Business Management Advisory

For Precision Custom Manufacturers

WS08 **File: WAGES AND SALARIES**

PROFIT SHARING PLANS — THE BASICS

SUMMARY

A Profit Sharing Plan is a defined contribution retirement plan that features flexible contributions by the company to assist employees in reaching their retirement financial goals. In fact, this type of plan is often referred to as the "no commitment" or "controlled commitment" plan. An employer may vary his contribution percentage or dollar amount from year to year. Profit sharing plans can offer significant advantages over other qualified plans:

- **The employer is not locked-in to a specific contribution each year.**
- **It is easy for your employees to understand and for you to administer.**
- **As with other plans, investment earnings on contributions are not subject to taxes until they are received as distributions**.

In fact, there are no disadvantages to profit sharing plans.

WHAT KIND OF COMPANY DOES THIS PLAN SUIT?

Profit sharing plans are frequently established by companies seeking simplicity and ease of administration and who find it necessary to have flexibility when making contributions. Profit sharing plans are most popular among successful new companies or companies whose profits may fluctuate from year to year.

HOW MUCH CAN AN EMPLOYER CONTRIBUTE?

The company chooses a percentage of the compensation of eligible employees or a dollar amount to be contributed. This contribution amount may change from year to year. In fact, there is no requirement that the company make a contribution for a given year. The contribution by the company may not exceed 15% of the compensation of all eligible employees. Each participant's share of the contribution is based on his compensation, and no individual employee can have more than $30,000 contributed for his benefit in any year. The formula can even give extra compensation credit to those employees whose compensation is over the social security limit each year.

WHO IS ALLOWED TO PARTICIPATE?

All full-time, non-union employees can participate after they meet the eligibility requirements established by your plan. Most profit sharing plans require that an employee be age 21 and have worked at least one year before he is eligible to participate in the plan.

Employer contributions may be immediately vested or subject to one of the following minimum vesting schedules: Schedule 1 - 100% vesting after five years of service, Schedule 2 - 20% vesting after three years of service with another 20% vesting for each additional year of service. Under this schedule, the employee is fully vested upon completion of seven years of service. Employees who leave the firm before becoming 100% vested forfeit the non-vested portion of their accounts. That forfeited benefit is shared by all the remaining plan participants.

ARE THERE ANY TAX ADVANTAGES?

For the Employer:

Contributions made by the company are 100% tax deductible on a federal basis, and in most cases, on a state basis as well. All investment earnings on employer contributions while in the plan are tax-free until the money is distributed.

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For the Employee:

Contributions to the plan are not considered compensation to the employee when made by the company.

At the time of distribution, participants may be able to delay tax payment by rolling their distributions into an IRA or another qualified plan within 60 days. Distributions that are not directly rolled from one eligible plan to another eligible plan are subject to a 20% withholding requirement.

ARE THERE OTHER ADVANTAGES?

Besides the tax advantages of establishing the plan, a company may obtain the advantages of retaining key employees; recruiting new employees and increasing the productivity of current employees. Since contributions are based on compensation, your key employees benefit the most from this plan.

WHO INVESTS THE CONTRIBUTIONS?

Many profit sharing plans allow each participant to direct the investment of his own account balance through a choice of professionally managed investment funds. If enough variety is offered to the participants, the employer reduces his fiduciary liability exposure. Other (actually most) profit sharing plans pool all of the funds and the employee, via employee/stockholder/trustees, directs all investments. Or, the investments can be made by an investment advisor or a trustee, usually a bank.

WHEN ARE DISTRIBUTIONS MADE?

Participants are eligible to receive distributions from a profit sharing plan upon retirement, death or termination of employment. Some profit sharing plans also allow distributions in the event of disability. At the occurrence of one of these events, generally, the plan distributes to the participant a lump-sum payment of his account balance. Some profit sharing plans allow other methods of distribution including annual installments for a specific number of years.

MAY DISTRIBUTIONS BE MADE FOR ANY OTHER REASONS?

Hardship Withdrawals:

Profit sharing plans may allow hardship withdrawals of the vested portion of a participant's account. Hardship withdrawals must be made on account of the participant's immediate and heavy financial need, and must be necessary to satisfy such need. Hardships include medical expenses, purchase of a principal residence, payment of tuition for the next semester or quarter of post-secondary education, and payments necessary to prevent eviction from or foreclosure on a principal residence. Even if all these categories are met, a hardship withdrawal must be the last available source of funds.

In-Service Distributions:

Profit sharing plans may also permit the distribution of a participant's account balance on that attainment of a specific age (usually 65), the completion of a stated period of participation or the lapse of a fixed number of years.

Plan Loans:

Profit sharing plans may also include a loan feature. Only plan participants are allowed to borrow from the plan, and even then, owner-employees and shareholder/employees of an S Corporation may not borrow from the plan. There are a number of strict rules regarding plan loans. These include the amount of the loan, limited to 50% of the participant's account balance, and the length of the repayment period, usually limited to five years.

WHAT ELSE DO I NEED TO KNOW?

As with other qualified plans, a profit sharing plan requires a legal plan document, which determines how the plan will be administered, including who is participating, how compensation is credited, who invests contributions, how and when distributions are made, etc...

You must file a tax return with the IRS, annually, to maintain the tax qualified status of your plan.

Most plans also provide participant statements of account, annually, so your employees know what you are doing for them.

WHAT DO I DO NOW?

Analyze your feelings in the light of your business circumstances. Is a profit sharing plan the right plan for you?...Some other employee benefit plan?

If you have any questions, you are welcome to call our office — Howard Simon & Associates, Inc. (Pension Consultants). Call (708) 564-0340.

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