Traditional Profit Sharing Plan

The basics: Employer contributions to the plan need not be a specific percentage and they need not be made every year, as long as they are “recurring and substantial.” Profits are not required in order to make a contribution.

How It Works

- Employer contributions are tax deductible.
- Contributions are not taxed currently to the employee.
- Earnings accumulate income tax-deferred.
- Distributions are generally taxed as ordinary income. Distributions may be eligible for 10-year income averaging,[1] or, at retirement from the current employer, rolled over to a traditional or a Roth IRA, or to another employer plan if that plan will accept such a rollover.
- Except for more than 5% owners, required minimum distributions (RMDs) must begin by April 1 of the later of (a) the year following the year in which the participant reaches age 70½, or (b) the year following the year in which the participant retires. More-than-5% owners must begin to receive distributions by April 1 of the year following the year they reach age 70½.

Additional Considerations

- **Maximum annual deduction:** Up to 25% of covered payroll can be contributed and deducted by the employer.
- **Contribution base:** Plan contributions are normally based on total compensation, e.g., base salary, bonuses, overtime, etc. The maximum compensation recognized in 2018 is $275,000.

[1] Those born before 1936 may be able to elect 10-year averaging or capital gain treatment; these strategies are not available to those born after 1935.

    - **Individual limits:** The allocation of contributions to a participant's account may not exceed the lesser of 100% of includable compensation[1] or $55,000 per year.

    - **Employer contributions:**

        - Most plans are discretionary as to the amount that the employer contributes.

        - If there are profits, the employer is expected to make "recurring and substantial" contributions. See IRS Reg. 1.401-1(b)(2).

- **Excluding persons:** Certain persons can be eliminated on the basis of months of service, age or coverage in a union plan; for example, persons under age 21 can be excluded from the plan.

- **Investment of plan assets:** Investments must be diversified and prudent. Subject to plan provisions, plan assets may be invested in equity products like mutual funds, stocks and debt-free real estate; or debt instruments like T-Bills and CD's. Insurance products like life insurance and annuity policies may also be used.

    - **Social Security integration:** Since the employer already contributes to the employee's Social Security retirement benefit, these contributions can be integrated into the allocation formula of the plan.

    - **Forfeitures:** As participants leave the company and separate from the plan, those less than 100% vested forfeit that part of the account in which they are not vested. The nonvested forfeitures may then be allocated to the remaining participants. Those participants who remain in the plan the longest will share in the most forfeitures, or forfeitures may be used to reduce future employer contributions.

    - **Parties which are favored:** Typically younger participants are favored because they have a longer time for their fund to grow and share in forfeitures.

[1] For those self employed, this rate applies to "net" self-employment income of the owner or partner, less the contribution and the deduction allowed for one-half of the self-employment tax.

How Much Will There Be at Retirement?

This will depend upon three factors.

- The frequency and amount of contributions,
- The number of years until retirement, and
- The investment return.

The risk of poor investment returns rests upon the employee. However, if investment results are favorable, the participant will have a larger fund at retirement age.

An Example of What $10,000 Per Year Will Grow to Over Several Years at Various Rates of Growth Without Tax[1]				
Years	**2.00%**	**4.00%**	**6.00%**	**8.00%**
5	$52,040	$54,163	$56,371	$58,666
10	$109,497	$120,061	$131,808	$144,866
15	$172,934	$200,236	$232,760	$271,521
20	$242,974	$297,781	$367,856	$457,620
25	$320,303	$416,459	$548,645	$731,059
30	$405,681	$560,849	$790,582	$1,132,832
35	$499,945	$736,522	$1,114,348	$1,723,168

Top-Heavy Plans

If more than 60% of the plan assets are allocated to "key" employees,[2] then the employer must contribute at least as much for "non-key" participants as it does for key employees. This requirement applies only to a contribution of up to the first 3% of includable compensation (higher in some instances).

[1] The rates of return used in this illustration are not indicative of any actual investment and will fluctuate in value. An investment will not provide a consistent rate of return; years with lower (or negative) returns than the hypothetical returns shown may substantially affect the scenario presented.

[2] A "key" employee is someone who, at any time during the plan year was: (1) an officer of the employer whose compensation from the employer exceeded $175,000; or (2) a more than 5% owner; or (3) a 1% owner whose compensation from the employer exceeded $150,000.

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Advantages to Employer

- Contributions are tax deductible.
- Contributions and costs are totally flexible.
- The plan is easy to understand by the employees.
- Forfeitures of terminating employees may reduce future costs or be reallocated among the accounts of those in the plan.
- It can provide employees with permanent life insurance benefits that need not expire or require costly conversion at retirement age.
- The employer can direct investments.
- Coordination with Social Security will reduce contributions for rank and file employees.
- If former participants do not provide the plan with distribution instructions, the plan may automatically distribute accounts less than $5,000. In the case of a plan that provides for such mandatory distributions, the plan must automatically roll an eligible distribution amount that exceeds $1,000 to a Rollover IRA in the former participant's name. A plan may allow direct rollovers of less than $1,000.

Advantages to Employees

- Annual employer contributions are not taxed to the participant.
- Earnings on the account are not currently taxed.
- ERISA and federal bankruptcy law provide significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans.
- Participants may be given the right to direct investments. If participants are given the right to "self-direct," plan sponsors are required to provide certain standardized investment fee and performance data. This information is intended to aid participants in making better-informed investment choices.

- Federal law allows a qualified plan to establish an “eligible investment advice arrangement” under which individually tailored investment advice is provided to plan participants. Any fees or commissions charged must not vary with the investment options chosen, or else a computer model meeting certain requirements must be used.

- Participants may also have a traditional, deductible IRA (subject to certain income limitations based on filing status), a traditional, nondeductible IRA, or a Roth IRA.

- If the plan allows, there is the ability to purchase significant permanent life insurance under the plan. Purchase of life insurance will create taxable income to the employee.

- Younger employees can accumulate a larger fund than with a defined benefit plan.

- The forfeited, unvested portion of accounts of former participants may be reallocated to the active participants’ accounts; this can have a major impact on future benefits.

- If the plan so provides, vested balances may be withdrawn if the funds have accumulated in the plan for at least two years, if an employee has participated in the plan for at least five years, or if the participant has a “financial hardship.” Under IRS regulations, this is defined as “immediate and heavy financial need where funds are not reasonably available from other sources.” There are safe harbor rules listing the conditions and requirements for hardship distributions.

- Participants may borrow from the plan within certain guidelines if provided for in the plan documents.

Disadvantages to Employer

- The profit sharing plan will generally not produce as large a contribution and deduction for older employees, as will a defined benefit plan.

- Deductible contribution limits are set at 25% of covered payroll.

- If a plan gives participants the right to direct investments, plan sponsors are obligated to provide participants with standardized investment fee and performance information. Failure to comply with these ERISA requirements may result in a breach of fiduciary duty to plan participants, and the loss of ERISA Section 404(c) protection. In this situation, the plan fiduciaries could be held responsible for the results of the participants’ own investment choices.

Disadvantages to Employees

- There is no guarantee as to future benefits.
- Investment risks rest on the participant.
- Older participants may not receive as large a benefit as with a defined benefit plan.
- There is no assurance as to the frequency and amount of employer contributions.