



Profit Sharing Plans

A profit sharing plan is a type of defined contribution plan where an employer can share profits with its employees. The employer can choose how much to contribute to the plan each year, as long as the contributions are recurring and substantial as defined by the Internal Revenue Service. The plan must state how the contribution is to be allocated, and it must be done on a nondiscriminatory basis.

Prior to 2002, the maximum contribution an employer could make to its profit sharing plan was 15 percent of eligible compensation. However, when the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was passed, it increased this maximum to 25 percent of eligible compensation. This change effectively eliminated the need for money purchase plans and made the profit sharing plan a much more attractive retirement plan option.

For example, an employer who needs the maximum tax deduction could contribute up to 25 percent of compensation for eligible employees. If the employer had a total payroll of \$1,000,000 but only \$680,000 of eligible compensation, the employer could contribute up to \$170,000 to its profit sharing plan.

Profit sharing plans are funded solely by the employer and the plan trustee is usually responsible for directing the investment of plan assets. The plan may be funded using insurance products, annuities or other qualified investments. The participants of the plan bear the investment risk. Profit sharing contributions are usually subject to a graded vesting schedule to reward long-term employees.

Profit sharing plans have funding flexibility. They are funded as the employer can afford to make contributions. The employer can fund the plan beginning with the first day of the plan year through its tax filing due date, including extensions. Additional features can be added to the profit sharing plan to customize the plan to better meet the employer's needs. For example, a 401(k) provision can be added to the plan to allow employees to make elective salary deferrals on their own behalf. A safe harbor 401(k) provision provides a minimum contribution to all employees which allows the highly compensated employees to defer up to the individual maximum.

Each defined contribution plan has a specific formula that is used to calculate the amount of profit sharing contribution to be deposited on behalf of each eligible participant. Common examples of these formulas include the salary proportionate plan where each employee receives a percentage of his compensation as a contribution, integrated with social security which considers a participant's social security benefit when calculating the contribution amount, and cross-tested plans.

The age-weighted profit sharing allocation formula is a cross-tested plan which weights the contribution more heavily to the older participants. In a new comparability profit sharing plan, the contribution allocation is defined by class, such as salary range, job title or job classification. For example, "owners" could be in Class 1, "managers and supervisors" in Class 2, and "all other employees" in Class 3. Each class could receive a different percentage of compensation as its allocation. Both types of cross-tested plans frequently benefit the owner, while providing a nondiscriminatory benefit to other eligible participants.

Contact your Lafayette Life representative to find out more about profit sharing plans and if one is right for your retirement planning needs.

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