

Profit Sharing and 401(k) Plan Contributions

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Profit Sharing Plan

The maximum tax deductible contribution to a Profit Sharing plan is like that of a SEP, 25% of compensation or \$49,000 if less for each eligible employee (20% of gross earned income after the ½ FICA deduction). There is no longer a requirement that there be profits in order for the employer to make a profit sharing contribution.

There are essentially two maximum participation requirements available to the employer. He can exclude all employees who are not age 21 and have less than one year of service or he can exclude all employees who are not age 21 and have less than two years of service. It is possible to set lesser limits, such as age 18 and six months of service. If more than one year of service is required, then 100% vesting is also required. If only one year of service is required, then a choice of vesting schedules is available. (One note: typically a year of service is a twelve month period, either counted from hire date or on a plan year basis, during which an employee works 1,000 or more hours.)

If the plan is not Top Heavy, namely less than 60% of the benefits are for key employees such as owners and certain officers, then the two maximum vesting schedules are: nothing with less than five years with 100% vesting after five years of service; or nothing for two years, 20% after three years of service with 20% per year until 100% after seven years of service. If the plan is Top Heavy, then the two maximum vesting schedules are: nothing for one year with 100% after three years of service; or 20% after two years of service with 20% per year until 100% after six years of service.

Non-vested benefits eventually are allocated to the remaining participants in addition to the employer contribution, but not so that the total allocation is greater than 25% of compensation or \$49,000 per year. Allocated non-vested benefits are called forfeitures.

The ability to exclude a greater number of employees than SEPs, along with the vesting schedules which create forfeitures, can make Profit Sharing plans less expensive in the long run for most employers with rank-and-file employees. In other words, it is possible for more of the contributions to reach the business owner eventually in a Profit Sharing plan than a SEP because fewer employees will receive contributions and some of the contributions for the rank-and-file will eventually be allocated to the business owner as forfeitures.

Another difference is that the business owner can be the plan's trustee. As long as he obeys Department of Labor rules on "party-in-interest" transactions, fiduciary requirements, and

prudent and diversified investments, he can invest in almost anything. There are limits on participant loans, and owner-employees, 5% partners of partnerships, and shareholder-employees of S corporations cannot have participant loans. Certain non-passive investments might cause the trust to owe income tax, but are allowed by law. There can even be investment in certain “qualifying employer securities”. Thus the investment of the plan’s assets can be as complicated or as simple as the trustee wants.

Accounts in all ERISA qualified plans (i.e. plans with rank-and-file employees) are generally protected from creditors, while other plans are protected in Bankruptcy.

There are restrictions on when an employee can get his money in all employer plans except SEPs. Usually he cannot receive his money until retirement age, death, disability, or separation from service although a Profit Sharing plan can allow some in-service distributions.

There are more stringent requirements for setting up and administering Profit Sharing and other employer plans than SEPs. For example, the Profit Sharing plan document must be signed by the last day of the employer’s fiscal year even though the contribution is due only by the due date of the employer’s income tax return. Changes to the allocation formula must be made by the end of the plan year. Annual reporting is required to be made to the government with form 5500, although there is a shorter form 5500-EZ for plans without rank-and-file employees. The 5500 series form is due seven months after the end of the plan year, although it is possible to get a 2-1/2 month extension to file. Starting with the 2009 plan year, the Form 5500 must be electronically filed with the DOL, although the Form 5500-EZ is filed on paper with the IRS.

With the right consulting firm providing assistance, a Profit Sharing plan can be an excellent way for the business owner to save for retirement.

401(k) Plan

A 401(k) plan is a Profit Sharing plan which allows the employees to make their own tax deductible contributions. There are annual limits on how much any employee can contribute and there are limits on how much highly compensated employees can contribute compared to what the rank-and-file employees contribute. The annual limit for 2009 is \$16,500. An employee who turned age 50 during or before 2009 can contribute an extra \$5,500 for a total of \$22,000.

An employer usually, although not always, matches the employees contribution to some extent. Usually the matching percentage is between 10 and 50%.

An employer can establish a “Safe Harbor” 401(k) plan. The main variant is for the employer to make a safe harbor, 100% vested contribution of 3% of compensation. This allows the 401(k) non-discrimination test (ADP test) to be waived so that highly compensated employees can contribute the maximum without fear of having excess deferrals returned. The 3% contribution also counts towards any required Top Heavy minimum contribution and can be used in a tiered

allocation formula (although it cannot be used in a formula integrated with Social Security).

The maximum allocation of all contributions, 401(k) deferral, matching, and discretionary employer cannot exceed \$49,000, although the age-50 catch-up can boost that to \$54,500. The maximum allocation also cannot exceed 100% of compensation for the year.

The maximum tax deduction for the employer is 25% of the sum of compensation for eligible employees. 401(k) deferrals are not included in the 25%. Any amount of contribution that cannot be allocated (see the prior paragraph) is not deductible. For example, if there was one participant with compensation of \$200,000, since \$50,000 could not be allocated it would not be deductible.

Because of the contribution non-discrimination tests and depending upon the investment choice offered to the employees, 401(k) plans can be much more expensive to operate than a regular Profit Sharing plan. However, in the right circumstances, a 401(k) plan can be a major morale booster and a wonderful vehicle for employee savings. It should be viewed as an employee benefit and not as a plan to benefit the business owner.

401(k) plan documents must be signed before the first 401(k) salary deferral is made from payroll for the year. A Safe Harbor 401(k) plan must be signed by September 30 of the Calendar year.

Age/Pay Weighted, Tiered, and New Comparability Plans

The final IRS regulations on Internal Revenue code Section 401(a)(4) has enabled Profit Sharing, 401(k), and Money Purchase Pension plans to not only weight the allocation of contribution and forfeitures by age in addition to compensation, but has allowed a plan to give different levels of contributions to different groups as long as the plan passes a numeric discrimination test. This may allow the favored group of employees to receive two, three, or four times as much contribution as a percentage of pay as another group.

Generally Age/Pay Weighted, Tiered, or New Comparability plans work better for business owners when they are older on average than the other employees, unlike Target Benefit Pension plans which don't generally work well when there are any employees older than the business owner. New Comparability plans can work well even if all of the business owners are in their 40's and most of the employees are in their 30's. They work especially well if some owners are in their 50's or 60's and some employees are in their 20's.

The start-up and administration costs are higher for these plans due to the extra level of complexity involved. However, usually the extra expense is dwarfed by the savings, making these plans very popular for the past few years.