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CASH-BALANCE PLANS ARE LAW FIRMS' NEXT 401(k)s

FORUM COLUMN

By Dan Kravitz

A recent analysis of Los Angeles-area law firms' 401(k) plans indicates that many partners have reached or soon will reach maximum contribution levels. Many of those partners desire to put additional money into their retirement plans on a tax-deferred status but cannot.

The fastest-growing retirement plan in the United States, 401(k) plans are cash or deferred arrangements by which eligible employees can elect to have a portion of their compensation (otherwise payable in cash) contributed to a qualified retirement plan as a pretax salary reduction. Employers have the discretion to make matching contributions to their employees' 401(k) accounts.

Law firms recognize the value of 401(k)s and are strong supporters of that type of plan. In the Los Angeles area, about 1,750 law firms have 401(k) plans with combined assets of \$4 billion.

Maximum 401(k) contributions, which vary by the participant's age, range from \$15,500 to \$20,500 for 2007. For law-firm employers interested in deferring additional taxable income in the form of tax-favored contributions to a retirement plan on behalf of eligible participants, a profit-sharing plan can provide another \$29,500.

But once the \$50,000 per-participant maximum contribution has been reached for those 50 and over, and the \$45,000 maximum has been reached for those

under 50, then 401(k)/profit-sharing-plan participants no longer can defer income or contribute to their retirement plans. At that point, the plan is "maxed out."

In the Los Angeles area, many law firms have reached the maximum contribution level to their 401(k) plans. Partners who earn more than \$250,000 and are willing to contribute more than \$45,000 annually to their 401(k)s might think they are out of luck.

Enter cash-balance plans, law firms' next 401(k)s. A number of Los Angeles-area law firms have implemented cash-balance plans as the answer to their maxed-out-401(k) dilemmas. Cash-balance-plan contributions, which vary by age, can be as much as \$200,000 a year.

In 1984, BankAmerica Corp. introduced the cash-balance plan, which addressed changes in its work force. A 2001 change in tax law allowed contributions to cash-balance plans to increase by as much as 60 percent, making such plans much more attractive to successful businesses and professional firms.

A cash-balance plan is a defined-benefit plan that specifies the contribution to be credited to each participant and credits investment earnings based on those contributions. Each participant has an account that resembles those in a 401(k) and/or profit-sharing plan. Those accounts are maintained by the plan actuary, who generates each annual participant's statement.

The account grows annually in two ways: The company contribution - a percentage of pay or a flat dollar amount - is determined by a formula specified in the plan document, and an annual interest credit is earned. The rate of return is guaranteed and independent of the plan's investment performance. That rate changes each year but usually is equal to the yield on 30-year Treasury bonds, which has hovered around 5 percent during recent years.

When participants terminate employment, they become eligible to receive the vested portion of their account balances, as determined by the plan's vesting schedule. Law firms typically make certain that partner accounts are fully vested.

The advantage of a cash-balance plan, relative to traditional defined-benefit plans, is that each partner or shareholder knows what is going into the plan on their behalf and what will come out when they leave. When partners reduce their compensation to contribute to a retirement plan, it is imperative they feel assured that when they leave the firm, what they put into the plan will come out (plus interest). Thus, many law firms invest their plans' assets conservatively to minimize the possibility of investment losses - though other firms invest a portion of their plans' assets in equities to achieve higher rates of return.

Because they are not profit-sharing plans, for which contributions can vary year to year depending on profitability, cash-balance plans must be amended to permit various contribution levels. Employers can designate different contribution amounts for various participants, but there is a restriction on the frequency of amendments unless a valid economic reason exists. For example, if a firm's profits are not expected to support its cash-balance-plan contribution, then the plan can be amended. A cash-balance plan also can be frozen or terminated.

Tax deductions for contributions on behalf of nonpartners are taken on the partnership return; tax deductions for contributions on behalf of partners are taken on their personal or corporate tax returns. To ensure 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.

Most partnerships that adopt a cash-balance plan do not want the partners' contributions allocated like most other firm expenses - in proportion to ownership. The partnership agreement or internal policy should 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 a year. Many attorneys neglect their personal retirement savings while building their practices; consequently, they need to catch up on retirement savings. Adding a cash-balance plan allows for acceleration of savings on a tax-favored basis. Annual pretax contributions of \$100,000 to \$200,000 are not unheard of within a law firm's cash-balance plan.

2. Consistent profit patterns. Because a cash-balance plan is a pension with required contributions, consistent cash flow and profits are important.

3. Firms that already contribute 3 percent to 4 percent to employees' plans or are willing to do so. Cash-balance plans often are established for the benefit of partners and other highly compensated employees, but other employees also benefit. Such plans usually provide a minimum contribution of 5 percent to 7.5 percent of pay for the firm's staff.

4. Partners over 40 who desire increased tax deferrals or wish to catch up on pension savings. Maximum allowable amounts for cash-balance plans are age-dependent, so the older the participants, the faster they can accelerate their savings.

For partners who have reached the limit for contributions to 401(k) and/or profit-sharing plans, a cash-balance plan provides a significant opportunity to increase contributions to a qualified retirement plan while deferring taxable income.

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