Providing sufficient retirement benefits for law firm partners

Law firms must plan carefully to provide sufficient retirement benefits to key partners. As senior partners look to retire and give up their equity, younger partners must ensure the firm has a viable plan in place to fund partner retirement benefits.

A lack of retirement planning can severely limit a firm's **succession plan**. Unfunded plans require an inefficient and expensive "pay as you go" approach and are not protected from the firm's creditors. If left unaddressed, this often creates a silent tension among partners in both small and large firms. Retiring partners seek to maximize their benefits and benefit security while younger partners realize that they will bear the long-term burden of providing those benefits.

A thoughtful approach to retirement benefit funding is essential to a firm's succession planning strategy. There are two core strategies for law firms should consider when funding partnership retirement obligations:

Using Life Insurance as an Investment Vehicle

Institutionally-designed life insurance programs are a critical tool in funding supplemental retirement benefits and play a key role in a company's succession planning strategies. Permanent cash value life insurance policies offer compelling advantages as a secured, tax-sheltered vehicle for key partners.

Advantages of using life insurance to fund future retirement benefits include:

- Policies can be individually-owned and secured against company creditors
- Partners build significant equity in a tax-sheltered policy
- Policy cash value can be invested in equity options with downside market protection
- Policies provide immediate death benefit protection for partners' beneficiaries
- Policies offer greater internal rates of return than taxable alternatives
- Firms can leverage company contributions into greater benefits by taking advantage of current low interest rate environment (more on this below)
- There are no ERISA requirements so, if desired, plans can be set up with varying contributions and vesting schedules to favor the highly compensated partners

In this context, the firm isn't buying life insurance for its traditional purpose–i.e. a tax-free death benefit. Instead, the firm is taking advantage of the tax-sheltered nature of cash value life insurance to accrue long-term investment returns without paying tax on those gains, a strategy used by corporations and banks for decades.

How much the firm contributes to the policies, which partners receive a policy, and whether the contributions are subject to a vesting schedule, are all questions unique to each firm based on their specific objectives and goals.

Using Bank Leverage to Further Enhance Partner Benefits

Aon has developed programs that take advantage of the current low interest rate environment to more efficiently fund retirement benefits. One such program, called a Leveraged Savings Plan ("LSP"), uses a third-party lender to "match" the firm's contributions into the participant's life insurance policy on a non-recourse basis.

Advantages of a Leveraged Savings Plan approach include:

- Greater amounts in the policy from day one, significantly enhancing a partner's future retirement benefits
- The law firm's required cash contributions are significantly reduced
- Partners are not taxed on the bank's contributions
- No outside collateral, financial underwriting, or personal guarantees are required
- A secure, tax-free target benefit with tax free distribution flexibility for the partner

By obtaining financing on a non-recourse basis, working with **experts** to implement this arrangement provides significant upside for the retiring partners while mitigating against traditional borrowing risks.

Partnership Leveraged Savings: An Example

The following is an example of how a Leveraged Savings Plan can be used as a succession planning strategy for key partners:

- A firm has a 55-year-old partner with unfunded retirement benefit obligations. The partner currently has K-1 earnings of approximately $575K.
- Instead of paying this partner's retirement benefits on a "pay as you go" basis at age 65 (which would be costly, inefficient, and unsecured), the firm starts contributing a fixed percentage of the partner's current compensation into an individually-owned life insurance contract annually for several years.
- The Leveraged Savings Plan lender "matches" the firm's contributions on a non-recourse basis with low-cost borrowing rates.
- Over a period of years, the policy's cash value accumulation exceeds the bank's borrowing costs, resulting in a positive spread for the policyowner.
- By retirement age, the lender is repaid from policy values and the partner owns the remaining net policy values tax-free. Assuming a 6% crediting rate, the partner receives over $2M in supplemental tax-free retirement income from the policy after retirement. Assuming death at age 95, the partner's heirs receive a $2.4M tax free death benefit.

Planning for partner retirement benefits is a critical step in a firm's succession planning strategy. Thoughtfully funding a program helps ensure retiring partners have benefit security and alleviates the future burden on younger partners. Using life insurance as a tax-sheltered investment vehicle provides a compelling approach, and benefits can be further enhanced with the use of non-recourse bank leverage in an institutionally-designed Leveraged Savings Plan.

For questions or to discuss how a program could look for your firm, please contact **George J Wolf, Jr.** or **Alan Ponce**.