
Age-Weighted Profit Sharing Plan

The Basics

Contributions are totally flexible and at the discretion of the employer, and need not be yearly, so long as they are “substantial and recurring.” Employer contributions are allocated to provide an equal assumed retirement benefit as a percentage of compensation at normal retirement age for all participants.



How It Works

- Employer contributions are tax deductible.
- Contributions not taxed currently to the employee.
- Earnings accumulate tax-deferred.
- Distributions are generally taxed as ordinary income. Distributions may be eligible for 10-year income averaging,¹ or, at retirement from the current employer, rolled over to a traditional or a Roth IRA, or to another employer plan if that plan will accept such a rollover.
- Except for more than 5% owners, required minimum distributions (RMDs) must begin by April 1 of the later of (a) the year following the year in which the participant reaches age 70½, or (b) the year following the year in which the participant retires. More-than-5% owners must begin to receive distributions by April 1 of the year following the year they reach age 70½.

Additional Considerations

- **Maximum annual deduction:** Up to 25% of covered payroll can be contributed and can be from current or past profits and deductible by the employer.

¹ Those born before 1936 may be able to elect 10-year averaging or capital gain treatment; these strategies are not available to those born after 1935.

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- **Individual limits:** The allocation of contributions to a participant's account may not exceed the lesser of 100% of includable compensation¹ or \$53,000 per year.
- **Employer contributions:**
 - Plans normally are discretionary as to the amount that the employer contributes.
 - If there are profits, the employer is expected to make “substantial and recurring” contributions. See IRS Reg. 1.401-1(b)(2)
- **Excluding persons:** Certain persons can be eliminated on the basis of months of service, age or coverage in a union plan; for example, persons under age 21 can be excluded from the plan.
- **Investment of plan assets:** Plan assets can be invested in equity products like mutual funds, stocks and real estate; or in debt instruments like T-Bills and CDs; or in insurance products like life insurance and annuity products.
- **Social Security integration:** Since the employer already contributes to the employees' Social Security Retirement, the assumed retirement benefit can be integrated with Social Security, but seldom is.
- **Forfeitures:** As participants leave the company and separate from the plan, those less than 100% vested forfeit that part of the account in which they are not vested. The nonvested forfeitures may then be allocated to the remaining participants. Those participants who remain in the plan the longest will share in the most forfeitures, or forfeitures may be used to reduce future employer contributions.
- **Parties that are favored:** Older participants are favored from a contribution perspective because they are closer to retirement. However, all participants would receive the same projected retirement benefit as a percentage of compensation at age 65.

How Much Will There Be at Retirement?

This will depend upon three factors:

¹ This rate applies to “net” self-employment income of the owner or partner, less the contribution and the deduction allowed for one-half of the self-employment tax.

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- The frequency and amount of contribution,
- The number of years until retirement, and
- The investment return.

The risk of poor investment return rests on the employee. However, if the investment results are favorable, the participant will have a larger fund at retirement age.

An Example of What \$10,000 Per Year Will Grow to Over Several Years at Various Rates of Growth Without Tax ¹				
Years	4.00%	6.00%	8.00%	10.00%
5	\$54,163	\$56,371	\$58,666	\$61,051
10	\$120,061	\$131,808	\$144,866	\$159,374
15	\$200,236	\$232,760	\$271,521	\$317,725
20	\$297,781	\$367,856	\$457,620	\$572,750
25	\$416,459	\$548,645	\$731,059	\$983,471
30	\$560,849	\$790,582	\$1,132,832	\$1,644,940
35	\$736,522	\$1,114,348	\$1,723,168	\$2,710,244

Top-Heavy Plans

If more than 60% of the cumulative benefits are going to “key” employees², then the employer must contribute at least as much for “non-key” participants as for key employees. This requirement applies only to the first 3%³ of compensation.

¹ The rates of return used in this illustration are not indicative of any actual investment and will fluctuate in value.

² A “key” employee is someone who, at any time during the plan year was: (1) an officer of the employer whose compensation from the employer exceeded \$170,000; or (2) a more than 5% owner; or (3) a 1% owner whose compensation from the employer exceeded \$150,000.

³ The requirement will be greater than 3% in some instances.

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Example – Allocation of Employer Contribution						
Participant	Age	Compensation	Traditional		Age-Weighted	Difference Between Age-Weighted and Nonintegrated
			Non-integrated	Integrated at 5.7%		
Owner A	55	\$265,000	\$38,181	\$41,732	\$53,000	\$14,819
Owner B	50	150,000	21,612	20,690	19,951	-1,661
Employee 1	40	55,000	7,925	6,928	3,236	-4,689
Employee 2	35	30,000	4,323	3,779	1500 ¹	-2,823
Employee 3	30	30,000	4,323	3,779	1500 ¹	-2,823
Employee 4	25	30,000	4,323	3,779	1500 ¹	-2,823
Totals		\$560,000	\$80,687	\$80,687	\$80,687	\$0

The employer contributions are equal to 14.41% of \$560,000 or \$80,687. The age-weighted allocation, when accumulated to normal retirement age of 65, would purchase an equivalent retirement benefit as a percent of compensation. The projected retirement is important only to calculate the allocation of the employer contribution.

Advantages to Employer

- Contributions are tax deductible.
- Contributions and costs are totally flexible.
- Forfeitures of terminating employees may reduce future costs or be reallocated among the accounts of those in the plan.
- It can provide employees with permanent life insurance benefits that need not expire nor require costly conversion at retirement age.
- The employer can direct investments.

¹ This is the "gateway" contribution at 5.0%.

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- If former participants do not provide the plan with distribution instructions, the plan may automatically distribute accounts less than \$5,000. In the case of a plan that provides for such mandatory distributions, the plan must automatically roll an eligible distribution amount that exceeds \$1,000 to a Rollover IRA in the former participant's name. A plan may allow direct rollovers of less than \$1,000.
- Plan can favor older employees.

Advantages to Employees

- Annual employer contributions are not taxed to the participant.
- Earnings on the account are not currently taxed.
- ERISA and federal bankruptcy law provide significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans.
- Participants can have the right to direct investments. Effective July 1, 2012, plan sponsors are required to provide participants in self-directed plans with expanded investment fee and performance data. This additional information is intended to aid participants in making better-informed investment choices.
- Federal law allows a qualified plan to establish an “eligible investment advice arrangement” under which individually tailored investment advice is provided to plan participants. Any fees or commissions charged must not vary with the investment options chosen, or else a computer model meeting certain requirements must be used.
- Participants may also have a traditional, deductible IRA (subject to certain income limitations based on filing status), a traditional, nondeductible IRA, or a Roth IRA.
- There is the ability to purchase significant permanent life insurance, which is not contingent upon the company group insurance program. Purchase of life insurance will generate taxable income to the employee.
- Older participants will receive a substantially greater allocation of the employer contribution than under traditional type of profit sharing plans.

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- The forfeited, unvested portion of accounts of former participants may be allocated to the active participants' accounts. This can have a major impact on future benefits.
- If the plan so provides, vested balances may be withdrawn if the funds have accumulated in the plan for at least two years, if an employee has participated in the plan for at least five years, or if the participant has a "financial hardship." Under Treasury regulations, this is defined as "immediate and heavy financial need where funds are not reasonably available from other sources." Safe harbor rules spell out the conditions and requirements for hardship distributions.
- Participant may borrow from the plan within certain guidelines if provided for in the plan documents.

Disadvantages to Employer

- The maximum deductible employer contribution is 25% of covered payroll.
- If the key employees are younger than the other employees, they will not receive as large a proportion of the employer contribution.
- It is more difficult to explain the plan to employees.
- Administration costs will be higher.
- Effective July 1, 2012, if a plan gives participants the right to direct any investments, plan sponsors must provide participants with expanded, standardized investment fee and performance information. Failure to comply with these ERISA requirements may result in a breach of fiduciary duty to plan participants and the loss of ERISA Section 404(c) protection (meaning the plan fiduciaries may be held responsible for the results of the participants' own investment choices).

Disadvantages to Employees

- There is no guarantee as to future benefits.
- Investment risks rest on the participant.
- There is no assurance as to the frequency and amount of employer contributions.