Matt W. Zeigler
Zeigler & Associates, P.C.
ATTORNEYS AND COUNSELORS AT LAW
Phone: (248) 643-9530 • Fax: (248) 643-0843 • E-Mail: matt@zeiglerlaw.com

AGE-WEIGHTED PROFIT SHARING PLANS

By: Matt W. Zeigler, Esq.

Age-Weighted Profit Sharing Plan? What is it? Sound too good to be true?

An age-weighted profit-sharing plan is a new method of allocating employer contributions to participants in a standard profit sharing plan. Yes, the formula is actually more heavily weighted toward those participants who are older than the rest of the employee workforce. In other words, age is a major factor in determining the allocation among participants of the employer contributions. It acts like a defined benefit plan but does not have annual minimum funding requirements. Instead, the annual discretionary determination of the amount of the contribution to the plan by the Board of Directors of the plan sponsor is all that is necessary to fund the plan. The Board of Directors could make its election to fund the plan or not depending on its own assessment of the corporate goals.

Permitted Age Discrimination? For many years, defined benefit plans have based their monthly benefit projections at normal retirement age, e.g. age 65, on a formula. A typical formula had two elements: 1) the number of years a participant has to work until retirement; and 2) the participant's compensation, using an average of the highest five years of compensation prior to retirement. Since the shorter each participant has to work until the normal retirement age, the higher the employer's contribution must be in order to fund the monthly benefit projected under the plan. Since these benefits and employer contributions are, in fact, a function of the age of a participant, age weighted employer contributions have been a part of the retirement plan menu for a long period of time.

The Positives: In employment situations where there are material age differences between those with the higher incomes and the other employees, an age-weighted formula will significantly benefit the older, more highly compensated employees. The same dollar amount of employer contribution could be made. It is the amount allocated between employees that would be different. See the example below. A further benefit is, that because it is a defined contribution plan, there are no insurance premium payments due to the Pension Benefit Guaranty Corporation. Moreover, as stated, there are no annual minimum funding requirements and no complex mathematical calculations that can only be performed and certified by an actuary.

How Does the Profit Sharing Plan Do This? It is accomplished through the use of the alternate testing method contained in the nondiscrimination regulations under section 401(a)(4). Under those regulations, it is possible to test the contributions made under the defined contribution plan, or profit sharing plan, by using the alternative method of testing those contributions as if it were a defined benefit plan. Although this may sound like a strained reading of the regulations, this method was clearly anticipated by the IRS in the drafting of the regulations and specifically discussed by the drafters of the regulations in professional employee benefits meetings.

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This Is How It Would Work Assume a plan bases the employer contributions on the present value of a benefit equal to, for example, 1% of each participant's compensation. The present value of the benefit is then discounted under a method acceptable to the IRS in the range of 7-1/2% to 8-1/2%. A standard mortality table is selected. The shorter the number of years to retirement (for the older employee), the lesser the number of years of the benefit discount (i.e. less discounted or a larger amount of actual dollars contributed for the older employee); and the longer the number of years to retirement (for the younger employee), the greater the number of years of the benefit discount (i.e. more discounted or a smaller amount of actual dollars contributed for the younger employee). The contribution is then converted to benefits and tested against the general nondiscrimination rule of section 401(a)(4).

Take, for example, the fact that there are two employees in a single plan: Employee A is age 50 and earned $50,000; and Employee B is age 30 and earns $30,000. Suppose the employer desires to make a $12,000 contribution to the profit sharing plan.

Traditional P/S Plan			Age-Weighted P/S Plan		
Employee A:	$ 7,500	15%	Employee A.	$10,739	21%
Employee B:	4,500	15%	Employee B:	1,261	4%
Er. Contrib.	$12,000		Er. Contrib.	$12,000	

In the traditional profit sharing example above, Employee A's share of the employer contribution is 15% of his/her compensation and Employee B is also allocated 15% of compensation. In the age-weighted formula, Employee A receives about 21% of his/her compensation in the employer contribution and Employee B is credited with about 4% of compensation.

The actual allocation of contribution will, in the end, depend upon the ages of participants in subject plan; however, the concept works as demonstrated in the above example.

The Negatives. The Plan with the age-weighted formula will not qualify as a Regional Prototype Plan to be eligible for the smaller user fee of $125. Instead, the $700 user fee for an individually designed plan is applicable. Further, the Internal Revenue Service is not accepting applications for favorable determination letters for them at this time, because the IRS agents are not geared up to review them for favorable qualification status.

The cost to administer this kind of a plan will be much less than a traditional defined benefit plan because it does not require an actuary to perform the services. But the plan still will be more expensive to administer than the traditional profit sharing plan. For this type of plan, the safe harbors as set out in the regulations probably will not work. Further, the participant demographics must be analyzed each year to determine whether or not the contributions made to the plan pass the general nondiscrimination test set forth in the regulations; and if not, the administrator must revisit the plan allocation formula and alter it for that year. Finally, this is not as yet a settled area with the IRS, and further changes may develop.

In Conclusion. The greatest benefit from the corporate adoption of an age-weighted profit sharing plan is that the more mature employee who is older than the balance of the employee complement, can receive a greater share of the plan contributions than would occur with the typical profit sharing plan. Your professional advisors can tell you whether such a plan would work for you and your company.

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