Profit Sharing Plan Executive Summary

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1. What is a profit sharing plan?

A profit sharing plan is a tax-qualified defined contribution plan where the employees can be rewarded with a share of the employer's revenue. Profit sharing plans offer both design flexibility and the option to make contributions. Employer contributions are discretionary, and can be allocated in a number of ways *(see question 3)*.

Although there is no fixed annual contribution commitment under a profit sharing plan, employer contributions must be substantial and recurring in order to prevent the plan from being considered terminated by the Internal Revenue Service (IRS).

2. How are profit sharing contributions determined?

The employer determines the amount of their profit sharing contributions in one of two ways. One is by a set formula that is written into the plan document. Such formulas are typically based on the employer's pre-tax net profits, earnings growth, or some other measure of profitability.

Rather than using a set formula, employers may decide to contribute a discretionary amount each year. That is, the employer (company's owners or directors), at their discretion, decide how much, if any, they will make as an employer contribution.

The IRS indicates that the employer does not need profits to make contributions to a profit-sharing plan.

3. What are the different types of allocation methods used in profit sharing plans?

There are several different types of allocation methods used in profit sharing plans. A brief description of each follows:

Pro-Rata Allocation: The discretionary employer contribution is allocated to all participants on a uniform basis. A fixed contribution can be a specified percentage of each participant's plan compensation or a specified dollar amount for each participant. For example, all participants would be allocated 10% of their compensation as their share of the contribution.

Permitted Disparity (or Integrated with Social Security) Allocation: This type of allocation method is integrated with an overall retirement scheme that includes Social Security; this combination is called "permitted disparity." By providing for permitted disparity, the employer gets the benefit of its Social Security Tax payments.

The integrated profit sharing plan compensation is broken out in two steps; the amount above the integration level (excess compensation), and the amount below the integration level (base compensation). Usually the integration level is the Social Security Taxable Wage Base in effect for the applicable year. The employer is permitted to offset their contribution to Social Security by applying a lower contribution percentage to the base compensation (i.e., the base percentage) and a higher contribution percentage to the excess compensation (i.e., the excess percentage).

However, there is a limit, or "permitted disparity," between the base percentage and the excess percentage. The permitted disparity depends on the contribution level to the plan. Generally, this type of allocation method tends to favor higher paid employees. For 2019, the Social Security Taxable Wage Base (TWB) is $132,900. Note that even though the TWB is $132,900, the integration can equal the TWB or be a lower number than the TWB and multiple steps can also be used in the calculation.

Example:

A company uses the Social Security TWB as the integration level. The employer decides to contribute 10% plus the additional contribution generated by the integration feature. Executive A earns $280,000. Thus he will receive 10% times $280,000, or $28,000 and then the maximum disparity of 5.7% times $147,100 ($280,000 - $132,900 = $147,100) or $8,385. Executive A will receive $28,000 + $8,385 = $36,385. The rank and file employee earns $35,000. Thus he will receive 10% times $35,000 or $3,500.

Age-Weighted Allocation: The age-weighted profit sharing plan allows the company to make contributions based on an employee's age as well as compensation. Under this arrangement, there is a chance for older employees to receive contributions that are much larger than those received by younger employees.

Example:

Scenario 1. Consider two employees, age 60 and age 25, each earning $30,000 and a total company contribution of 10% of compensation ($6,000). In a pro-rata allocation, each would receive $3,000. Under the age-weighted profit sharing plan, the allocation could be $5,673 for the older employee and $327 for the younger employee.

Scenario 2. Now assume the older employee earns $150,000, the younger $30,000, and the company again contributes 10% of compensation ($18,000). The standard allocation would be $15,000 and $3,000; a five-to-one ratio. Under the age-weighted profit sharing plan it could be $17,795 for the older and $205 for the younger.

Service-Based Allocation: The service-based allocation method allows the employer to reward employees with more service by weighting contributions by service. A fixed contribution can be a specified percentage of each participant's plan compensation or a specified dollar amount for each participant, which is then based on a specified period of service.

Example:

An employer can specify $10 for each week of employment or 1% of plan compensation paid for each hour of service.

Tiered (or New Comparability or Cross Tested) Allocation: In this type of plan, the employer separates the eligible employees into "non-discriminatory" categories (i.e., job classification, title, hourly vs. salaried, etc.) and designates different contribution rates for each group. It is possible to have each eligible employee in their own tier, provided the allocation method passes all required testing.

Note: All allocation methods are governed by top-heavy and nondiscrimination rules.

(Please see Exhibit A for a chart comparing the allocation methods side-by-side.)

4. Must all employees be eligible to participate?

No. The plan may exclude:

- Union employees
- Employees under age 21
- Employees who have less than 12 months of service (up to 24 months may be required for employer matching contributions and/or profit sharing contributions)
- Employees who work less than 1,000 hours per year

If certain discrimination tests under IRC Section 410 can be passed, the plan may also impose certain class exclusions, such as hourly employees, salespersons, etc.

5. Can a profit sharing plan be combined with a 401(k) plan?

Yes. A profit sharing plan can be combined with a 401(k) plan to include provisions allowing employee salary deferrals. Most 401(k) plans provide employer matching contributions based on the participant's contribution, with an additional option for a profit sharing contribution.

6. When must profit sharing contributions be made?

Employer non-elective contributions to a profit sharing plan may be credited in the year they are deposited. Most often, however, contributions made after the end of the employer's fiscal year and before the due date for filing its federal tax return (including extensions) may be considered to have been paid as of the last day of the fiscal year. If the employer's fiscal year is different than the plan year, other factors may have to be considered.

7. Must in-service withdrawals be allowed?

No. The employer is not required to allow for in-service withdrawals. The employer may include a plan provision allowing for loans, hardship distributions or other in-service withdrawal options.

8. Can a vesting schedule be applied?

Yes. Profit sharing contributions can be made subject to a vesting schedule. Plans may utilize a vesting schedule no longer than the 6-year graduated or 3-year cliff shown below. Note: If the profit sharing plan has a 401(k) feature, employee elective deferrals, safe harbor contributions and employer Qualified Non-elective Contribution (QNEC) accounts must always be 100% vested immediately.

GRADUATED	
Year	**%**
0-1	**0**
2	**20**
3	**40**
4	**60**
5	**80**
6+	**100**

3-YEAR CLIFF	
Year	**%**
1	**0**
2	**0**
3	**100**

9. What are the contribution limits?

- Compensation limit per person is $280,000 in 2019.
- Contributions are capped at 100% of the employee's compensation, or up to $56,000 in 2019, whichever is less.
- The maximum deductible limit on all employer contributions in any one fiscal year is 25% of the total of all benefiting employees' compensation.
- If the profit sharing plan has a 401(k) feature, employee deferrals do **NOT** reduce the overall deductible limit.

10. Is a profit sharing plan subject to nondiscrimination testing?

Yes. Most profit sharing plans are subject to annual, nondiscrimination testing to ensure that the amount of contributions does not discriminate in favor of highly compensated employees (HCE), such as owners and managers. If the employer allocates a uniform percentage of compensation to each participant, then the plan automatically satisfies the nondiscrimination requirement and no testing is required.

11. When is a profit sharing plan considered Top Heavy?

If, as of the end of the prior plan year,[1] the key employees have more than 60% of the plan assets, the plan is considered top-heavy. The 60% excludes rollovers from other unrelated qualified plan or from IRA rollovers. If a plan is top-heavy, the employer must make a minimum profit sharing contribution to non-key[2] employees equal to the contribution received by any key employee, up to, but not in excess of, 3% of compensation.

A key employee is:

- A more than 5% owner;
- A more than 1% owner earning over $150,000;
- An officer earning over $180,000; or
- Family members (spouses, children, grandchildren or parents) of owners.

[1] Assets from plans that existed in the prior year and in-service distributions made during the last 5 years may also be included in the top-heavy calculation.

[2] Non-key employees must be employed on the last day of the plan year to be eligible to receive the top-heavy contribution.

A Highly Compensated Employee (HCE) is:

- A more than 5% owner of the company (including family members of the owner, spouse, children, grandchildren or parents) at any time during the current or proceeding year, OR
- Received compensation in excess of $125,000 in the preceding plan year, for plan years beginning in 2019.

12. What are the tax benefits of a profit sharing plan?

For the eligible employee (participant): Both the pre-tax profit sharing contributions, and any investment earnings on the contributions, are tax-deferred until they are withdrawn from the plan.

For the employer: Profit sharing contributions (up to 25% of total compensation) are tax-deductible and excluded from payroll taxes. Businesses with 100 employees or less receive an annual tax credit of 50% on the first $1,000 of administrative costs ($500 maximum) for each of the first 3 years of a new plan. The credit is available only if at least one non-highly compensated employee (NHCE) is participating. *We urge you to discuss the tax credit with your tax advisor to verify current IRS requirements.*

13. What are the advantages of a profit sharing plan?

Profit sharing plans are the most popular tax-qualified plan because:

- They allow the employer to fluctuate contributions each year based on business considerations;
- They provide tax-deferred growth of the underlying investments;
- If structured properly, they can provide different contribution amounts to selected groups of employees; and
- In cases where there are two or more principals, each principal may have differing amounts of contributions allocated on his or her behalf in the same plan year.

Unlike SEPs or SIMPLE plans, the profit sharing plan offers the following advantages:

- Vesting schedules so that the employees must work six years (for example) to receive the full amount of the contributions and earnings upon termination of employment;
- Ability to receive penalty-free (still taxable), lump sum distributions as early as age 55 if the principal retires at that time; and
- Ability to “tier” the contributions to favor certain individuals.

14. What are the disadvantages of a profit sharing plan?

Administrative costs may be higher than those of a more basic arrangement, such as a SEP or SIMPLE IRA. In addition, testing is required to ensure that benefits do not discriminate in favor of Highly Compensated Employees.

Exhibit A – Comparison of Profit Sharing Allocations

			INTEGRATED DESIGN*		AGE-WEIGHTED DESIGN		TIERED DESIGN	
Participant	Age	Compensation	Contribution	% of Comp	Contribution	% of Comp	Contribution	% of Comp
Principal A	58	$280,000	$56,000	20%	$56,000	20%	$56,000	20%
Principal B	49	$200,000	$37,909	19%	$19,195	10%	$56,000	28%
Employee 1	26	$70,000	$11,840	17%	$1,029	1%	$3,500	5%
Employee 2	37	$70,000	$11,840	17%	$2,524	4%	$3,500	5%
Employee 3	60	$50,000	$8,457	17%	$11,772	24%	$2,500	5%
Employee 4	34	$50,000	$8,457	17%	$1,412	3%	$2,500	5%
Employee 5	39	$40,000	$6,766	17%	$1,698	4%	$2,000	5%
Employee 6	38	$40,000	$6,766	17%	$1,565	4%	$2,000	5%
Employee 7	23	$30,000	$5,074	17%	$345	1%	$1,500	5%
Employee 8	24	$30,000	$5,074	17%	$375	1%	$1,500	5%
Totals:		**$860,000**	**$158,182**		**$95,915**		**$131,000**	
Principal's Share			**59%**		**78%**		**85%**	

**Calculated using 100% of the 2019 Taxable Wage Base.*