6. Profit-Sharing Plans

Introduction

A profit-sharing plan is a type of defined contribution plan that is sometimes used as a supplement to a primary defined benefit plan. Sometimes these plans are structured in such a way that employees share in their companies' profits and potentially gain a greater interest in their firms' success.

About 100 years ago, Pillsbury Mills and Procter & Gamble each established a cash (defined below) profit-sharing plan. In 1916, Harris Trust & Savings Bank in Chicago established the first deferred (defined below) profit-sharing plan. In 1939, legislation clarified the tax status of deferred plans. This legislation and the World War II wage freeze resulted in rapid growth of profit-sharing plans in the 1940s. The Employee Retirement Income Security Act of 1974 (ERISA) furthered the growth by imposing less burdensome regulations on profit-sharing plans than on defined benefit pension plans, thus increasing their attractiveness.

Types of Plans

There are three basic types of profit-sharing plans.

Cash Plan— At the time profits are determined, contributions are paid directly to employees in the form of cash, checks, or stock. The amount is taxed as ordinary income when distributed.

Deferred Plan— Profit-sharing contributions are not paid out currently but rather are deferred to individual accounts set up for each employee. Benefits— and any investment earnings accrued— are distributed at retirement, death, disability, and sometimes at separation from service and other events.

Combination Plan— In this type of plan the participant has the option of deferring all or part of the profit-sharing allocation. That portion taken as a deferral is placed into the participant's account, where it and investment earnings accrue tax free until withdrawal. Any amount taken in cash is taxed currently. For tax purposes, Internal Revenue Service (IRS) qualification of profit-sharing plans is restricted to deferred or combination plans. Therefore, the remainder of this chapter will focus primarily on these two types of profit-sharing arrangements.

Plan Qualification Rules

Profit-sharing plans, as other retirement plans, must meet a variety of requirements to qualify for preferential tax treatment. These rules, created under ERISA and discussed in chapter 3, are designed to protect employee rights and to guarantee that pension benefits will be available for employees at retirement. The rules govern requirements for reporting and disclosure of plan information, fiduciary responsibilities, employee eligibility for plan participation, vesting of benefits, form of benefit payment, and funding. In addition, qualified plans must satisfy a set of IRS nondiscrimination rules (under Internal Revenue Code (IRC) secs. 401(a)(4), 410(b), and, in some cases, 401(a)(26)) designed to insure that a plan does not discriminate in favor of highly compensated employees.[1]

Contributions

Employer Contributions— Plans must define how employer contributions will be allocated to employee accounts. The allocation formula is generally based on compensation. Sometimes the allocation is a flat percentage of pay, or it may be determined by calculating the proportion of each employee's compensation relative to the total compensation of all plan participants. For example, if the employee earns $15,000 annually and total annual compensation for all participants is $300,000, he or she would receive 5 percent of the employer's annual contribution.

Some plans base their allocations on compensation and service credits. These plans must be careful to assure that the wage/service formula meets the regulatory scheme for demonstrating that the formula does not discriminate in favor of highly compensated employees. Whether a plan uses compensation or both compensation and service in determining allocations depends on an employer's objectives. If employee retention is a primary goal, this can be reflected in a pay-and-service allocation formula. Allocation formulas may be integrated with Social Security within prescribed limits. (For more information about integration with Social Security, see chapter 13.)

Maximum annual contributions (employer and employee, if any) on behalf of each plan participant are limited by the defined contribution limits under IRC sec. 415— the lesser of 25 percent of compensation or $30,000. (For further details on contribution limits, including future increases in the dollar amount, see chapter 4 on pension plans.) But the total amount of contributions for all employees that an employer may deduct for federal tax purposes is limited to 15 percent of all covered employees' compensation.

Until recently, an employer's contribution to a profit-sharing plan was limited to the extent of an employer's current or accumulated profits. Currently, an employer does not have to have profits to establish a profit-sharing plan, and total contributions are not restricted to total profits. However, plan documents must specify that the plan is a profit-sharing plan.

If an employer's contribution for a particular year is less than the maximum amount for which a deduction is allowed, the unused limit may not be carried forward to subsequent years unless the carryforward existed as of December 31, 1986. These limit carryforwards may be used to increase the general deduction limit to 25 percent until the carryforwards are exhausted.

A deduction carryforward of contributions in excess of the deduction limit for a particular year may be deductible in succeeding taxable years to the extent allowed. However, such contributions may be subject to a 10 percent nondeductible excise tax. Excess contributions are defined as the sum of total amounts contributed for the taxable year over the amount allowable as a deduction for that year plus the amount of excess contributions for the preceding year, reduced by amounts returned to the employer during the year, if any, and the portion of the prior excess contribution that is deductible in the current year. In other words, if an excess contribution is made during a taxable year, the excise tax would apply for that year and for each succeeding year to the extent that the excess is not eliminated. Excess contributions for a year are determined at the close of the employer's taxable year, and the tax is imposed on the employer.

Employee Contributions— Pure profit-sharing plans do not require employee contributions, but some may permit voluntary employee contributions up to certain limits. The plan then generally looks more like a thrift plan. (See chapter 7 for a discussion of thrift plans.) Employee contributions in the form of a salary reduction are becoming increasingly popular. When pretax salary reduction is allowed, the plan must follow rules for 401(k) arrangements (see chapter 8 for a discussion of 401(k) plans).

Taxation— Employer contributions to a profit-sharing plan are deductible by the company as a business expense (up to the limits noted previously). Employees are not taxed on the deferred contributions— and any interest accrued— until distribution. Any allocation (all or part) taken in cash is taxed on a current basis.

Investments

Profit-sharing funds may be invested in a wide variety of vehicles including corporate stocks, bonds, real estate, insurance products, and mutual funds. In general, retirement plans may not hold more than 10 percent of their assets in employer securities. However, an exception exists for profit-sharing plans, stock bonus plans, thrift plans, and employee stock ownership plans, as well as money purchase plans that were in existence before ERISA's enactment and invested primarily in employer securities at that time. Therefore, contributions are frequently invested in employer securities. This practice may give participants an increased interest in the firm's success.

Individual account assets can be held in one fund or in several funds. The plan sponsor usually has responsibility for developing broad investment policies. The trustee (e.g., a bank) is usually responsible for the actual investment of plan assets. Some employers permit participants to select among several investment options. In addition, participants may be given individual direction within certain limits set forth in Department of Labor regulations.

Distributions

Retirement, Disability, and Death Benefits— The law requires that participants' account balances fully vest at retirement. In addition, plans generally provide for benefits on death and disability. The plan's vesting provisions determine whether an employee will receive full or partial benefits on other types of employment termination. However, if the plan is contributory (i.e., employees make contributions), the employee will always receive the benefits that are attributable to his or her own contributions.

Profit-sharing plans typically give retiring participants and beneficiaries of deceased participants a choice between a lump-sum payment and installments. Usually, those who terminate employment for reasons other than retirement, death, or disability receive lump-sum distributions, although if the benefit exceeds $3,500, the participant cannot be forced to take an immediate benefit. Distributions from profit-sharing accounts must follow the distribution rules for all qualified retirement plans. Distributions must generally begin by the year following the attainment of age 70½, unless the individual has not retired. There are minimum and maximum limits on the amount of annual distribution, both subject to penalty taxes if not followed. (See chapter 4 for a complete description of pension plan distributions.)

In-Service Withdrawals— Some profit-sharing plans provide for partial account withdrawals during active employment. Plans allowing participants to elect account withdrawals impose certain conditions, which vary widely. But generally the funds must be held in the plan for two years before a withdrawal is allowed.

A 10 percent additional income tax applies to most early distributions made before age 59½. The 10 percent additional tax does not apply to distributions that are: (1) due to the participant's death or disability; (2) in the form of an annuity or installments payable over the life or life expectancy of the participant (or joint lives or life expectancies of the participant and the participant's beneficiary); (3) made after the participant has separated from service on or after age 55; (4) used for payment of medical expenses deductible under federal income tax rules; (5) made to or on behalf of an alternate payee pursuant to a qualified domestic relations order; or (6) rolled over to an individual retirement account or another qualified plan within 60 days.

Loans– Some plans permit employees to borrow a portion of their vested benefits. In general, the employee must repay the loan according to a level amortization schedule, with payments made at least quarterly. If loans are permitted, they must be available to all participants on a comparable basis and must bear a reasonable interest rate. (For a detailed explanation of loan requirements, see chapter 4 on pension plans.)

Conclusion

Profit sharing offers employees a chance to share in their company's success. The level of company success is directly related to profits, which often define the amount of profit-sharing allocation. So the greater the profits of the company, the larger the potential allocation. However, profit-sharing plans can serve several goals. If the plan is cash only, it is generally viewed as a form of bonus. If profits are good, benefits are paid. However, these can become viewed as certain, and employees may spend anticipated benefits before they materialize. Deferred plans are generally intended to supplement other pension plans and thus are generally more appropriate for retirement purposes.

Because of their advantages to both employees and employers, profit-sharing plans will probably continue to play an important role in employee benefits planning.

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[1] A highly compensated employee is defined in chapter 4.