



RETIREMENT PLANNING

Profit-Sharing Plan

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RETIREMENT PLANNING

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PLEASE NOTE

The Consolidated Appropriations Act, 2021 continues many temporary CARES Act provisions through 2021 to ease access to retirement funds, including:

- ◆ The exception to the 10% early withdrawal penalty for distributions prior to age 59½
- ◆ The elimination of the mandatory 20% withholding requirement on distributions
- ◆ The option to take out up to \$100,000 in a loan or withdrawal (if otherwise allowed under plan provisions)



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The Concept

- ◆ Profit-sharing plans are employer-sponsored qualified retirement plans in which the amount of each employee's retirement benefit is determined by the employer's contributions and the investment performance of the employee's account.
- ◆ Although employers are not required to contribute to a profit-sharing plan each year, they must make "recurring and substantial" contributions—at least three of every five years usually satisfies this requirement.
- ◆ Many profit-sharing plans allow employees to invest and manage their accounts. Regardless of whether the employee or the employer manages the plan assets, the employee bears the risk of investment performance.

The Design

- ◆ In a profit-sharing plan, the employer has great flexibility in determining how and when to make contributions. For example, a company may base contributions on profits exceeding a certain amount, or the board of directors may determine the contribution each year.
- ◆ Deductible employer contributions cannot be more than 25% of a participating employee's total compensation.
- ◆ Employers often base contributions on the employee's total compensation including salary, commissions, bonuses, overtime pay, etc. The maximum compensation to be taken into account for any one employee is \$290,000 in 2021.
- ◆ There are also limits on annual additions to defined contribution plans, which may not exceed the lesser of 100% of the employee's compensation or \$58,000 for 2021. This dollar amount is indexed annually for inflation.



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The Tax Picture

- ◆ Employer contributions are tax deductible within the 25%-of-compensation limit.
- ◆ Employer contributions are not taxed to employees when they are made.
- ◆ Investment earnings in the plan accumulate on a tax-deferred basis.

The Benefits

- ◆ Employers can manage costs based on profitability or the discretion of the board.
- ◆ Employees may be motivated when they share in company profits.
- ◆ Employees enjoy greater flexibility than a typical pension plan, including the possibility of rolling the account balance into a new employer's plan if the employee changes jobs.

The Bottom Line

Profit-sharing plans are particularly attractive to companies with widely fluctuating profits and a desire to avoid a fixed annual contribution requirement. The employer may choose to include a 401(k) feature permitting employees to make elective salary deferrals to supplement employer contributions.



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SUMMARY

WHAT ARE PROFIT-SHARING ARRANGEMENTS?

Profit-sharing plans are a specific form of qualified retirement plan called a “defined contribution plan” in which the employer makes periodic contributions to the plan. Each employee’s retirement benefit depends on the amount of the employer’s contributions plus the investment performance of each employee’s account.

While the employer is obligated to make the specified contributions, the employee bears the risk of investment performance. These plans may be set up so employees can invest and manage their individual accounts.

HOW DO PROFIT-SHARING PLANS WORK?

A distinguishing feature of profit-sharing plans is that employer contributions are not required every year. However, contributions must be “recurring and substantial.” Contributions in at least three out of every five years usually satisfy this requirement.

The employer has flexibility in determining how and when to make contributions. For example, the amounts can be based on company profits in excess of a certain amount, a percentage of the company’s net income, or an annual determination by the board of directors. While contributions are deductible, they are limited to 25% of the participating employees’ total compensation.

HOW ARE CONTRIBUTIONS DETERMINED?

Employer contributions are often based on the employee’s total compensation, which can include salary, commissions, bonuses, overtime pay, etc. The maximum compensation that can be taken into account is \$290,000 in 2021. The participant’s annual contribution is limited to the lesser of 100% of the employer’s includable compensation or \$58,000 (in 2021).



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WHAT ARE THE BENEFITS?

Profit-sharing plans enjoy the usual advantages of other types of qualified retirement plans, including employer contributions that are tax deductible (within limits) and not taxed to the employee when they're made. Investment earnings also accumulate on a tax-deferred basis.

Profit-sharing plans are generally attractive to companies with relatively young owner-employees, widely fluctuating profits, and a desire to avoid being committed to annual contributions. Another attractive option is the opportunity to include a 401(k) feature that permits employees to make elective salary deferrals to the plan.

Profit-sharing plans offer a convenient, tax-advantaged way to prepare for retirement, while still allowing contribution decisions to be based on sound business practices.



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