

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.”¹ Employer contributions are allocated to provide an equal assumed retirement benefit at normal retirement age for all participants.

How It Works

- Employer contributions are tax deductible. See IRC Sec. 404(a).
- Contributions not taxed currently to the employee. See IRC Secs. 402(a) and 403(a).
- Earnings accumulate tax-deferred. See IRC Sec. 501(a).
- Distributions are generally taxed as ordinary income. Distributions may be eligible for 10-year income averaging², or rolled over into an IRA, at retirement. See IRC Secs. 402 and 403.

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.
- Individual limits:** The allocation of contributions to a participant’s account may not exceed the lesser of 100% of includable compensation³ or \$42,000 per year.
- Employer contributions:**
 - Plans normally are discretionary as to the amount which the employer contributes.
 - If there are profits, the employer is expected to make “substantial and recurring” contributions.¹ As a “rule of thumb,” contributions during three out of five years or five out of 10 years will usually gain IRS approval.
- 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.

¹ See IRS Reg. 1.401-1(b)(2).

² 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.

³ 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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—**Parties which 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 percentage at age 65.

How Much Will There Be at Retirement-

This will depend upon three factors:

- 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.

Forfeitures

As participants leave the company and separate from the plan, those less than 100% vested forfeit that part of their 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.

Top-Heavy Plans

If more than 60% of the cumulative benefits are going to “key” employees, 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%¹ of compensation.

| 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 | \$200,000 | \$26,731 | \$29,143 | \$40,000 | \$10,857 |
| Owner B | 50 | \$150,000 | \$20,049 | \$20,647 | 19,951 | -696 |
| Employee 1 | 40 | \$55,000 | \$7,351 | \$6,210 | 3,236 | -2,974 |
| Employee 2 | 35 | \$30,000 | \$4,010 | \$3,387 | 1,174 ² | -2,213 |
| Employee 3 | 30 | \$30,000 | \$4,010 | \$3,387 | 900 ² | -2,487 |
| Employee 4 | 25 | \$30,000 | \$4,010 | \$3,387 | 900 ² | -2,487 |
| Totals | | \$495,000 | \$66,161 | \$66,161 | \$66,161 | \$ 0 |

¹ The requirement will be greater than 3% in some instances.

² This amount is the top-heavy minimum allocation.

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The employer contributions are equal to 13.37% of \$495,000 or \$66,161. 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

- A. Contributions are tax deductible.
- B. Contributions and costs are totally flexible.
- C. It can provide employees with permanent life insurance benefits that need not expire nor require costly conversion at retirement age.
- D. The employer can direct investments.

Advantages to Employees

- A. Annual employer contributions are not taxed to the participant.
- B. Earnings on the account are not currently taxed.
- C. Distributions may be eligible for a 10- year income averaging,¹ or rolled over into an IRA, at retirement. See IRC Secs. 402 and 403.
- D. Participants can have the right to direct investments.
- E. Participants may also have a traditional, deductible IRA (subject to certain income level limitations based on filing status), a traditional, nondeductible IRA, or a Roth IRA.
- F. 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.
- G. Older participants will receive a substantially greater allocation of the employer contribution than under traditional type of profit sharing plans.
- H. The forfeited, unvested portion of accounts of former participants may be allocated to the active participants' accounts. This can have a substantial impact on future benefits.
- I. Participant may borrow from the plan within certain guidelines if provided for in the plan documents.

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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Disadvantages to Employer

- A. The maximum employer contribution is 25% of covered payroll.
- B. If the key employees are younger than the other employees, they will not receive as large a proportion of the employer contribution.
- C. It is more difficult to explain the plan to employees.
- D. Administration costs will be higher.

Disadvantages to Employees

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