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Be careful with retirement provisions in partnership agreements

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Relationships are the lifeblood of every successful accounting firm. The relationships among the partners in a firm and with their clients are among a firm's most valuable assets. So, when partners retire, maintaining client relationships and providing retiring partners with clear expectations for their retirement are important building blocks for a firm's sustained success and future growth. Here are a few retirement considerations you should take into account when drafting or reviewing your firm's partnership agreement. (For purposes of this discussion, we will use the term "partner" to refer to an equity partner.)

Transition plans

Any partnership agreement should include a transition plan — it's critical to ensure the firm retains the clients, skills and abilities of the retiring partner. The transition plan itself is something that will be developed by the retiring partner in consultation with and with the ultimate approval of the managing partner or the managing partner's designee. It is quite common to have penalties built into a partnership agreement for failure to give the requisite notice or failure to adhere to a transition plan. I like to give the executive committee latitude (within a range) to reduce retirement payments in the event of a failure. In fact, I recently drafted a partnership agreement allowing the executive committee to reduce a retiree partner's payments by up to 50 percent for failure to give the requisite notice or failure to adhere to the transition plan.

Vesting period

Retirement benefits typically have a defined vesting period — 20 years is not uncommon. Your firm can decide to give partial or full credit for any years a partner spent as an income partner. Merged-in partners will be given credit for the period of time they were a partner at their old firm. Death and disability typically do not accelerate vesting, although in some firms it does.

Payout period

The retirement payout period is typically 10 years, with the total aggregate amount payable to retired partners each year usually capped at some portion of the annual revenue or net income of the firm, for example, 4 percent of firm revenue. This is to ensure the firm continues as a financially healthy organization while it is paying out the retired partners. It's also worth noting that, while not universal, retirement payouts typically do not accrue interest.

Retirement payment protections

Your firm may also need to account for retirement payment protections. These protections are more common in firms that still have their founders. Retirement payment protections may include personal guarantees of retirement payments by the remaining partners, the right to vote on certain matters (like mergers) and a security interest in the assets of the firm. You typically do not see these things in more mature firms as they could hinder the ability of the firm to grow and combine with other firms.

Retirement ages: early and mandatory retirement

The vast majority of firms provide for mandatory retirement. The larger the firm, the younger the age seems to be. Mandatory retirement is generally somewhere between the age of 62 to 70 years old. I used to see generally younger mandatory retirement ages in accounting firms, but in the last few years I have seen the age trending upward, as economic factors and people beginning families later in life has kept them working longer. The current average retirement age stands around 67, though 65 is still common.

Most partnership agreements will allow for early retirement starting at ages 55 to 60, provided the individual has a specified number of years of service as a partner. Should your firm include a provision for early retirement, the notice period should be long. Ideally you want a notice period of two years in order to allow for the proper transition of clients.

My own experience is that early retirement is often discussed but rarely used. Most partners are not in a position to retire at 55 or 60 years old. Additionally, many partners do not want to retire around that age because they find this to be the time in life when they are most effective. Walking away from a successful accounting practice when they're in their prime isn't an appealing option.

Working after retirement

Whether they retire early or not, many partners still want to work in some capacity after they retire. What retirement means in this context is a partner gives up his or her equity in the firm and becomes an employee. Typically, retired partners are paid for their personal productivity and for new clients. If your partnership agreement allows retired partners to continue working at the firm, my recommendation is to have year-to-year contracts in these situations. These short-term contracts help to manage expectations.

Don't forget tax considerations for the partners-turned-employees. If your firm continues to compensate the partner for services rendered after retirement, self-employment tax issues need to be considered on the retirement payments.

Life insurance

Many firms obtain life insurance on their partners. This could be used to fund some or all of the retirement payments. Firms will often keep the insurance for a period after a partner retires and may allow their partners to take over the policies if they no longer want them.

Clawbacks

There has been a recent revival in retirement "clawback" provisions. These provisions essentially reduce otherwise expected retirement payments if the retired partner's book of business does not remain with the firm after the partner's retirement. Clawback provisions are intended to encourage a well-executed retirement transition that accounts for the firm's best interests. Several years ago, firms were moving away from clawbacks, but now, at least anecdotally, I see firms using them again in a limited manner.

There is usually a buffer zone and a maximum on the retirement benefit amount that may be clawed back. For example, you might see an approach where if the partner's historical book falls 20 percent or more in the 24-month period after retirement, then the retirement payments could be reduced on a pro rata basis up to an aggregate of, say, 25 percent of the retirement payments.

Transitioning retirement systems

As a firm evolves, it may be appropriate to transition retirement systems. A firm might originally use a "book of business" approach, that is, the partnership will pay for someone's book of business when they retire. But as the partnership matures, the firm might find that approach results in partners behaving in a manner not in the best interests of the firm as a whole. As a result, the firm may move to a deferred compensation or equity-based model to pay partners upon retirement. Similarly, a firm with an equity-based model may change to a deferred compensation model if, after a period of time, the equity approach no longer works for them.

Retirement system transitions are sometimes used to prevent founding partners from getting too much upon retirement based on their founding equity percentages. However, firms with an equity-based model have ways to address this besides converting to a deferred compensation model, such as requiring purchases and sales between partners to ameliorate the effects of highly disproportionate equity allocations.

When moving from one system to another, firms need to take care to avoid creating disadvantages for those who grew up in the firm and are at or near retirement. One option is using floor amounts for partners over a certain age. Another option is to maintain two separate systems and give the legacy partners the ability to select the higher of the two.

Preparing for retirement in a partnership agreement does not have to be complicated or set in stone. The retirement provisions in your partnership agreement today may not make sense 20 years from now. Discuss retirement payouts, mandatory retirement age, transition plans and vesting periods with your partners to determine what provisions make the most sense for your firm today and where it will likely be in 10 years. It can save you a lot of time and hassle as the key members of your firm start getting gray hair and migrating toward warmer climates during the winter months.

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