Financial Planning for the Law Firm Partner

Financial planning for the law firm partner takes specific experience and an understanding of the complexities that arise throughout the life cycle of a partner. One of the most significant events in this cycle is the promotion to partner. The changes involved go well beyond the compensation component and touch on almost every aspect of their financial lives—from cash flow and taxation changes to investing and capital account funding, longer-term retirement planning, insurance, and trust and estate planning. While all law firms are structured differently to some degree, they tend to share similarities in their benefits, taxation and retirement plan programs, many of which are unique to the law firm world. Becoming familiar with the general structure of these programs allows an advisor to provide specific and relevant advice and guidance to clients across the law firm universe.

Cash Flow and Tax Planning

One of the most significant changes to occur upon elevation to partner is the switch from a W-2 employee to a K-1 partnership method of taxation. Coupled with the back-end nature of law firm revenue recognition, this can often lead to high quarterly estimated tax payments due, without the corresponding cash flow to fund them. While many firms will make some form of cash distribution to partners at or near quarterly estimated payment time, these payments are often inadequate to fully fund the tax liability. In the early years of partner status, when sizeable portfolio wealth has not yet been amassed, this can often lead to a need for short-term borrowing or potentially selling off portfolio assets (sometimes at a taxable gain) to fund cash flow. This has become especially relevant in recent years due to many law firms' decision to take advantage of the pass-through entity tax (PTET) election. By making this election, state taxes must be paid currently while a corresponding federal deduction is not realized by the partner until a later date.

Working with the partner's accountant and formulating a proactive plan to address these cash flow needs can be imperative, especially in the early years. On the positive side, the majority of a partner's annual after-tax savings usually comes in a lump sum distribution during the first quarter of each calendar year, allowing for a methodical approach to portfolio rebalancing and a chance for confirmation that longer-term planning goals are being met (or a reevaluation of why they are not).

Investment Planning

Many law firms have an extensive and ever-changing list of public securities/investments that partners cannot buy or sell because the firm may have sensitive nonpublic information about them. It can be a challenge for a partner to create a holistic investment plan around those restrictions. Additionally, many law firms offer their partners several private investment opportunities, usually extended by law firm clients. These are typically illiquid vehicles with different risk profiles and long-term investment horizons. Advisors should be prepared to analyze and offer insight not only into the specific investment opportunities but also the impact they would have on overall asset allocation and client liquidity. Another consideration impacting investment decisions is the tax regime under which law firm partners fall, especially in light of many firms' expansion overseas. For example, the United Kingdom's offshore funds regime can create significant negative tax consequences for partners that are U.S. taxpayers residing in the United Kingdom. Wherever possible, investment in U.S. registered funds (not passive foreign investment companies) that are U.S.- and U.K.-compliant is recommended.

Firm Capital Account

Partners in most law firms may be required to maintain a capital account with the firm that is used for ongoing firm business operations, to weather periods of low revenue or billing lags, and, most importantly, to satisfy creditors should the firm find itself in financial trouble. This is a real risk, as demonstrated by the 2012 collapse of Dewey & LeBouef, the largest law firm failure in history.

The amount and structure of the required capital contribution will vary depending on the law firm, but the initial contribution, even if prorated over several years, can be a sizeable amount for a new partner. It is important to understand the various funding and financing options available for the initial and ongoing contributions. Most large firms have a banking relationship that offers attractive financing terms. The interest paid on these loans is deductible against firm income, making them more attractive than other potential funding sources, such as home equity loans, even in the current higher interest rate environment.

Capital account balances should also be considered in the context of retirement planning, as these balances can often exceed $1,000,000 or more at retirement and can represent a significant liquidity source and balance sheet item in the period immediately following retirement. Importantly, in most cases, the capital account funds are after-tax dollars, making them more attractive than retirement plan savings post-retirement.

Retirement/Pension Plans

Many firms offer partners the ability to participate in a number of qualified retirement plans as well as nonqualified pension plans that are not widely seen outside the industry. Regardless of the plan type, partners will be able to make significantly higher contributions than the traditional 401(k) plan limit they are accustomed to. One such plan that has become more popular at firms is the cash balance pension plan. Participation in these cash balance plans (a type of qualified defined benefit plan) requires an irrevocable election of mandatory annual contributions to an additional tax-deferred account, where the funds are pooled and managed at the firm level rather than segregated at the partner level. Many firms also offer nonqualified unfunded pension plan structures that can be specifically tailored by the firm with unique rules or structures. It helps to know the specifics of each firm's plan, which are often provided in the firm partnership agreement. Many include a "cap" on amounts that can be paid out based on firm income or significant haircuts for early retirement. Therefore, familiarity with the firm's benefit department and plan structure is critical for financial, retirement and insurance planning.

Insurance

Most law firms require that each partner maintains a certain minimum amount of life and disability insurance coverage. When viewed as an income replacement mechanism, these amounts are often inadequate based on typical law firm partner compensation and the many years of potential future earnings at risk. This typically means obtaining additional coverage using a laddered term life insurance structure that declines as a partner builds their post-tax savings, along with acquiring additional long-term disability coverage in the private market. A separate life insurance analysis will often be necessary as a partner nears retirement, for while the balance sheet has normally increased sufficiently to self-insure in line with the expiration of term policies, the need to make a pension decision between single life or joint and survivor payments is often required. An analysis on an individual partner basis to decide between a survivorship election or a single life election coupled with life insurance should be performed to determine the optimal economic result.

Trust & Estate Planning

The timing of becoming a partner often coincides with a revisiting (or in many cases an initial drafting) of a client's estate plan. In prior years, many of the larger law firms provided this service free of charge to partners or at a discounted cost using internal trust and estate staff. Many firms have reduced their internal estate planning departments, resulting in a greater role for the financial advisor to play in the planning, structuring and eventual implementation of these estate planning goals. It is important to not only design a plan that accomplishes these goals but also one flexible enough to adapt to any balance sheet changes and future estate tax regulations.

Use of a revocable trust in conjunction with a pour-over will ensures that the estate gets distributed based on the client's dispositive intent with no disruption of management. Building in the option for a surviving spouse to disclaim assets to a marital and/or credit shelter trust can provide additional flexibility, regardless of the estate tax rules in effect at the time of passing. For those partners who have significant net worth, utilizing the lifetime gift tax exemption (currently $13.61 million per individual) by making gifts to irrevocable trusts may be appropriate given the uncertainty of this exemption amount after current law sunsets post-2025. Certain trusts such as a spousal lifetime access trust ("SLAT") can accomplish this goal while providing flexibility through continued family access to the funds.

Our advisors at Cerity Partners have extensive experience working with law firm partners at the largest firms in the world. We have developed a deep understanding of the complex and unique issues affecting partners throughout their careers, and we are able to deliver every stage of the planning process from initial formulation through execution.

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