How Can We Add More Flexibility to our Standard Profit Sharing Contributions?

Facts

We have made profit sharing contributions each year, and we plan to continue to do so every year that our financial situation allows. Historically, we have contributed the same percentage of pay for each person, but your previous Question of the Week about using the profit sharing feature to reward certain key performers piqued our interest.

Question

Is there a way for us to continue to make the same type of profit sharing contribution we always have, i.e. the same percent of pay, but also give ourselves the flexibility if we want to give different amounts to different employees in the future?

Answer

There sure is, and it's really easy to do!

There are several different ways that the rules allow you to allocate your profit sharing contribution each year. While the amount of the contributions is typically discretionary, the plan document must specify which allocation method to use. And, just to make sure we're all speaking the same language, listed from least to most flexible, the three most common types of profit sharing allocations are:

- **Pro-rata:** Each participant receives the same percentage of pay;
- **Integrated:** Participants whose pay exceeds the social security wage base receive higher allocations; and
- **New Comparability:** Allows different groups of participants to receive different contribution levels.

If you want to dig a little deeper on the specifics of each method, we've got a handy cheat sheet for you here.

From your description, it sounds like you've been using the pro-rata method. From there, let's jump to the most flexible option - new comparability. New comparability might be a bit of a misnomer since its been available for a few decades now, and just to keep you on your toes, you'll also hear this method referred to as "cross-tested" or the "grouping method."

All of these terms refer to a profit sharing allocation method that allows the company to make different levels of contributions on behalf of different groups of employees. Hypothetically, it allows you to go as far as providing a different allocation to every single plan participant. It would get a bit unwieldy, but you could do it. That is what makes it so flexible. With that said, the most common use is to maximize contributions to a few key individuals (usually company owners and officers) while minimizing contributions for everyone else.

So why would you care about new comparability if you prefer the salary proportional option? If you think of the three allocation methods as a multiple choice exam, choosing new comparability is like choosing “all of the above.” In other words, in addition to the flexibility that makes new comparability a powerful tool to target contributions to select individuals or groups of employees, it also gives you the flexibility to use the pro-rata or integrated method in years where it makes sense.

One more factor that comes up when discussing profit sharing allocations is whether or not to require employees to satisfy additional requirements to receive a contribution. Two of the more common allocation conditions are being employed on the last day of the year and/or working at least 1,000 hours during the year. If you make the move to new comparability, we’d suggest that you remove any of these conditions if they are currently in your plan document.

We know how that sounds, but hear us out. Since new comparability allows you to make allocation decisions on a participant-by-participant basis, you generally have the option to operationally allocate a 0% contribution to any participant who, for example, is not employed on the last day of the year or who doesn’t work at least 1,000 hours during the year. Sticking with our theme, this adds another layer of flexibility to your plan.

All of that flexibility without the need to amend your plan each time you want to use a different method? Right about now, you may be wondering, “What’s the catch?” Believe it or not, there isn’t one. We should mention, however, that for any years you elect to utilize the new comparability provision to make “extra” contributions to targeted individuals, additional nondiscrimination testing applies if any of those individuals happen to be highly compensated employees.

Moral of the story? Adding new comparability and removing allocation conditions for profit sharing means you can continue to allocate in the same pro-rata manner you always have. That said, when and if you need or want some additional flexibility, you’ve got it built into your plan ready for use.

If you want to explore how this or other changes might be beneficial, reach out to us. With mandatory Cycle 3 document restatements right around the corner, it could be a great time to incorporate new provisions into your new plan document.