

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.”¹ 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 averaging², or, at retirement from the current employer, rolled over to a Traditional or a Roth IRA³, or to another employer plan if that plan will accept such a rollover.

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 2008 is \$230,000.
- **Individual limits:** The allocation of contributions to a participant’s account may not exceed the lesser of 100% of includable compensation⁴ or \$46,000 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”¹ contributions.¹
- **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.

¹ See IRS Reg. 1.401-1 (b)(2).

² 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.

³ Beginning in 2008, distributions from qualified retirement plans, IRC Sec. 457 plans, and tax-sheltered annuities may be rolled directly into a Roth IRA. These rollover distributions are taxable events, subject to the same requirements as a Roth conversion.

⁴ 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.

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- **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.

How Much Will There Be at Retirement?

This will depend upon three factors.

1. The frequency and amount of contributions,
2. The number of years until retirement, and
3. 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 Tax¹				
Years	4.00%	6.00%	8.00%	10.00%
5	\$54,163	\$56,371	\$58,666	\$61,051
10	\$120,061	\$131,808	\$144,866	\$159,374
15	\$200,236	\$232,760	\$271,521	\$317,725
20	\$297,781	\$367,856	\$457,620	\$572,750
25	\$416,459	\$548,645	\$731,059	\$983,471
30	\$560,849	\$790,582	\$1,132,832	\$1,644,940
35	\$736,522	\$1,114,348	\$1,723,168	\$2,710,244

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.

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Top-Heavy Plans

If more than 60% of the plan assets are allocated to “key” employees¹, 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).

Advantages to Employer

- A. Contributions are tax deductible.
- B. Contributions and costs are totally flexible.
- C. The plan is easy to understand by the employees.
- D. Forfeitures of terminating employees may reduce future costs or be reallocated among the accounts of those in the plan.
- E. It can provide employees with permanent life insurance benefits that need not expire or require costly conversion at retirement age.
- F. The employer can direct investments.
- G. Coordination with Social Security will reduce contributions for rank and file employees.
- H. 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

- A. Annual employer contributions are not taxed to the participant.
- B. Earnings on the account are not currently taxed.
- C. Federal bankruptcy law provides significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans.
- D. Participants can have the right to direct investments.

¹ 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 \$150,000; or (2) a more than 5% owner; or (3) a 1% owner whose compensation from the employer exceeded \$150,000.

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- E.** 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.
- F.** 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.
- G.** 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.
- H.** Younger employees can accumulate a larger fund than with a defined benefit plan.
- I.** 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.
- J.** If the plan so provides, vested balances may be withdrawn 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.
- K.** Participants may borrow from the plan within certain guidelines if provided for in the plan documents.

Disadvantages to Employer

- A.** The profit sharing plan will generally not produce as large a contribution and deduction for older employees as will a defined benefit plan.
- B.** Deductible contribution limits are set at 25% of covered payroll.

Disadvantages to Employees

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

How a Traditional Profit Sharing Plan Works



Employer

- Employer contributions are discretionary and flexible.
- Employer contributions need not be a specified percentage of compensation, nor made each year, as long as they are recurring and substantial.
- Contributions are tax deductible to the business.¹



Employee

- The allocation of contributions to an employee's account may not exceed the lesser of 100%² of compensation or \$46,000² per year.
- The maximum compensation recognized in 2008 is \$230,000.³
- Employee may be given right to direct investments.

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- Employer contributions are not currently taxable to employee and account growth is tax deferred.
- Investment risk remains on employee.
- The forfeited, unvested portion of former employee's accounts may be reallocated to current participants.

Early Withdrawal

- A 10% penalty generally applies if withdrawals are made before age 59½.
- Some exceptions to 10% penalty are available.
- Employee may borrow from plan within certain guidelines if provided for in plan documents.

Retirement

- Distributions must begin by specified date.⁴
- Funds may be distributed as lump sum or periodic payments.
- Distributions are generally taxed as ordinary income; may be eligible for 10-year income averaging or rolled over into an IRA.

Death

- Value of account is included in owner's gross estate.
- Proceeds can pass to surviving spouse with payments made over survivor's lifetime.
- Income and estate taxes can severely reduce funds left to nonspousal heirs.

¹ Up to 25% of covered payroll can be contributed and deducted by the employer.

² These are 2008 limits.

³ For those self-employed, compensation is limited to net self-employment income; e.g. gross income less the contribution and the deduction allowed for one-half of the self-employment tax.

⁴ Except for more than 5% owners, distributions must begin by the later of (1) April 1 of the year following the year in which the participant reaches age 70½, or (2) the year following the year in which the participant retires.