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Retirement Plan Solutions For Your Business

Cross-Testing: The Right Tool for Many Jobs

As the national economy continues its recovery, more and more businesses are beginning to see their financial situations improve to near pre-recession levels. Companies that have not thought about making profit sharing contributions for years are starting to consider their options.

Just as the economy as a whole or the circumstances of a particular company change over time, companies should review their retirement plans to make sure the design changes with them.

Companies that find themselves on solid footing may find themselves thinking of making employer contributions to their retirement plans. Whether the goal is to maximize benefits to the owners, reward employees, reduce tax liability or some combination of all of these, the cross-tested plan design is one worth considering.

Background

Although there are a number of ways a company may choose to divide a profit sharing contribution among the employees, there are three methods that are commonly used.

- **Salary Proportional (a/k/a Pro Rata):** This method divides the contribution based on the proportion that each individual participant's compensation bears to the total compensation of all eligible participants. It results in each person receiving a uniform percentage of his or her pay.
- **Integrated (a/k/a Permitted Disparity):** This method considers that employees whose pay exceeds the taxable wage base do not receive social security benefits on their total compensation and allows those people to receive a larger profit sharing contribution to help equalize the benefit.
- **Cross-Tested (a/k/a New Comparability):** This method allows employees to be divided into groups based on valid business classifications, i.e., owners and employees, and provides different levels of contribution to each group.

The first two methods are relatively straightforward and are considered to be "safe harbor" allocation methods, meaning that they automatically satisfy certain nondiscrimination requirements. However, with ease and safe harbor status often comes limited flexibility.

The cross-tested method, on the other hand, provides a great deal of flexibility but also comes with a few more rules to follow and must undergo additional testing to ensure it complies with the nondiscrimination rules. For companies that are willing to accept a

little more complexity, new comparability plans can be used to meet a number of business goals.

The General Concept

Cross-tested designs generally rely on the time value of money to allow companies to maximize benefits to the owners who may have spent the earlier parts of their careers reinvesting everything into growing the business. Since they are closer to retirement, it takes a larger contribution to fund an equivalent benefit than it does for someone who is just entering the workforce.

A simple example may help to illustrate. A company has two participants in its plan–the owner (age 55) and an employee (age 35)–and it wants to provide a retirement benefit of $100,000 to each one at age 65. Assuming there are no investment gains, the owner would need a contribution of $10,000 per year for 10 years to reach the target benefit, while an annual contribution of $3,333 would get the employee to the goal.

Once you factor in an assumed interest rate, the spread gets even greater. The actual calculations and tests are much more involved, but this is the general concept.

Unlike a defined benefit plan in which the company would have to commit to making those contributions each and every year, in a cross-tested profit sharing plan, the company has the discretion to contribute more or less or nothing at all each year.

The Ground Rules

There are several additional rules that apply to cross-tested plans.

Contribution Groups

As noted above, the plan must define the employee groups that are used to allocate contributions. In the early days of this design, many plans would specify groups based on company ownership, officer status, division, office location, etc. Some often-seen combinations were owners and employees; partners, associates and non-lawyers; doctors, nurses and staff; etc.

More recently it has become common for plans to specify that each participant makes up his or her own group, providing maximum flexibility in making contributions. While a law firm could still decide to contribute the same amount for all non-lawyers, it could decide to contribute more or less for certain employees as long as all of the other testing requirements are met.

Contribution Gateway

To ensure that rank-and-file employees receive enough of a benefit relative to the highly compensated employees or HCEs (generally the owners and those earning more than $115,000 per year), the company must provide a minimum gateway contribution to the non-HCEs. This is kind of like the cover charge to get into the cross-testing club. In other words, it does not guarantee the plan will pass the other nondiscrimination tests.

The amount of the gateway contribution is the lower of 5% of compensation or one-third of the highest percentage allocated to any HCE. For example, if the highest HCE allocation is 9% of pay, the gateway contribution to the non-HCEs is 3%. Once the highest HCE contribution reaches 15%, however, the gateway is capped at 5%.

For 401(k) plans that make a flat 3% of pay contribution to meet the safe harbor rules, that safe harbor contribution actually counts toward the gateway requirement if the

company also decides to make a cross-tested profit sharing contribution. In other words, assuming all other tests are met, it may be possible for the sponsor of a safe harbor 401(k) plan to contribute an additional 6% of pay on behalf of the owners (bringing the total to 9%) without having to contribute anything more for the employees.

Average Benefits Test

This is another nondiscrimination test the plan must pass. Essentially, all of the contributions made on behalf of each employee (in some cases, including 401(k) deferrals) are added together and converted to a benefit at the plan's retirement age using several factors taken from IRS tables. The average benefit of the non-HCEs is then compared to the average benefit of the HCEs to make sure they are within the appropriate range of each other.

Some plans will pass the test giving only the gateway contribution to the employees and providing the maximum to the owners. Other plans will need to provide additional contributions to some or all of their non-HCE participants in order to increase the average benefit to a passing level.

Since this test is based on the demographics of the workforce, the results are likely to change each year depending on the degree to which the demographic composition fluctuates. Using a small medical practice as an example, the addition of a new physician who is much younger than the other doctors and maybe some of the longer-term staff could cause a plan that was once passing with ease to fail.

Another common cause for extreme demographic shifts is when the child of an owner comes to work for the company. Since children are generally attributed their parent's ownership, they will be considered HCEs even though their actual pay might be very low. Companies anticipating such changes should speak to their TPAs ahead of time to determine the impact to the average benefits test and consider any design modifications that might avoid a problem.

Practical Uses for Cross-Testing

We have already discussed using this design as a means of maximizing the benefits for owners or certain key individuals; however, there are other situations when cross-testing can come in handy.

Rewarding Employees

With the improving economy, some companies are also beginning to pay employee bonuses again. But, along with the cost of the bonus itself comes additional payroll taxes. By using a cross-tested plan design, a company could make individualized profit sharing contributions to certain employees without incurring the cost of the payroll taxes.

Not only does this option eliminate the extra payroll cost, it also helps to address increasing concerns of employee retirement readiness that are becoming more prevalent among companies. Recognizing that a bonus is meant to be a reward, and many employees appreciate cash in hand more than a contribution, some companies will split the "bonus" amount, contributing half to the plan and paying out the other half in cash.

Reimbursing Surrender Charges or Market Value Adjustments

From time-to-time when a company removes certain investment options from the menu, that change can trigger a surrender charge to all those invested in the option being eliminated. This most often occurs in conjunction with a change in service providers. Some

companies facing this situation do not want their participants to be harmed as a result of the change and would like to "reimburse" them by contributing to the plan.

The challenge is that these types of charges are usually assessed proportionately based on account balance; however, the money the company deposits as a reimbursement must be allocated as a contribution. Plans that provide for pro rata or integrated allocations would have to allocate the reimbursement accordingly. By amending the plan to provide for a cross-tested allocation with each participant in his or her group, the company could target the contribution to those impacted by the surrender charge.

It might not be possible to make everyone whole, but this option can sometimes get very close. For example, to the extent any HCEs share in the allocation, it could trigger the gateway requirement for all non-HCEs (including those not affected), so it may be necessary to find another way to compensate HCEs. In addition, some people who share in the surrender charge will be former employees, and contributions can only be allocated to those who are participants during the year of the contribution. While not a perfect solution, it can be a step in the right direction.

Conclusion

A well-designed cross-tested plan can be a very effective tool for satisfying a variety of company objectives, but it also comes with a few more moving parts. As a result, it is even more important to work with a knowledgeable TPA or consultant who will ask the right questions to understand your goals and design a plan tailored to meet them.

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