Profit-Sharing Plans

David Wray, the president of the Plan Sponsor Council of America, once said that the purpose of profit-sharing plans is “to generate goodwill and a feeling of partnership” between employer and employee. Profit-sharing plans give employees a share in the profits of a company each year and can help fund their retirements.

All the money contributed to a profit-sharing plan accumulates tax deferred, as it does with other defined-contribution retirement plans, but employer contributions are tax deductible only if the plan is defined as an *elective* deferral plan, which means that instead of accepting their profit shares as cash, employees defer the assets into retirement funds.

Profit sharing is attractive to business owners because of its flexibility. Employers can choose how much to allot to employees each year based on the amount of revenue taken in. There is no required minimum. If the company has a bad year, the employer has the option of giving very little or nothing at all to employee accounts.

Employees are usually enrolled automatically in profit sharing once they become eligible. Companies can choose eligibility requirements based on age and length of service. A company is allowed to contribute up to 25% of an employee’s salary or $53,000 (whichever is less) in 2016 (unchanged from 2015). This amount is indexed annually for inflation.

Typically, companies set up vesting schedules that dictate how long workers must be employed in order to claim profit-sharing contributions when they move to another job or retire. Once employees are fully vested, they can take the entire amount contributed on their behalf and roll it over to an IRA or to a new employer’s qualified retirement plan.

If you participate in a profit-sharing plan, you may begin withdrawing funds after age 59½ without incurring a 10% income tax penalty. Withdrawals are taxed as ordinary income. Some plans may allow early withdrawals. Profit-sharing providers have greater flexibility when it comes to deciding the terms of early withdrawal than do administrators of other plans, such as 401(k)s. However, the trend has been to permit no early withdrawals.

Generally, you must begin taking required minimum distributions after reaching age 70½. You can elect to withdraw the assets as a lump sum and be taxed on the entire value of the fund or you can set up a minimum distribution schedule based on your life expectancy.

Some companies offer a combination arrangement with both a profit-sharing plan and a 401(k). A conjoined plan allows employers to contribute as much or as little as they would like each year, while giving employees a way to supplement their retirement funds.

If you are a business owner, profit sharing may be a way to attract high-caliber employees. It provides retirement funds for your employees yet still gives you the freedom to choose how much you wish to contribute each year.