Most small business owners are concerned about retirement, both for themselves and for their employees. The question isn’t whether or not to implement a retirement plan. The two most important issues are what type of plan you should start with and what are the considerations for choosing the right plan. A profit sharing plan is often a good place for a small business to start. There are two basic categories of qualified retirement plans available: defined benefit and defined contribution plans. Both profit sharing and money purchase plans are types of defined contribution plans.

**Profit Sharing Plans**

Profit sharing plans offer both design flexibility and discretion as to making contributions. Company contributions are determined by the plan sponsor and can be allocated in a number of ways. If the company makes little or no profit that year, no contribution is required, although low profits don’t restrict the contribution level. A profit sharing plan can include an option allowing the company to make contributions even if the company has no profit.

Profit sharing contributions are allocated to employees based on compensation. An employer’s maximum deduction is limited to 25% of the annual compensation paid to eligible employees. (The individual participant limits applied to all defined contribution plans are the lesser of 100% of compensation or $46,000.)
Salary Ratio

The salary ratio method is designed to allocate employer contributions to all participants on a uniform basis. For example, if one employee receives a 10% of pay contribution, all eligible employees would be allocated 10% of compensation as their share of the contribution. A profit sharing plan with a salary ratio formula is similar to a Simplified Employee Pension (SEP) plan, but may be more attractive than a SEP plan in situations where an employer: (a) does not wish to cover certain part-time employees, (b) wants to make employer contributions subject to a vesting schedule or, (c) wants more control over the assets.

Social Security Integration

This allocation method provides an additional contribution based on compensation in excess of some specified amount, frequently the Social Security wage base. This favors higher paid employees by providing an additional share of the contribution to be based on compensation that would otherwise accrue minimal Social Security benefits or none at all.

Social Security integration should be used to provide larger proportionate contributions to higher paid employees that are the same age or younger than other employees.
The age-weighted method allocates contributions based on both the age and compensation of eligible employees. It is similar to a defined benefit pension plan, only with discretionary contributions. Since the participant’s age, or length of time until retirement, is factored into the allocation formula, older participants receive a larger proportionate share of the contribution. This can be advantageous in situations where the key employees are significantly older than the other employees.

Although this type of plan is available to any size company, age-weighted plans are designed to be top-heavy and are especially well-suited for small business and professional practices.

In certain situations, an age-weighted plan design works extremely well, but some employees with the same salaries may receive different allocations, based on age. In addition, an older nonprincipal employee may receive a larger share than a younger principal.

### Comparability

The comparability, or cross-tested, allocation method allows the employer to divide the employees into different classifications for purposes of allocating the contribution. If nondiscrimination requirements are met, a larger share of the company’s contribution may be made on behalf of those employees to whom the employer wishes to provide a more significant benefit.

Nondiscrimination testing, like an age-weighted plan, is based on projected benefits at retirement, similar to a defined benefit plan. If the aggregated age of the preferred class is higher than the other classes, the allocation of current dollars can be skewed proportionately toward the older group. This type of plan involves complicated calculations and may require actuarial consulting, but it is still less expensive and more flexible than a defined benefit plan.

This plan may be appropriate in a situation where a business wants to favor older or highly paid participants. These plans may establish several “class” designations of employees, e.g., principals would be in the first group, officers in the second group and all other employees in the third group.
Frequently Asked Questions About Profit Sharing Plans

Q. Can a profit sharing plan be combined with a 401(k) plan?
A. A 401(k) plan is simply a profit sharing plan with a provision allowing employee salary deferrals. Most 401(k) plans provide employer matching contributions based on the participant’s contribution, with an additional option for a profit sharing allocation. Although most 401(k) plans use a salary ratio formula for profit sharing plan allocations, any of the other formulas could be used.

Q. What are the costs of implementing and maintaining a profit sharing plan?
A. It can vary significantly depending on the design complexity of the plan, the number of employees, and the structure of the investment portfolio.

Q. Can an IRA be rolled into a profit sharing plan?
A. If the IRA is specifically created as a “conduit” IRA, it can be rolled into a profit sharing plan. Otherwise, the plan document would have to specifically allow IRA rollovers, tracking these assets separately.

Q. Do all employees have to be included in a plan?
A. Certain employees may be excluded, but strict coverage rules are enforced to prevent the plan from discriminating in favor of highly compensated employees.

Q. What is the difference between a profit sharing plan and a SEP plan?
A. The profit sharing plan allows vesting schedules, while SEP plans require 100% immediate vesting. A profit sharing plan can require employees to work at least 1,000 hours to share in the contribution, but a SEP plan covers all eligible employees, regardless of hours worked.

Q. What are the administrative requirements?
A. All profit sharing plans are subject to IRS reporting requirements. This includes keeping the plan up to date with new laws, performing nondiscrimination tests, filing a Form 5500 return each year and providing benefit statements and other plan information to participants at least annually. Self-employed persons with no employees are not required to file returns until the plan has $250,000 in assets. It is recommended that a professional pension plan administrator be retained to perform these annual reporting functions.

Choosing an appropriate retirement plan is an important decision for small business owners. A profit sharing plan could be a good place to start. For more information or to open a profit sharing plan, please contact your Raymond James financial advisor today.