.

Finally, describe how payment will be made to a decedent's estate. Will the firm return capital? Will it pay out a pro rata share of the firm's value? For disabilities, state whether the partner will receive full or partial compensation and for how long.

DEFINING CAPITAL AND PROFITS

Your partnership agreement should define the capital structure, document how much capital each partner has contributed and establish the amount of retained earnings required to maintain financial stability. You

also may want to provide a method for raising additional capital for emergencies, expansion or other reasons.

In addition, your agreement should address the return of capital (including fixed capital and undistributed earnings) and equity interests to retiring partners. You may need to detail a valuation process and payment schedule for a partner's interest in accounts receivable and work in progress.

Most firms are better off not getting into too much detail about profit distribution in their partnership agreement. Rather, outline the profit allocation structure and give partners the flexibility to change relevant factors or alter compensation without formal amendments to the agreement.

CLARIFYING RETIREMENT ISSUES

Retirement raises many issues. For starters, will retirement be voluntary, or will your firm enforce a mandatory retirement age? What if a partner is still contributing when retirement age rolls around? Some firms enforce mandatory retirement at a certain age but offer renewable annual contracts on a case-by-case basis.

Postretirement compensation is another vital issue. In the past, firms regularly paid retired partners a stipend for a limited period, usually an amount based on former compensation. Many firms now use transition agreements that base postretirement compensation on client transfers and, if applicable, continuing part-time work and business generation.

And don't overlook postretirement liability obligations. If your firm has large loans with personal guarantees, it may need to institute a capital call or require a pledge of additional collateral from the remaining partners. Tax obligations in the case of a postretirement audit of preretirement tax years also warrant attention.

LONG-TERM STRATEGY

Law firms can use their partnership agreements to address a wide variety of issues — some of them potentially divisive. Even if your firm doesn't undergo big changes, you should periodically review your agreement to confirm it still aligns with the firm's long-term strategic objectives. Failing to regularly review the agreement can lead to issues down the road. Take the time now to review and make necessary updates. •

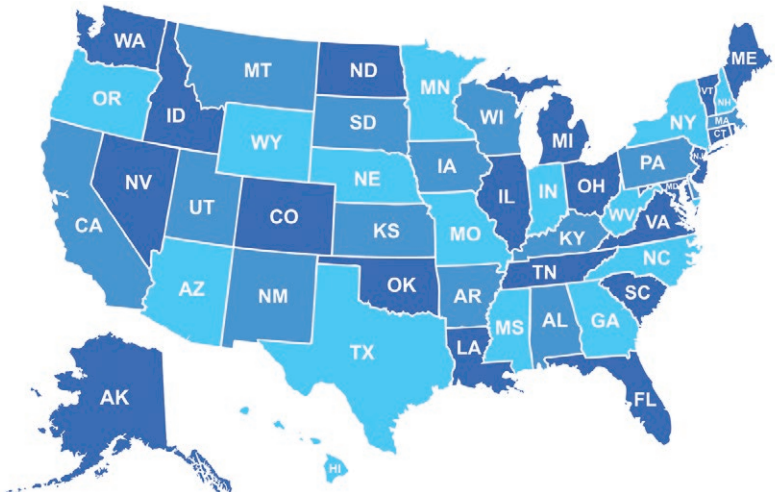
Could the nexus net snare your firm for multistate taxes?

Many states have become more aggressive in recent years about their pursuit of income, franchise or gross receipts taxes from multistate businesses. While you may think your law firm need not worry about the revenue departments in states other than where you're located, those states might disagree.

THE BROADENING DEFINITION OF NEXUS

For the purpose of taxation, nexus generally refers to the connection a taxpayer has with a jurisdiction. Each state determines the level of activity sufficient to create a nexus that justifies imposing taxes.

Traditionally, nexus was based on a taxpayer having a physical presence in a state. If you didn't have an office there, then you probably weren't subject to that state's tax. Beginning in the 1990s, though, a growing number of states started adopting "economic nexus" standards, on the theory that a business that derives income from sources in a state has sufficient local presence there for taxes to be imposed. (The specific threshold of economic activity that triggers nexus varies by state.)



The interpretation of both forms of nexus has expanded in recent years. For example, sending an attorney to perform legal services for a client in another state could lead to taxes. This is especially relevant as remote work gains in popularity — a single attorney working from home in a state could subject your firm to taxes there. Similarly, a state could claim economic nexus if your firm performs legal services related to property there, even if the services are conducted entirely out-of-state.

REVENUE SOURCING METHODS

If you're found to have sufficient nexus with a state, your tax liability will depend on its apportionment rules. Apportionment refers to how a taxpayer's tax base is allocated among different states.

One factor typically considered in apportionment formulas is the amount of the taxpayer's revenue in a state. Most states apply one of two formulas to determine the amount of revenue:

1. Market-based sourcing. This is based on where the client receives the benefit of your services. Most states with an income tax have adopted this method, but they have different approaches for determining where the benefit is received. Did the client receive it at their home address or billing address? What if the services involved property in a different state than those addresses?

2. Cost-of-performance sourcing. In this method, a state will allocate revenue based on where the costs to perform the related service were incurred. If the service was performed in multiple states (for example, if discovery was conducted in one state for a trial held in another), the associated revenue may be sourced based on the proportionate costs incurred for each. Alternatively, the revenue might be sourced entirely where the most costs were incurred. Regardless, the cost tracking can quickly become burdensome.

For the purpose of taxation, nexus generally refers to the connection a taxpayer has with a jurisdiction.

And imagine if a firm is in a cost-of-performance state but provides services solely to clients in a market-based state. Both could theoretically claim 100% of the firm's revenues for tax purposes, although tax credits or reciprocity agreements might preempt such double taxation.

PROCEED WITH CAUTION

If you don't want to incur penalties and interest, you need to stay on top of the rules of all the states where you may have nexus, including their filing obligations and deadlines. We can help you cover your bases and minimize your tax liability. •

States mull legal "paraprofessional" programs

The high price of legal services has prompted various states to consider granting paralegals limited licenses to provide attorney-type services in uncomplicated matters. Read on to learn how the so-called "limited license legal professional" movement is playing out.

DIFFERENT STATES, DIFFERENT DIRECTIONS

The acceptance of legal paraprofessionals across the country has been a bit of a mixed bag. For example, California's state legislature last year acted to block the state bar association from expanding the scope of paralegals' services.

The Washington Supreme Court had earlier decided to sunset the state's Limited License Legal Technician program, which had launched in 2012. The court cited the overall costs of the program and the small number of interested individuals. Licenses could be issued through July 31, 2023, though, and properly licensed paralegals can continue to provide services.

Other states, including Minnesota and Arizona, are moving ahead. Applications for the Arizona program will open soon, allowing the licensing of professionals with specific education and experience to provide legal services. Applicants must pass an examination in areas of law in which they intend to practice, including:

- Family law,
- Limited jurisdiction civil cases,
- Limited jurisdiction criminal cases involving no jail time, and
- State administrative law, where allowed by the respective agency.

Arizona "legal professionals" will be able to provide a variety of services. They can draft, sign and file legal documents, as well as appear before a court or tribunal. They can give advice, opinions or recommendations about possible legal rights,

remedies, defenses, options or strategies. And they can negotiate on behalf of a client in their licensed areas of law.

Notably, Arizona has established two licensing paths. Applicants who don't satisfy the specific education-based requirements may qualify through certain experience that allows applicants to take the exam and apply for a license.

In Minnesota's statewide pilot project, an applicant can obtain a license with anything from a degree earned at an accredited law school to a high school diploma and five years of substantive paralegal experience. No exam is required. The project, however, is limited to select housing and family matters.

In addition, legal paraprofessionals must be supervised by a licensed Minnesota attorney. Supervision is at the attorney's discretion, based on the paraprofessional's expertise, experience and the circumstances of the case; such attorneys aren't required to appear in court proceedings with their paraprofessionals.

THE BRIGHT SIDE

While some attorneys may resist the concept of legal paraprofessionals, the Minnesota Judicial Branch has highlighted a potential benefit. "Forward-thinking" firms that use paraprofessionals, it said, will have an additional income stream and the ability to serve more people. •

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