Profit sharing today: plans and provisions

A BLS survey shows that profit-sharing plans today possess a variety of features; rules for determining employer contributions, allocations among employees, and employees' access to funds differ widely among plans.

Edward M. Coates, III

It is stated by some observers as tools for increasing the productivity of workers or for increasing the flexibility of labor markets, profit-sharing plans have attracted much attention in recent years. Other observers have questioned the benefits of these plans, arguing that they expose employees to risk by shifting a portion of the compensation package from relatively stable wages and salaries to payments contingent upon company profits. (See exhibit 1 for a summary of these contrasting views.)

The debate is complicated by the fact that today's plans vary considerably in how they are designed. A plan that distributes profits immediately in cash, for example, may forge a direct link between work performance and compensation. On the other hand, a plan that places profits in relatively inaccessible accounts for employees may function primarily as a long-term retirement and savings vehicle.

Data from the Bureau of Labor Statistics' (BLS) 1989 Employee Benefits Survey show that profit-sharing plans differ in many key features. While 16 percent of all full-time employees in medium and large private establishments—or just over 5 million workers—participated in these plans, it was also true that:

- Most participants were in deferred plans, wherein profits are credited to employees for distribution at retirement or some other future date.
- One percent were in cash plans, in which profits are paid directly to employees as soon as profits are determined.
- Two percent were in plans that combined cash and deferred features. 1 (See table 1.)

Other features may also affect the incentives a profit-sharing plan offers. For example, not all deferred plan participants had to wait until retirement to gain access to their share of profits:

- One in five could borrow money from their accounts.
- One in ten could withdraw funds from their accounts for any purpose.

Plans also differ in many other key features, such as how profits are split between the company and its employees, how the employees' share of profits is allocated to them, how profits are invested in employee accounts, and how long employees must work before earning a nonforfeitable right to their accounts.

This article describes the major features of today's profit-sharing plans, based on data on plan provisions from the BLS 1989 Employee Benefits Survey. This survey provides representative data for 32 million full-time employees in more than 109,000 private industry establishments with 100 or more employees located in the 48 contiguous States. The data are presented for all full-time workers combined and separately for three broad occupational groups: professional and administrative, technical and clerical, and production and service workers.

In the Employee Benefits Survey, profit-sharing plans are defined as arrangements in which companies make contributions, based on profits, to individual employee accounts. To be considered a profit-sharing plan in the survey, a plan must have its level of employer contributions determined primarily by the level of company profits. Similar types of plans, such as savings and

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thrift plans, in which employer contributions were not determined primarily by profit levels, were not considered profit-sharing arrangements in the survey.\(^3\)

**Growth in profit sharing**

Profit sharing as a form of employee compensation has a long history in the United States. America’s first profit-sharing plan was introduced in 1794 at the New Geneva, PA, glass works by Albert Gallatin. The latter, Secretary of the Treasury under Presidents Jefferson and Madison, believed that “the democratic principle on which this nation was founded should not be restricted to the political process, but should be applied to the industrial operation as well.”\(^4\) The glass works plan, like many early plans, was a cash profit-sharing plan.

Even with the success of this first plan, formal profit-sharing arrangements were not prevalent until after the Civil War. This slow growth in profit sharing during the 1800’s can be traced mostly to the way businesses were structured. During the period, most enterprises were family-owned agricultural or small-craft businesses, which, by their nature, shared profits among employees.

After the Civil War, as the American economy became more industrialized, profit sharing began to grow. During this period, several corporations introduced such plans. One of the earliest, in 1887, was at Proctor and Gamble. Following its success, plans were introduced at Sears in 1916 and at Kodak and Johnson’s Wax in 1917.

Many employers in the early 1900’s offered profit sharing as a means of discouraging unionization. These employers believed that sharing profits would unite workers and management in pursuit of the same goal of improving company performance. At the same time, unions maintained a skeptical view of profit sharing. This sentiment was voiced by the American Federation of Labor’s first president, Samuel Gompers, who maintained that employers “pared down wages of their employees,” so that even with profit sharing, the employees’ compensation was below that of other employees in a given industry.\(^5\)

During the stock market boom in the 1920’s, some employers shifted their emphasis from profit sharing to employee stock ownership plans (ESOP’s). Employers felt that by giving the workers ownership in the firm, they would encourage more productive work habits. The stock market crash and the onset of the Great Depression made many of these plans worthless.

The use of profit-sharing plans also declined during the depression. In 1934, the National Industrial Conference Board found that of 134

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### Exhibit 1. Profit sharing: pros and cons

**PROS:**

*Link between profit sharing and productivity.* A recent study by Rutgers University’s Institute of Management and Labor Relations reported that profit-sharing firms were more productive than non-profit-sharing firms in 13 of 15 years from 1971 to 1985.\(^1\)

*Data on profit sharing and wages.* A study by the U.S. Chamber of Commerce reported that workers in profit-sharing firms tended to be compensated as well as or better than those in non-profit-sharing firms. In the manufacturing sector, profit-sharing firms’ wages were equal to those of non-profit-sharing firms. In the non-manufacturing sector, the wages of workers of profit-sharing firms were 60 cents per hour higher than those of workers of non-profit-sharing firms.\(^2\)

**CONS:**

*Difficulty in measuring link between profit sharing and productivity.* It is easy to see the effect profit sharing has on a firm with a single worker, but it is difficult to measure the effect in a large organization. In large firms, the research has been made suspect by the “free rider” problem. A “free rider” is an employee who ignores his or her responsibilities, believing that other workers will pick up the slack. A “free rider” has a negative effect on productivity.

*Employee wage concerns.* Many skeptics of profit sharing fear that firms with profit sharing pay lower wages compared to firms in like industries without profit-sharing plans. Skeptics also doubt that profit sharing makes up the difference.

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See footnotes at end of exhibit.

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Exhibit 1. Continued—Profit sharing: pros and cons

PROS:
Employers enjoy flexibility. Profit sharing is based on company performance; when business is down, the company is not obligated to make any contributions. Profit sharing is also easier to administer and maintain than the more heavily regulated defined benefit pension plans. To allay some employee concerns, sponsoring companies have added provisions to reduce risk to their workers. These provisions have included minimum employer contributions, stated formulas, and immediate cash distributions.

Automakers find profit sharing successful. The auto industry, which was suffering one of its largest downturns in the early 1980’s, employed profit sharing as a means of regaining profitability. When negotiations on new collective bargaining agreements took place, the automakers asked the unions for wage concessions. In exchange for such concessions, the automakers offered profit-sharing plans to their employees. As the auto industry recovered in the mid-1980’s, the benefits from these agreements began to pay off. Not only did auto workers regain lost wages from the previous contracts concessions, but they also received large profit-sharing allocations from automakers. Many of the automakers treated their profit-sharing plans as a means of better employer-employee relations and as a contributing factor in their renewed profitability.

CONS:
Workers fear management control. One fear is that profit sharing allows management too much control over how profits are shared. A second is that by participating in profit sharing, employees are risking a portion of their compensation because the benefit is not guaranteed.

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3 A defined benefit pension plan obligates an employer to provide retirement benefits calculated through the use of a specific formula contained in the plan. Benefits are generally based on salary and/or years of service. Such plans are required to meet more rigid provisions than are profit-sharing plans.

plans surveyed, 57 (42 percent) had been discontinued. In a followup survey in 1937, of 161 plans, 111 (69 percent) had been discontinued.

Renewed growth in profit sharing began around 1939, when there were only 37 qualified deferred profit-sharing plans. By 1944, the number of plans had risen to 2,113. Much of this increase resulted from taxes on excess income imposed during World War II. These taxes discouraged employers from distributing profits for a period of 10 years, making deferred profit sharing a frequent option. After the war, the number of profit-sharing plans, especially deferred plans, continued to grow. (See table 2.) Deferred plans have continued to be the most prevalent form of profit sharing. Recently, the use of profit sharing has been influenced by the introduction of the Employee Retirement Income Security Act and the Internal Revenue Code, section 401(k). Enacted in 1972, the Employee Retirement Income Security Act tightened the standards that must be met for a plan to be considered a "qualified plan." The initial effect of the Act was a reduction in the number of plans introduced. In the early 1980’s, the introduction of Internal Revenue Code section 401(k) led to an increase in the number of deferred profit-sharing plans. The rule provided tax incentives for employees to save money to-
Profit-sharing Plans Today

wards retirement by allowing the employees to defer profit-sharing allocations and, thereby, to defer paying taxes on the income set aside.10

Plan provisions

In the late 1980's, the majority of participants in profit-sharing plans were in deferred plans. In recent years, deferred plans have undergone many innovations in structure and provisions. As a result, the typical profit-sharing plan offered to workers in the 1980's is significantly different from that offered 40 years ago. New provisions, such as deferred savings, shorter vesting requirements, and conditions on withdrawal and loans, have changed the shape of profit-sharing plans. Present-day plans are designed to be flexible vehicles for accumulating savings.

The remainder of this section details some typical provisions of deferred profit-sharing plans offered to today's employees.

Eligibility requirements. A typical profit-sharing plan requires a participant to complete an eligibility period prior to receiving an allocation of profits. The 1989 Employee Benefits Survey showed that nearly all participants in deferred profit-sharing plans had to meet an age and/or service requirement to be eligible to share in profits. Just over half of the participants, while having no age requirements, were required to work for the firm for at least 1 year in order to participate in the plan. One-quarter of participants had to meet both an age requirement of 21 years and a service requirement of 1 year with the firm.

Employer contribution. Employers use a variety of methods to determine the amount of profits they will share with profit-sharing plan participants. Two-fifths of the participants in 1989 were in plans that had no predetermined formula for employer contributions. In most cases, the company board of directors approves a percentage of profits to be set aside for the plan each year. For example, a company with profits of $10 million may set aside 1 percent ($100,000) for a given year's profit-sharing contribution. Such a contribution would only be for that year and is not guaranteed in the future.

The remaining three-fifths of participants were in plans with stated formulas for determining the amount of employer profit sharing. Blue-collar workers were more likely than white-collar workers to participate in a plan with a stated formula, in part due to formal provisions included in collective bargaining agreements. One-tenth of participants in deferred plans had profit sharing based on a fixed percentage of profits. For participants in such plans, the average employer contribution was 9.5 percent of profits in 1989. About 20 percent of participants in deferred plans were in plans with contributions based on a sliding percentage that varied by profits, sales, or return on assets. Finally, one-third of participants were in plans that had other stated formulas based on profits, such as a fixed percent of profits in excess of a reserved amount, a contribution related to dividends paid to stockholders, or a contribution related to pretax profits.

Allocating profits. Employers used several different methods to allocate profit-sharing contributions to employee accounts. Nearly two-thirds of the participants in deferred plans received their allocation based on their earnings compared with the total earnings of all participants in the plan. (See table 3.) For example, an employee making $20,000 per year in a company with an annual payroll of $10 million would receive 0.2 percent of the company’s profit-sharing account. If the company’s profit-sharing contribution was $100,000, then the participant’s share would equal $200.

Several other methods were also used to allocate profits among employees. One in ten participants received their allocation of profits under a points system based on earnings and service. According to this method, a participant typically receives a point for each year of service and a point for each thousand dollars in earnings. The employee’s allocation is determined by the ratio of his or her total points to the total points of all participants. For example, an employee with 20 years of service earning $30,000 would receive 50 points (1 point for each year of service and 1 point for each $1,000 of earnings). If the total points of all the participants is 10,000, then the employee receives 0.5 percent (50 points/10,000

<table>
<thead>
<tr>
<th>Table 1. Percent of full-time employees participating in profit-sharing plans, by type of plan, medium and large firms, 1985-89</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of plan</td>
</tr>
<tr>
<td>------------------------</td>
</tr>
<tr>
<td>Profit sharing</td>
</tr>
<tr>
<td>Immediate cash only</td>
</tr>
<tr>
<td>Deferred benefits only</td>
</tr>
<tr>
<td>Combination</td>
</tr>
</tbody>
</table>

points = 0.005, or 0.5 percent) of the employer contribution.

The remaining one-fourth of participants received their allocation based on either (1) earnings and unit performance, (2) equal shares among all participants, (3) hours paid in relation to total hours paid for all participants, or (4) the contribution required of participants by the plan.

**Investment options.** Once profits are allocated to employees, their accounts are typically invested, sometimes with the employee choosing the investment. Almost two-fifths of participants could choose how to invest their profit sharing accounts. The following investment options, ranked from most to least prevalent, were available: Company stock, a common stock fund, guaranteed investment contracts, fixed-interest securities, and diversified investments.11

Three-fifths of participants did not have a choice in how their deferred profit-sharing accounts were invested. The following investment vehicles, ranked from most to least prevalent, were used: Company stock, diversified investments, a common stock fund, fixed-interest securities, and guaranteed investment contracts.

**Employee contribution.** Typically, plan participants are not required to make contributions to profit-sharing accounts. However, in 1989, one-fifth of profit-sharing plan participants were required to make contributions. The range of required contributions was usually between 2 percent and 10 percent of the employee’s salary. As with the company’s share, in most cases the employee had no choice as to how his or her contributions were invested. A majority of the participants were in plans that called for the employee’s contributions to be invested in company stock.

Nearly one-fourth of participants were allowed to make voluntary contributions to their profit-sharing accounts. These contributions were generally made on a prorata basis, and the employee usually had a choice in how the contributions were invested.12 Voluntary employee contributions generally ranged from 1 percent to 8 percent of salary.

Slightly more than half of the participants who were required to make contributions also received their company allocation based on the amount they contributed. Under such a plan, the employee’s share of profits is determined by the ratio of employee contributions to total participant contributions, multiplied by the amount of the employer contributions. For example, suppose that an employee contributes $1,000 to a profit-sharing plan during a year in which a total of $1 million is contributed by participants. Then the employee would receive $1,000/$1,000,000 = 0.001 = 0.1 percent of the employer’s profit-sharing contribution.

**Vesting schedule.** In most deferred profit-sharing plans, participants are required to be vested before gaining access to their funds. Vesting confers upon the employee the right to receive benefits from the plan in the future. Three different forms of vesting are used in profit-sharing plans: Graduated vesting, cliff vesting, and immediate vesting. Graduated vesting was the most prevalent form of vesting found in the Employee Benefits Survey, covering one-half of the participants. In a graduated vesting schedule, a participant becomes vested in a percentage of the account each year, until fully vested. A typical example is 20-percent vesting each year, with full vesting attained after 5 years.

Under cliff vesting, covering slightly more than 10 percent of participants, the participants gain ownership of their account in full after completing a predetermined period of service—for example, 5 years. If the employee leaves the company or drops out of the plan before completing the required length of service, the employee receives no benefit. Immediate full vesting, covering a little more than a third of participants, gives the participant 100-percent ownership of the account from the beginning of his or her participation.

The Tax Reform Act of 1986 instituted a shortening of vesting periods by 1989. The law now requires that a graduated vesting schedule provide full vesting in 7 or fewer years and that cliff vesting schedules provide full vesting in 5 years.13

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**Table 2. Cumulative growth in the number of qualified profit-sharing plans, 1939-89**

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>1939</td>
<td>97</td>
</tr>
<tr>
<td>1944</td>
<td>2,113</td>
</tr>
<tr>
<td>1949</td>
<td>3,565</td>
</tr>
<tr>
<td>1954</td>
<td>8,242</td>
</tr>
<tr>
<td>1959</td>
<td>20,204</td>
</tr>
<tr>
<td>1964</td>
<td>43,032</td>
</tr>
<tr>
<td>1969</td>
<td>87,219</td>
</tr>
<tr>
<td>1974</td>
<td>186,499</td>
</tr>
<tr>
<td>1979</td>
<td>261,281</td>
</tr>
<tr>
<td>1984</td>
<td>374,684</td>
</tr>
<tr>
<td>1989</td>
<td>442,771</td>
</tr>
</tbody>
</table>

1 Data for 1989 include only the first 9 months.

SOURCE: Profit Sharing Research Foundation and the United States Treasury Department.

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*Present-day profit-sharing plans are designed to be flexible vehicles for accumulating savings.*
**Table 3. Percent of full-time participants with deferred profit-sharing plans, by provisions, medium and large firms, 1989**

<table>
<thead>
<tr>
<th>Item</th>
<th>All participants</th>
<th>Professional and administrative participants</th>
<th>Technical and clerical participants</th>
<th>Production and service participants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Method of determining employer contributions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Based on stated formula</td>
<td>60</td>
<td>56</td>
<td>54</td>
<td>65</td>
</tr>
<tr>
<td>Fixed profit</td>
<td>10</td>
<td>11</td>
<td>9</td>
<td>9</td>
</tr>
<tr>
<td>Sliding percentage on profits, sales, or return on assets</td>
<td>18</td>
<td>12</td>
<td>10</td>
<td>24</td>
</tr>
<tr>
<td>Determined by unit profits</td>
<td>('1)</td>
<td>('1)</td>
<td>('1)</td>
<td>('1)</td>
</tr>
<tr>
<td>Other stated formula</td>
<td>33</td>
<td>35</td>
<td>35</td>
<td>32</td>
</tr>
<tr>
<td>No predetermined formula</td>
<td>40</td>
<td>44</td>
<td>46</td>
<td>35</td>
</tr>
<tr>
<td>Allocation of profits to individual employees</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equally to all participants</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Based on earnings</td>
<td>64</td>
<td>57</td>
<td>71</td>
<td>60</td>
</tr>
<tr>
<td>Based on earnings and service</td>
<td>9</td>
<td>10</td>
<td>8</td>
<td>9</td>
</tr>
<tr>
<td>Based on participants' contributions</td>
<td>9</td>
<td>7</td>
<td>7</td>
<td>11</td>
</tr>
<tr>
<td>Other</td>
<td>17</td>
<td>16</td>
<td>14</td>
<td>18</td>
</tr>
<tr>
<td>Loans from employees' accounts</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Permitted</td>
<td>19</td>
<td>28</td>
<td>28</td>
<td>11</td>
</tr>
<tr>
<td>Not permitted</td>
<td>01</td>
<td>72</td>
<td>72</td>
<td>09</td>
</tr>
</tbody>
</table>

1. Less than 0.5 percent.
2. Includes participants in plans that based allocation on unit performance or on the ratio of employee compensated hours to total compensated hours.

NOTE: Because of rounding, sums of individual items may not equal totals. Where applicable, dash indicates no employees in category.

Withdrawal provisions. Although the main purpose of a deferred profit-sharing plan is to accumulate retirement savings, many plans allow employees access to their accounts. Approximately one-fifth of participants in 1989 were in plans that allowed them to make withdrawals from their accounts. These participants were generally allowed to make withdrawals without suffering any penalties. Plans that did impose penalties usually suspended employer contributions to the employee’s account for a period of time, typically 12 months.

Of those participants allowed to make withdrawals, just over two-thirds had to prove financial hardship to qualify for a withdrawal. Financial hardship generally is considered to cover, among other things, the purchase of a home, educational expenses for an immediate family member, sudden uninsured losses, and expenses related to unexpected illness or death.

Recent Internal Revenue Service regulations have put constraints on employee withdrawals before retirement. These regulations were imposed to encourage plans to be used as savings for retirement. There is a 10-percent penalty, in addition to a current income tax liability, on funds withdrawn from qualified deferred plans if the participant is under the age of 59½ years, does not qualify for hardship withdrawals, or does not meet other strict requirements.14

Loan provisions. To avoid the tax penalty associated with withdrawal of funds, and to give participants another means of access to their money, loan provisions are included in some profit-sharing plans. In 1989, 1 in 5 participants was covered by a plan that allowed loans. (See table 3.) White-collar workers were more likely than blue-collar workers to be in a plan with a loan provision.

Loan provisions allow participants to borrow funds from their profit-sharing accounts prior to retirement, but participants are required to repay the loans with interest. The typical loan is for up to 5 years, except if used to purchase a home, and the interest rate is generally set at current market levels. Normally, the size of the loan is limited to the maximum allowed by the Internal Revenue Service: The entire account if less than $10,000, or the lesser of 50 percent of the account or $50,000.15 If repaid, loans are not subject to any tax for early withdrawal; principal and interest payments are repaid into the participant’s account.

Distribution options. At retirement, participants in deferred profit-sharing plans may have several options for receiving their account balances. The most frequently available option is a single lump-sum payment of the entire balance. Another typical option is installment payments spread equally over a specific period, such as 5 years. A third option is to use the total account balance to purchase a lifetime annuity. Such annuities make payments to the retiree for the rest of his or her life and may continue payments to a survivor.

Conclusion

Today’s profit-sharing plans paint a mixed picture. In 1989, they were long-term vehicles for accumulating savings but had many flexible provisions for giving employees access to their funds. Some plans linked the employee’s remuneration closely to profit levels, while in others, the relationship was less direct.

Developments in profit-sharing plans will be keenly watched by policymakers in the 1990’s. Particularly at issue is whether the plans will move more in the direction of
long-term capital accumulation vehicles or whether the short-term incentives will be emphasized instead. Perhaps the need will be such that profit sharing will continue to evolve along both paths. At this juncture of their evolution, it is still too early to tell.

Footnotes

1 Some plans offering both cash and deferred benefits are Internal Revenue Code section 401(k) cash or deferred arrangements. Such arrangements allow the employees to choose to take a profit-sharing contribution in currently taxable cash or to place the contribution in a tax-deferred account.

2 Data on employer-sponsored benefits in medium and large establishments are available in Employee Benefits in Medium and Large Firms, 1989, Bulletin 2363 (Bureau of Labor Statistics, 1990). The Employee Benefits Survey also provides information on a variety of other benefits, including health insurance, life insurance, and retirement benefits.

3 Savings and thrift plans base employer contributions on the level of contributions made by employees to the plan, rather than on the level of company profits. In a typical savings and thrift plan, the employer matches 50 percent of employee contributions, up to 5 percent of the employee’s salary. For a discussion of such plans, see Michael Bucci, “Contributions to savings and thrift plans,” Monthly Labor Review, November 1990, pp. 28–30.

4 B.L. Metzger, Profit Sharing in Perspective (Chicago, Profit Sharing Research Foundation, 1964), p. 4.


10 For details on the Internal Revenue Code section 401(k), see Revenue Act of 1978, P.L. 95–600.

11 Fixed-interest securities include corporate bonds and treasury securities. Diversified investments are a mix of stocks and bonds. Employees are typically allowed to decide how their account is invested among the several options offered.

12 Voluntary pretax contributions are made through a salary reduction arrangement. Employees agree to defer income, which is placed in their account and not taxed until distributed. Such arrangements are allowed under Internal Revenue Code section 401(k).

