Profit Sharing

A profit-sharing plan is a type of Defined Contribution Plan. This type of plan can be used as a stand-alone plan or in many cases it is used in conjunction with a 401(k) plan. Contributions to profit-sharing plans can vary in method of allocation and dollar amount from one year to the next.

Profit-sharing contributions are discretionary. The plan sponsor can choose each year how much the contribution will be for the year. If the plan is determined to be top-heavy, each non-key employee must receive a minimum top-heavy contribution (generally 3%). The maximum deductible contribution by an employer for a profit-sharing plan is 25% of the total plan's eligible compensation. The most that can be allocated to a participant including both 401(k) and profit-sharing contributions is the lesser of 100% of compensation or $56,000 (employees age 50 or older can receive an additional catch-up contribution of $6,000) for 2019 under the Code Section 415.

There are several different allocation methods that can be used with a profit-sharing plan, including proportionate compensation, Social Security integration/permitted disparity, and new comparability/cross-tested. Each allocation formula is highlighted below.

PROPORTIONATE COMPENSATION

In this allocation formula, the plan sponsor will select the percentage to be allocated to each participant under the plan. Typically, the allocation is between 0% and 25%. Each participant (whether owner or eligible employee) will receive the same percentage of contribution based on their compensation. The actual dollar amount of the contribution will vary based on the compensation received by each participant.

PERMITTED DISPARITY

Permitted disparity refers to special rules that permit employers to take into account contributions to the Social Security system, on behalf of employees, when they compute retirement plan contributions. This method allows contributions to be weighted in favor of highly paid employees because they do not get Social Security benefits on income above the taxable wage base.

With permitted disparity, contributions to retirement plans are reduced for all workers, but only to the extent of retirement plan contributions relating to salary below a certain level, "the permitted disparity level." Typically, the permitted disparity level is the taxable wage base in effect for the year – $132,900 for 2019. Permitted disparity levels below the taxable wage base are allowed, depending on the plan document, but certain other adjustments to the calculation must be made if a lower level is chosen.

When performing the Social Security permitted disparity calculation, specific requirements must be met to avoid being discriminatory. As an example:

- The permitted disparity level used in the plan must meet certain requirements
- The percentage of contribution allocated to excess compensation (the amount of compensation earned over the stated permitted disparity level in the plan is limited based on the permitted disparity level and the contribution percentage allocated to base compensation – this is the amount of compensation at or below the permitted disparity level).

The actual calculation can vary somewhat depending on the specific integration formula chosen and if the plan is top-heavy. For this reason, the calculation should be performed by The Benefit Advantage.

When should an employer consider using this method?

- The employer has a desire to reduce the total contributions to the plan, but still provide a larger benefit to the higher paid participants.
- There is a disparity between the compensation levels of those employees targeted for the higher benefits.

CROSS-TESTING

A cross-tested plan is a Defined Contribution Plan that uses a certain testing method to show that the plan does not discriminate in favor of highly compensated employees (HCEs). In order to be entitled to favorable tax treatment, a qualified retirement plan cannot discriminate in favor of highly compensated employees. An individual is generally an HCE for a particular year if the individual earned over a certain dollar amount in the preceding year (e.g., $110,000 in 2010); or was a “more than 5% owner” in the current or prior year.

In a Defined Contribution Plan, providing an allocation for a year based on a uniform percentage of all participants’ compensation is not discriminatory in favor of HCEs. Likewise, a Defined Benefit Plan that provides a promised benefit at retirement that is based on a uniform percentage of compensation is also not discriminatory.

Cross-testing is the term used to describe a technique where an allocation in a Defined Contribution Plan for a year is converted to a projected benefit at retirement. Then, the projected retirement benefits for all participants in the plan are tested to ensure that the plan does not discriminate in favor of HCEs. If all of the projected benefits at retirement are a uniform percentage of compensation for all participants, then the plan is not discriminatory. Even if the projected benefits are not a uniform percentage of compensation for all participants, a plan may still be considered nondiscriminatory depending on the level of benefits provided to the non-highly compensated employees.

The advantage of a cross-tested plan is to demonstrate that allocations under the plan are not discriminatory; it permits substantially larger contributions to be made for older participants than for the younger participants. In some situations, the employer might be able to make a 20% contribution for the HCEs and only a 5% contribution for all other employees.

The reason for this difference can be explained by a simple example. Suppose a company has two employees who each earn $50,000. One is age 60 and the other is age 30. If a uniform percentage of compensation is to be allocated under the plan, then each individual will receive the same contribution. But, if the goal is to ensure that the contribution each individual receives will provide the same projected benefit at normal retirement age (generally age 65), then a larger

contribution must be made for the 60-year-old employee than for the 30-year-old employee. This is because the older employee has fewer years for the contribution to accumulate before the employee reaches age 65 (i.e., there will only be five years for the contribution to accumulate earnings). The contribution for the younger employee will accumulate earnings for 35 years, thus a smaller current contribution needs to be made.

When the contributions are “cross-tested” or converted to a projected retirement benefit, each individual will have the same projected benefit at age 65.