WELLS FARGO Advisors

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Profit sharing plans

Reward employees with flexible retirement contributions

There are times when you want to reward your employees for the contributions they make to your business's success. Consider a profit sharing plan, which is a flexible type of retirement plan that lets you vary contributions from year to year.

What is a profit sharing plan?

A profit sharing plan is a form of defined contribution retirement plan generally funded exclusively by your company. Although its name might suggest that the plan is based on your company's profits, it actually is not. Contributions, in fact, can be made even if the business does not make a profit for a given year. Instead, the term profit sharing refers to the flexibility with which you can determine the amount contributed to employees each year. These contributions are generally based on each employee's salary, not on company profitability. In addition, a profit sharing plan can be coupled with a 401(k) plan to give employees the opportunity to make salary deferral contributions.

The maximum contribution you can make is 25% of all eligible employees' compensation, up to a maximum of $58,000 per employee in 2021. These tax-deductible contributions are discretionary, so in a highly profitable year, you can contribute the maximum allowed. In an "off" year, you can reduce or eliminate your contribution entirely. In addition, your contributions can be subject to a vesting schedule, which ties employees' rights to receive their account balance to their length of employment.

Is a profit sharing plan right for your business?

Profit sharing plans are a good idea for your business if:

- You want a flexible employee incentive.
- You want to make all contributions.
- You want variable, annual, tax-deductible employer contributions.
- You are interested in potentially contributing up to $58,000 per employee in 2021.
- You want to determine vesting options.

Who is eligible?

To be eligible, an employee may be required to attain age 21 and work at least 1,000 hours for the company in each of the two prior years. If implementing a vesting schedule, you can require no more than one year of service for an employee to be eligible. You may always elect more liberal eligibility requirements if you prefer.

Establishing a profit sharing plan

All types of businesses, including corporations, partnerships, and sole proprietorships, may establish profit sharing plans. The plan assets can be managed in a number of different ways with varying complexity. They can, for instance, be held in a pooled account with you or a trustee directing their investment. Or each participant can direct the investments in his or her own account (similar to 401(k) profit sharing plans).

The plan itself must be established by the employer's tax filing deadline, including extensions. Contributions can also be made up until the business tax filing deadline for that year, including tax extensions.

Annual employer tax filings using IRS Form 5500 are due within seven months of the end of the plan year.

Common allocation formulas

Profit sharing plans are subject to government nondiscrimination and top-heavy testing to ensure that allocations to rank-and-file employees are similar to those of owners, shareholders, and key employees. There are many different formulas available to allocate contributions to participants. The plan document determines the methods available. Common formulas include:

Proportionate compensation lets you determine a percentage of compensation, typically between 0% and 25%, that will calculate the contribution to the plan for each employee. For example, you could choose to contribute an amount equal to 5% of each employee's compensation.

The permitted disparity rules let you take into account Social Security contributions made on behalf of employees. Because Social Security contributions are capped for those earning more than $142,800 in 2021, your contribution for a highly compensated employee when compared to his or her salary is smaller than that for a rank-and-file employee. As a result, permitted disparity allows you to put more into the profit sharing plan for highly compensated employees versus the rank-and-file.

The age-weighted allocation gives you the ability to skew contributions in favor of older employees. The theory behind age weighting is that older employees are nearing retirement age and have less time for assets to grow. Therefore, this allocation allows them to receive larger allocations when compared to younger employees, who have time on their side.

The new comparability or cross-tested allocation (an age-sensitive method) lets you divide employees into specific groups and allocate the contribution differently to each group. The plan must define groups, and employees can be divided by "class" distinctions. For example, owners and highly compensated employees can be in one group and all other employees in another. Typically, these plans are used for companies where the employees who are selected to receive larger contributions are, on average, older and receive higher compensation than other employees.

You can count on us

Although a profit sharing plan offers many benefits, it may not be right for every business. Wells Fargo Advisors offers a range of plans and can help you match the right plan with your needs and objectives.

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