

Tiered Profit-Sharing Plans

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Many small to mid-size corporations have found additional uses for multiple-tiered (also known as cross-tested or new comparability) profit-sharing plans. If structured properly, and as long as the requirements of IRC Sections 410(b) and 401(a)(4) and the regulations thereunder are satisfied, these plans allow the corporation to place each eligible participant into his or her own "tier," and the corporation would then determine on a year-by-year basis how much is contributed on behalf of each tier or group of tiers. Tiers can be based on compensation, longevity on the job, meritorious service, attaining certain sales and/or managerial goals, etc. These strategies need not be limited to small to mid-size corporations.

For example, company S had two divisions. Division A's sales force was by far the most effective sales force in the company. However, division A's production staff was plagued with missed deadlines, absenteeism on Mondays and Fridays, and higher workers' compensation claims. On the other hand, division B's sales force was lagging, but its production staff was much better in terms of deadlines, reduced absenteeism, and less workers' compensation claims.

Company S's profit-sharing plan allocation formula was changed to a multiple-tiered allocation, and both divisions were notified that profit-sharing allocations would be largely based on amount of sales as well as reductions in adverse behavior by the production staff. Managers and line supervisors of the "competing" divisions were promised and received rewards (larger contributions) based on their contributions to improvements with specific goals and monitoring procedures installed. The employees of the "winning divisions" each year were also given a larger contribution than their counterparts in the other division. The experiment proved successful, and as an added bonus, the contributions the company made did not require additional payroll taxes by the company nor by the employees. This is an important consideration. Depending upon the state in which the corporation is operating, and the type of business involved, payroll taxes and workers' compensation premiums could result in \$0.18 or more for each dollar paid—

especially if the employee earns less than the Social Security taxable wage base. Therefore, giving an employee a \$1,000 bonus may cost the company \$1,180 or more. Similarly, if the employee receives a \$1,000 bonus, the net after taxes may be around \$0.70. Put another way, this bonus arrangement costs the company for the employee to receive \$0.70.

WELCOME CONTRIBUTION

Of course the multiple-tiered allocation approach would not be a complete replacement to a direct bonus, whatever the tax consequences, but for the employees who are (or should be) planning for retirement, it is a welcome contribution, which hopefully would yield years of tax-deferred growth.

For example, if the employee receives a \$1,000 bonus, which after taxes amounts to \$700, it is more likely that the bonus would be spent rather than saved. \$1,000 contributed to the profit-sharing plan for 25 years (compounded at eight percent interest for 25 years) would yield approximately \$73,000.

In another case, corporation A adopted a cross-tested profit-sharing plan with each participant in his or her own tier, with the express purpose of acquiring exceptional personnel for their technical positions. Normally these positions, paying in the \$70,000 to \$85,000 range, would be filled mostly by relatively older and experienced personnel. This provided the company with the opportunity to tailor retirement benefits to each qualified applicant. Whereas its competition would be required to make the same contribution percentage for all their participants, corporation A could develop different profit-sharing benefits, in its sole discretion, to allow for flexibility in hiring. Here again, it is much less costly to the corporation and the participant to have the corporation make these tax-deductible contributions to the profit-sharing plan than to pay the same amount in taxable bonuses.

LONGEVITY COUNTS

Corporation B carried this idea one step further. It was facing a retention problem and wanted to stem the costs of hiring and training replacements for these qualified employees. Under the multiple-tiered approach, certain

participants whom corporation B determined were more valuable were granted higher percentage of pay contributions based on their longevity with the business as well as their overall contributions to the business's success.

Law corporations favor multiple-tiered plans, because they allow the practice the opportunity to reward certain employees more than others based on their performance.

For example, if certain associates are bringing in more business than others, they can be suitably rewarded under the multiple-tiered approach. Similarly, the partners can have contributions allocated to themselves in the same ratio as their stock ownership, contributions to the success of the practice, etc.

In addition, law corporations especially are adopting the multiple-tiered approach but expanding upon it by covering partners and certain other support staff in one plan and adopting a separate profit-sharing plan for the associates and certain other support staff. If structured properly, the "carved-out" participant can be placed in a separate plan that can have a different (in most instances) less costly program and (in many instances) not subject to "top heavy" requirements.

In other instances, the multiple-tiered plan is paired with a 401(k) arrangement. If the profits from the corporation are not sufficient to provide the principals with the ability to have contributed on their behalf the current defined contribution limit of \$44,000, deferrals to a 401(k) plan might allow them to do so. Additionally, if the profit-sharing allocation to any principal only resulted in, for instance, \$35,000, that principal need only defer \$9,000 to reach the limit, as opposed to deferring the

full \$15,000. In too many instances, when the principals defer \$15,000, the rank-and-file do not defer sufficient amounts, and deferrals must be refunded to the principals.

EXAMPLE

Assume corporation C has one principal and 10 non-highly-compensated employees. The principal earns \$220,000 and defers \$15,000 into the 401(k) plan. The deferral percentage for the principal is 6.82 percent. Therefore, the other eligibles must defer, on average, 4.82 percent. However, if the principal needs to defer only \$9,000 to reach the full \$44,000 annual addition, the deferral percentage is reduced to 4.09 percent, so the other eligibles need only defer, on average, 2.05 percent, which is much easier to accomplish.

In another instance, a tax-exempt entity decided to encourage its employees to contribute to their individual 403(b) plans and to reward for longevity. Although its employees were not highly paid, they were very valuable to the employer and provided valuable services to the community. It is very difficult to obtain such dedicated individuals, and, unfortunately, economic pressures do force some of these employees to leave for higher-paying jobs.

The solution was to install a multiple-tiered plan, which allocated the contributions based on the amount each participant contributed to the 403(b) program and the longevity of the participant. For example, if participant A did not contribute to the 403(b) plan and was with the organization for less than five years, the contribution would be 1.5 percent of pay. If the 403(b) contribution for that same individual was five percent of pay, the organization would

"match" \$0.50 on the dollar up to six percent of pay through the separate-tiered allocation program. The percentage amounts of the "match" would be increased based on the rate of contributions to the 403(b) program and longevity. This program has been in effect for several years and has been expanding.

ISSUES TO CONSIDER

Care must be given in designing these programs to the following:

1. The demographics and operations of the company would lend themselves to such a multiple-tiered arrangement.
2. The corporation, in the final analysis, determines the contribution to each tier or group of tiers.
3. The allocations meet the required non-discrimination tests.
4. Any "carve-outs" meet the requirement of IRC Section 401(b) and the regulations thereunder.
5. If the second plan is designed so as not to provide "top heavy" benefits to the participants, there cannot be any key employees covered in the second plan, and, of course, the first plan must meet myriad requirements and testing on its own.

In the past, the profit-sharing plan was seen as the tail to the employer's dog. By utilizing the concepts described above, the multiple-tiered approach may perform other functions to enhance the employer's business. 🌐

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