Can We Offer Higher Profit Sharing Contributions to Employees Based on Performance?

Facts

We've had a 401(k) plan for years, but we are now looking at ways to make it a more strategic part of our overall compensation package. In one of your previous Questions of the Week, you mentioned that we cannot really give employees the choice between higher pay or a profit sharing contribution, but we would like to explore ways to use profit sharing to reward certain star performers within the company.

Question

Is there a way to design/utilize our plan to reward certain employees with a profit sharing contribution without having to contribute the same amount to everyone?

Answer

In a word, yes! You can use a feature referred to as new comparability (or cross testing) to do exactly that. If you are not familiar with new comparability, here's a Cliff's Notes recap on how it works:

In its most basic form, it is a method for allocating profit sharing contributions among participants that allows you to vary the percentage or dollar amount that each person receives. Although this methodology must be written into the legal plan document, the dollar amounts or percentages do not have to be pre-determined. In other words, you retain the flexibility/discretion regarding the amounts you contribute each and every year.

So how does this allocation method serve to improve your compensation package and get you more bang for your HR buck? Although often used to target contributions to company owners and officers, new comparability also allows you to reward individual employees directly for performance, tenure, or key accomplishments. While you cannot give employees the choice between a cash bonus or a profit sharing contribution (we cover this here), the company can decide to make a contribution in addition to or in lieu of cash for certain participants. This route provides several additional benefits beyond the obvious:

- The participant does not pay current tax on a profit sharing contribution the way s/he would if receiving a cash bonus.
- Company contributions are not subject to Social Security or Medicare tax, so there are additional tax savings.
- If the plan has a vesting schedule, a profit sharing contribution is not only a current reward but also becomes a retention tool.

Let's take a quick look at how those last two bullets play out.

FICA Savings

Let's say you set performance benchmarks for your employees. If they hit those objectives, you reward them with a $10,000 bonus. In addition to the employee paying income tax on that amount (at a higher-than-normal withholding rate), both the company and the employee pay an additional $765 in FICA taxes (7.65% of $10,000). If you make a $10,000 profit sharing contribution rather than the bonus, both parties save that $765. Depending on the number of employees and overall amount in question, that FICA savings can really add up.

Retention Tool

While saving on FICA might be nice, there's another element to reward-by-profit-sharing that may resonate with your HR goals. Unlike employee deferrals that must be immediately vested, profit sharing contributions can be subject to a vesting schedule of up to six years. When you pay a bonus directly to a high performer, the money is theirs the second they receive that paycheck. With the retirement plan contribution, that vesting schedule becomes a retention tool, increasing the likelihood of having those individuals remain part of your organization for the long haul.

For full disclosure, if there are any highly compensated employees (HCE) receiving a profit sharing allocation, additional nondiscrimination testing is necessary and it could trigger a requirement to make a minimum level of contribution on behalf of eligible non-HCEs. That said, once the NHCEs have received the minimum required to satisfy testing, you can pick and choose any NHCEs to receive additional contributions.

Could new comparability offer a way to strengthen your retirement plan offering by allowing you to reward your best employees, save on FICA, and build in a retention strategy? Depending on your plan demographics and the desired levels of contributions, this allocation method may very well do just that. While the testing requirements mean that new comparability may not provide absolute flexibility, this type of profit sharing allocation can still be a very powerful tool for creating a dynamic benefit plan and compensation package for your participants.

The best way to know if this option might be a useful tool for your plan is to run projections and preliminary non-discrimination testing to determine the cost-effectiveness. If you'd like to discuss the possibilities of this or other plan designs, reach out to the DWC team to get things rolling. We'd love to dig in and help you find ways to stretch your HR dollars for the best possible benefit to your organization and employees.

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