Killing Two Birds with One Stone

How firms are addressing the retention imperative while efficiently funding partner buyouts

We have seen some interesting recent trends in the use of nonqualified plans by professional service firms. In particular law firms are utilizing **Non-Qualified <u>Defined</u> <u>Benefit</u>** style plans to address important retention and retirement issues.

Background:

The firms referenced are those organized as tax-conduits (pass-throughs). The tax characteristics of NQ plans and the nature of pass-through entities generally inhibit the effectiveness of traditional NQ deferred compensation arrangements. With a salary deferral or organizational contribution for a partner having no real current tax advantage to the individual, most partners simply opt for current cash. The absence of a current entity tax deduction for deferrals impacts the partners' (share of) income.

Meanwhile, law firms still have a complex problem. How do they build a retention vehicle and then finance it appropriately so that it benefits both the firm and the partner?

The approach some mid-larger firms are using is to develop a NQ defined benefit plan providing a retirement benefit which supports the retention and retirement needs of the firm and its eligible equity partners (often rainmakers or significant contributors).

Note that this is **not a tax play** on the benefit. The program does, however, build a retention benefit in a tax-efficient manner with which to fund a substantial payment at separation.

Plan Mechanics:

Often equity partners are eligible for a nonqualified defined benefit pension style program based on years of service and average compensation. For example, at normal retirement the partner receives an annual lifetime benefit based on 40% of his/her last five years of compensation less certain defined offsets recognizing other firm contributions. In many cases minimum service requirements are applied.

What kinds of **administrative and oversight services** are important to support this type of program?

Benefit Calculations & Communications: Depending on frequency and complexity, this generally requires (at least) annual statements and additional calculations at distribution, separation, retirement, etc. Further, depending on the offsets this may mean another series of program calculations to support the plan.

Financing: Determine the type of asset most efficient for the firm's particular plan and organization. Institutional Corporate-Owned Life Insurance (COLI) is often effective due to its cost efficiencies, tax advantaged accumulation, and potential cost recovery attributes.

Financial Review: Based on how these plans work (DB style) financing and collateral assumptions should be reviewed and tested at least annually (actuarial review). There are several variables and design considerations in styling a financing program, including the amount to be financed, periodic budget considerations, payments from cash flow, assumptions around plan growth, etc.

Flexibility: Firms have unique characteristics. Our broad experience in designing & implementing a range of tailored programs allow us to work effectively with the firm's leadership and financial advisors, and accommodate their preferences in accounting method.

Bottom Line:

The transparent design encourages loyalty by benefitting tenured partners; it inspires retention. The "losers" are those who pay into the plan and leave the firm either before vesting (an unfavorable outcome) or before accruing a full benefit.

Due to the tax characteristics of conduit firms, these plans shine in organizations valuing retention and appreciating the compounding power of time, regular funding, and tax-advantaged accumulation. The partners' on-going, formal financing of this benefit out of their own pockets underlies the value they accord continuity as strategic advantage. In essence this cost/benefit to the individual formalizes their decision to become part of an enduring economic engine.

Michael McDonough, RICP, AIF, CPA (inactive)
Michael M. McDonough, Inc.
2009 Mackenzie Way; Suite 100
Cranberry Township, PA 16066
(724) 720-9317
michael@mmcdonough.net