Knowing the Rules for Retirement Planning Is Important at Various Stages of a Lawyer's Career

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Summary

- Understand the concepts and choices for retirement saving at various ages.
- Planning for retirement should begin at the start of a lawyer's career.
- Lawyers need to understand the rules on retirement saving and make sensible choices at various times in their lives, taking advantage of very favorable tax provisions that can significantly improve their financial status at retirement.

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The Ages of Retirement Planning

It might seem odd to consider planning for eventual retirement at the beginning of a lawyer's career. Yet, this is a time when contributing to a retirement plan can yield the greatest benefit in later life. There are, in fact, several stages in a lawyer's career when he or she needs to give careful thought to retirement planning. Here are a few mileposts to consider.

Ages 25–35

At the beginning of your career, it might be possible to contribute to a tax-qualified retirement plan, such as a 401(k) plan, in which you contribute part of your own compensation, sometimes with an employer add-on. If you are eligible to do so, you may also contribute to an individual retirement account which, like a 401(k) plan, reduces federal income tax liability and defers taxes on earnings for many years. Some lawyers will be eligible to contribute to a Roth IRA, which offers no current income tax deduction but instead tax-free distributions in later years. The value of contributions at this stage lies in the compounding effect: allowing contributions and earnings to grow without current taxation has the effect of dramatically increasing their value by the time of retirement.

Young lawyers sometimes respond that they have too many expenses at the beginning of their careers to be able to contribute toward retirement. But in my opinion that is a short-sighted view. The tax benefits from retirement plans and IRAs that are offered by the Internal Revenue Code are among the most extensive and advantageous available to individual taxpayers. If they are not used in a year, the tax benefits are generally lost––they do not cumulate. This is why careful planning regarding career-long finances will take the maximum advantage of the ability to defer taxes for 40 years or more.

Ages 35–50

As lawyers continue to practice, they might have the opportunity to enhance their retirement contributions. Those in government or corporate employment will have access to whatever retirement plans are offered by those entities. For those in law firms, there should be a plan offered by the firm. At the very least, it should be a 401(k) plan, but the most effective plans will go beyond that. They will allow for employer contributions for staff and associates and something more substantial for partners, who are in effect paying for their own contributions. There are a variety of types of plans that could be adopted by law firms to help ensure a retirement benefit that permits lawyers to make their decisions about when to retire without regard to financial need. Achieving this result probably requires contributions exceeding the Internal Revenue Code section 401(k) limits ($23,000 in 2024). An actuary or retirement plan expert would be needed to determine the contribution/benefit formula needed for such a plan, but it probably includes mandatory contributions by partners. The aim would be to reach, to the greatest extent possible, a contribution level for partners that equals the maximum amount permitted under Code section 415(c) ($69,000 in 2024).

That contribution level might present a burden to some lawyers, and their response to the suggestion might be like that of younger lawyers, except in this case the reason might be the need to pay for children's education or a second home. But as with younger lawyers, the very valuable tax benefits derived from retirement plan contributions are generally lost if not used in a year. A better suggestion would be to take the fullest advantage of the retirement plan and, if necessary, borrow for other needs.

Ages 50–73

As lawyers get older, there are other ways to maximize retirement contributions. These include:

- Catch-up contributions (up to $7,000 in 2024 for 401(k) plans; $1,000 for IRAs), which are permitted even if the maximum allowed contributions were made in prior years.
- A technique known as a backdoor Roth IRA, which is defined below.
- Other individually designed plans, the purpose of which is to make the greatest use of the tax deductions and deferral benefits available for retirement saving.

As to the more specialized planning at these ages, the best course for lawyers is to consult their tax advisors on the optimum strategies for retirement saving. But this should be the goal of such planning: to derive the maximum benefit from the retirement saving provisions of the Internal Revenue Code as early as possible.

Ages 73 and Over

Eventually, for nearly all retirement plans and IRAs, an age is reached when minimum distributions must be taken each year, and the failure to do so can generate a significant penalty (originally age 70 ½; then 72; now 73; in a few years 75). The rules on distributions are complex and surely require expert assistance. For most people, the best tax strategy will be to delay distributions as long as possible, to take only the minimum required amount each year––in effect to extend the tax deferral as long as possible.

A Glossary of Terms Lawyers Should Understand

Lawyers who practice in the field of tax and employee benefits are familiar with many concepts and definitions that apply to retirement planning. But those who practice in other areas might be less familiar with these technical terms. Having at least a basic understanding of them can help in participating in the planning process in a meaningful way.

Qualified Retirement Plan

A retirement plan that satisfies the requirements of section 401(a) of the Internal Revenue Code will be termed qualified. There are detailed rules on contributions, participation and discrimination in benefits. The significant benefit of qualifying is that contributions will be deductible for federal income tax purposes and the earnings on the amounts contributed will not be subject to federal income tax until withdrawn. This is one of the most advantageous provisions of the Internal Revenue Code for individuals.

Individual Retirement Account

This saving vehicle was added to the federal tax law by the Act referred to as ERISA in 1974. It allows individuals to save for retirement on their own, within specified contribution limits. Over time, there have been several varieties of IRAs added to the law. The basic version is referred to as the traditional IRA. A nondeductible IRA is similar but permits no income tax deduction. It can be useful if the ability to make deductible contributions phases out at higher income levels.

Roth IRA

This type of IRA was added to the law as a proposal from the Delaware senator for whom it is named. As indicated above, there is no income tax deduction when amounts are contributed, but earnings on the contributions can escape taxation completely provided certain requirements are met. (In tax laws, there are always "certain provisions" as well as "exceptions" and "special circumstances".) The choice between a traditional IRA and a Roth IRA has led to frequent debates: is it better to get a current tax deduction and to pay tax on distributions or get no current tax deduction and pay no tax on distributions? The answer is not obvious and not the same in every situation. The ability to use a Roth IRA phases out at higher income levels, but some planners suggest the use of the so-called backdoor Roth IRA technique, by which a nondeductible IRA is established and is then converted to a Roth IRA. This technique has several moving parts and requires some careful planning and the assistance of a tax professional.

401(k) Plan

This is the variety of qualified retirement plans that has become the predominant retirement planning technique in the last few decades. It relies on that subsection of section 401, which permits employees to reduce their compensation and to have the reduced amount contributed to a qualified retirement plan. This technique reduces taxable income by the amount deferred and thus reduces federal income tax liability. There are limits to the contribution amounts and discrimination rules. In some plans, employers make an additional contribution, which can be a match for the amount or percentage deferred by the employee.

Defined Contribution and Defined Benefit Plan

These are the two overall varieties of qualified retirement plans. A defined contribution plan is one in which amounts are contributed and invested. The plan participant has a lump sum account, and however much it gains or shrinks over time determines what is available to the participant at retirement. There is no guaranteed amount. The risk of loss is on the participant. By contrast, a defined benefit plan, usually referred to as a pension plan, promises a benefit at retirement, determined pursuant to a formula established in the plan. It is then up to the employer to ensure that there are enough assets in the plan to provide the benefits. Sometimes there will also be employee contributions, but the risk of loss lies with the employer. Defined benefit plans, which are a very efficient way of providing for retirement, were once the predominant type of retirement plan. However, they have been mostly replaced by 401(k) and similar plans, and they are now generally found in unionized industries and government service. Within each of these broad categories are a wide range of alternative methods of benefit and contribution calculations.

Required Minimum Distributions

You receive a tax deduction (most of the time) on money going in and a deferral of income tax while amounts are invested in the retirement plan or IRA, but eventually the IRS wants to tax the retirement account. The exceedingly complicated minimum distribution requirements of section 401(a)(9) of the Internal Revenue Code are designed to have a certain level of distributions required to be made and taxed each year, using a formula that allows the retirement account to continue to be available for the remainder of the participant's life. As noted above, the beginning date is now tied to age 73, and will eventually rise to 75. There are a great many detailed rules on when distributions must be made during the participant's life and the lives of the participant's beneficiaries. Plan administrators for retirement plans and IRAs are required to tell you the minimum required amount to be distributed each year. It is difficult to maneuver among the many rules for distributions. A very complete guide to them by a well-known author requires more than 500 pages of explanation.

Retirement or whatever life brings in later years will surely be more comfortable, perhaps more enjoyable, with a retirement account that reflects taking the maximum advantage of Internal Revenue Code provisions that offer valuable tax benefits at all stages of a lawyer's career. Putting the achievement of this goal in the forefront of planning is the best course of action, even if it requires some sacrifices. This is a process that begins when the lawyer starts practicing and continues throughout his or her years of practice and beyond.

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