**Chapter 7 Profit Sharing Plans**

**Q 7.01: What is a profit sharing plan?**

A profit sharing plan is defined as:

A plan established and maintained by an employer to provide for the participation in its profits by its employees or their beneficiaries. The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment.[[1]](#footnote-1) The term “plan” implies a permanent as distinguished from a temporary program. Thus, although the employer may reserve the right to change or terminate the plan, and to discontinue contributions to it, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general. To be a profit-sharing plan, there must be recurring and substantial contributions out of profits for the employees.[[2]](#footnote-2)

The preceding definition from the regulations to Code Section 401(a) identifies several conditions that are necessary to maintain a valid profit sharing plan:

1. Employees must have the opportunity to share in the employer’s profits.

2. The plan must be intended to be permanent.

3. The contributions must be recurring and substantial.

4. The plan document must provide for distributions to employees at times specified in the plan.

5. The plan document must provide a nondiscriminatory method for allocation of the contributions.

Although the original concept and basis for profit sharing plans was for employees to share in profits, that was changed by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). TAMRA eliminated the need for contributions to be based on profits and allowed for the adoption of profit sharing plans by tax-exempt organizations.[[3]](#footnote-3) As a result of that change, a “profit sharing” plan is really a discretionary defined contribution plan.

Contributions are limited to the lesser of 25 percent of the employee’s compensation or a dollar limit. For 2014 compensation is limited to $260,000 and the dollar limit is capped at $52,000.

**Q 7.02: What is meant by the requirement that a plan must be permanent?**

The determination of permanency in a profit sharing plan is a facts-and-circumstances issue. If the plan has a fixed formula, i.e., the contributions are dependent on profits, the fact that no contributions are made in years with no profits generally does not adversely affect the qualified status of the plan as it relates to the permanency requirement. A fixed formula could read as follows: “A contribution will be made of 10 percent of profits in excess of $50,000.” A corporation that fails to make contributions to a profit sharing plan for five years because of net operating losses during those five years, resulting in the corporation’s having no current or accumulated earnings or profits at the end of any of those five years, has not permanently discontinued payments. This is so only if the plan requires the corporation to resume contributions as soon as it has profits.[[4]](#footnote-4) Because it is no longer necessary to make contributions from profits the resumption of contributions is more of a facts-and-circumstances determination based on the financial ability of the plan sponsor to make those contributions compared to the actual action taken.

Although the determination of the contribution is discretionary the method of allocation of that contribution to each participant has to be set forth in the plan document to satisfy the profit sharing equivalent of the requirement in pension plans that benefits be definitely determinable.[[5]](#footnote-5) With the change in the nature of profit sharing plans to discretionary defined contribution plans, this issue has changed to a more limited interpretation of “permanent.” Permanency and recurring and substantial contributions are closely related.

**Q 7.03: What is the result of a discontinuance of contributions?**

Although the plan sponsor may choose to suspend contributions temporarily as a result of financial cycles, a determination may be made that the suspension is really a discontinuance of contributions. A complete discontinuance of contributions may occur even though some amounts are contributed by the employer under the plan, if these amounts are not substantial enough to reflect the employer’s intent to continue to maintain the plan. The determination of whether a complete discontinuance of contributions under the plan has occurred is made with regard to all the facts and circumstances in the particular case, and without regard to the amount of any contributions made under the plan by employees. If it is determined that the cessation of contributions is a “discontinuance,” all participants become 100 percent vested as if the plan were terminated. This is a result that most employers want to avoid.

Whether a plan is dealing with a suspension or discontinuance is based on whether:[[6]](#footnote-6)

1. The employer may merely be calling an actual discontinuance of contributions a suspension of such contributions, to avoid the requirement of full vesting as in the case of a discontinuance, or for any other reason;

2. Contributions are recurring and substantial; and

3. There is any reasonable probability that the lack of contributions will continue indefinitely.

**Q 7.04: How are profit sharing contributions allocated to participants?**

After the contribution is determined, the plan must provide a method of allocating that contribution to the eligible employees. The traditional method is based solely on each participant’s compensation. More recent developments in profit sharing plan design add the participant’s age and service to the variables.

*Traditional Plan*



This type of allocation provides a true employee benefit plan, in which the employees’ share in the contribution is based only on their compensation, i.e., the relative value of the work they do and their impact on the company’s bottom line. This is consistent with the original purpose of profit sharing plans, i.e., for employees to share in company profits created by their efforts.

The next step up the ladder is an allocation integrated with Social Security, also known as permitted disparity.

*Plan Integrated with Social Security (Permitted Disparity)*

The application of the rules for permitted disparity are as follows:

1. If the integration level is the taxable wage base (TWB), $117,000 in the following example, the excess percentage can be up to 5.7 percent.

2. If the integration level is more than 80 percent but less than 100 percent of the TWB, the excess contribution percentage is reduced to 5.4 percent. (The 2.7 percent in step 3 would be reduced to 2.4 percent.)

3. If the integration level is more than 20 percent but less than or equal to 80 percent of the TWB, the excess contribution is reduced to 4.3 percent. (The 2.7 percent in step 3 would be reduced to 1.3 percent.)

4. The excess contribution percentage cannot exceed the base contribution percentage by more than the base contribution percentage.



Using Harold in this example, here is the process:

Step 1: 3% × $260,000 = $7,800, +

Step 2: 3% × ($260,000 – $117,000 ) = $4,290, +

Step 3: 2.7% × ($260,000 + ($260,000-$117,000 )) = $10,881 +

Step 4: ($260,000/$516,000) × remaining total contribution (after steps 1 through 3 for all employees)

In steps 1 and 2 the percentage must be the same. If the total contribution is insufficient to fund steps 1 and 2 at 3 percent, the percentage would be reduced to accommodate the lower total contribution. For the plan above, steps 1 and 2 generate a contribution of $19,770 for all employees. If the amount available to contribute were less than $19,770, the 3 percent would be reduced.

For step 3 a similar adjustment must be made to the 2.7 percent if the total contribution is insufficient to fund step 3. Again, in the plan above step 3 generates a contribution of $17,793 for all participants. So far the total contribution to fund steps 1, 2, and 3 is $37,563 ($19,770 + $17,793). If there is still an additional contribution available to allocate, the plan goes to step 4, which is the same method as in the Traditional Plan. The balance of the contribution is $57,611 for a total plan contribution of $95,174.

*Age Weighted Plan*

The newer profit sharing plan designs, including age-weighted plans and “new comparability” plans, satisfy the nondiscrimination rules based on cross-testing, i.e., testing a defined contribution plan based on benefits rather than contributions. If the owners take the approach that they would like to provide each employee with a retirement income benefit of 1 percent of compensation beginning at retirement age, that plan would be nondiscriminatory because all participants are receiving the same “benefit” as a percentage of compensation.

Because each participant is a different age and is paid a different salary, those variables would have to be considered in determining the amount necessary to fund a participant’s benefit. The issue would be to determine what amount would have to be deposited today, at x percent rate of return, to accumulate to a value sufficient to pay a monthly benefit of 1 percent of average monthly compensation (the reserve) at the testing age (usually retirement age, commonly age 65). The interest rate to be used must be between 7.5 percent and 8.5 percent, and the testing age is defined in regulations.[[7]](#footnote-7)

After funding is calculated as above for each participant, the profit sharing plan contribution is allocated in proportion to each participant’s present value of 1 percent of salary. The issue is one of determining the present value of a monthly retirement benefit of 1 percent of the participant’s compensation payable at the testing age at 7.5 percent and then allocating the plan contribution in proportion of that present value. Participants in the plan who are very young may have a contribution of less than 3 percent of compensation. If the plan is top-heavy (see Chapter 5), contributions will have to be increased to the top-heavy minimum contribution of 3 percent.



The contribution for Harold is calculated as follows:

(PV of 1% of salary / Total PV of 1% of salary for all employees) × contribution

(1811.05 / 2549.05) × $73,190 = $52,000

Because the contribution for Louis and Randy is below the top-heavy minimum of 3 percent, their contribution must be increased to 3 percent bringing the total contribution to $73,689.

*Point Allocation Plan*

The illustration below allocates ten points for each year of service, one point for each $100 of compensation, and five points times age.



The contribution for Harold is calculated as follows:

(His Total Points) / (Total Points for all employees) × contribution

(3150) / (7330) × $121,003 = $52,000

*Class Allocation Plan*

Another method used to allocate contributions is referred to as class allocation. This allows the employer to define classes of employees and allocate a different percentage to each class. The classes can be defined based on job description, geographic locations, departments within the company, or any other objective business criteria. (Testing is based on 7.5 percent pre- and post-retirement interest and mortality.)

Here is the result of a class allocation plan:



This illustration allocates the maximum contribution to the two owners, Harold and John, of the lesser of 25 percent of compensation or the dollar limit of $52,000 (for 2014) and 7.0 percent to the rank and file employees. Nondiscrimination testing for this approach can be found in Chapter 4.

**Q 7.05: How are employees benefits determined?**

Because a profit sharing plan, like all other defined contribution plans, is an individual account plan, the assets have to be valued periodically to determine each participant’s accrued benefit, i.e., the value of his or her individual account balance.[[8]](#footnote-8) This valuation is required to be done at least annually.[[9]](#footnote-9) In most cases, this is a simple matter unless the plan holds assets that are not easily valued, e.g., real estate, limited partnership shares, or collectibles. These assets should be valued by an outside appraiser, and appropriate documents in support of the appraisal should be kept on file with the plan documents.

Typically the assets in a profit sharing plan are pooled and reported to participants on a balance-forward basis. Each employee’s opening balance, gains or losses, and contribution is reported when year-end participant statements are provided. In a plan that provides for self-directed investments, e.g. 401(k) plans, the employee’s accounts are not pooled but maintained individually so values are available daily.

**Q 7.06: Are plan assets subject to outside audit?**

Because each employee’s benefit is directly linked to the value of plan assets, the security of the assets and the timing of the asset valuation are of prime concern. The US Department of Labor (DOL) issued proposed regulations that would make small plans (those with fewer than 100 participants) subject to the Employee Retirement Income Security Act of 1974 (ERISA) Section 103(a)(3)(A), which requires the engagement of an independent accountant to prepare an audit of the plan’s assets. This could add significant additional costs to administer the plan. Under final regulations issued by the DOL, the audit can be avoided if the plan satisfies all the following conditions each year: [[10]](#footnote-10)

1. a. At least 95 percent of the assets of the plan constitute qualifying plan assets (defined later), or

b. Any person who handles assets of the plan that do not constitute qualifying plan assets is bonded under ERISA Section 412, with the amount of the bond being not less than the value of the nonqualifying assets.

2. The summary annual report for the plan includes the following additional information:

a. The name of each regulated financial institution holding qualifying plan assets and the amount of such assets held by each institution as of the end of the plan year,

b. The name of the surety company issuing any bond required under the regulations,

c. A notice indicating that participants and beneficiaries may, upon request and without charge, examine or receive copies of evidence of any bond required under the regulation and copies of the statements received from each institution holding qualified assets that describe the assets held by the institution as of the end of the plan year, and

d. A notice stating that participants and beneficiaries should contact the Pension and Welfare Benefits Administration if they are unable to examine or obtain copies of the statements or evidence of the bond.

3. When requested by a participant or beneficiary, the administrator makes available for examination, or provides copies of (at no charge), the evidence of any bond required by the regulation and the statements of assets from the financial institutions holding qualifying assets.

Qualifying plan assets are defined as:

1. Qualifying employer securities as defined in ERISA Section 407(d)(5), i.e., stock, a marketable obligation, or an interest in a publicly traded partnership;

2. Participant loans meeting the requirements of ERISA Section 408(b)(1);

3. Any assets held by the following institutions:

a. A bank or similar financial institution as defined in DOL Regulation Section 2550.408(b)-4(c),

b. An insurance company qualified to do business under the laws of the state,

c. A broker-dealer registered under the Securities Exchange Act of 1934, and

d. Any other organization authorized to act as a trustee for individual retirement accounts under Code Section 408;

4. Shares issued by an investment company registered under the Investment Company Act of 1940 (mutual funds);

5. Investment and annuity contracts issued by any insurance company qualified to do business under the laws of the state; and

6. In an individual account plan (defined contribution plan), any assets over which the participant or beneficiary exercises control and for which the participant or beneficiary receives, at least annually, a statement from a regulated financial institution (listed in items 3 and 5 in this list), describing the assets held or issued by the financial institution and the amount.

**Q 7.07: When should the value of plan assets be determined?**

For benefit determination, the timing of the asset valuation is essential.

**Example 7:** As of December 31, 2013, Employee A had an account balance of $75,000. Employee A is terminated, whether voluntarily or not, on September 30, 2014. The value of Employee A’s account on December 31, 2014, is $66,000. How does the plan determine which value to use consistently when it pays out the employee’s benefits? Generally, the value of the account as of the end of the plan year in which the employee terminated is used. In this case, Employee A is paid out based on a value of $66,000.

The only way to avoid this problem is to value the plan assets every time an employee terminates and pay them out immediately, which means a guaranteed increase in administrative costs. Some plans base the timing on whether the employee has incurred a break in service (BIS). A BIS is a plan year during which the participant has worked fewer than 500 hours. In the example above if Employee A had terminated on April 3, 2014, with fewer than 500 hours worked, Employee A would have been paid based on the account value of $75,000, the value in the plan year before the BIS, if this were the plan’s administrative policy.

Whatever policy is adopted, it must be applied consistently. Sometimes this can result in what appears to be discrimination. Consider the following:

**Example**8 Employee B is a highly compensated employee (HCE). Qualified plans cannot discriminate in favor of HCEs. Employee B terminates with fewer than 500 hours worked and is paid out based on the prior plan year’s value. Between the time Employee B terminates and the end of that year, the value of the plan’s assets goes down 35 percent. Employee C, a nonhighly compensated employee (NHCE), terminates with more than 500 hours worked and will be paid out based on the lower asset value because Employee C’s BIS will occur the following year.

Is this discrimination? Technically, it is not if the plan’s policy is followed consistently for all employees.

1. Treas. Reg. §1.401-1(b)(1)(ii). [↑](#footnote-ref-1)
2. Treas. Reg. §1.401-1(b)(2). [↑](#footnote-ref-2)
3. TAMRA §1011(A)(j)(2). [↑](#footnote-ref-3)
4. Rev. Rul. 80-146, 1980-1 CB 90. [↑](#footnote-ref-4)
5. Treas. Reg. §§1.401-1(b)(1)(i), 1.401-1(b)(1)(ii). [↑](#footnote-ref-5)
6. Treas. Reg. §1.411(d)-2(d)(1). [↑](#footnote-ref-6)
7. Treas. Reg. §10401(a)(4)-12. [↑](#footnote-ref-7)
8. IRC Sec. 411(b)(3)(C). [↑](#footnote-ref-8)
9. Rev. Rul. 80-155, 1980-1 C.B. 84. [↑](#footnote-ref-9)
10. DOL Reg. §§ 2520.104-41, 2520.104-46. [↑](#footnote-ref-10)