<u>"CROSS-TESTING" IN QUALIFIED PROFIT SHARING PLANS</u>

Updated 1-2009

A) **<u>What is "cross-testing"</u>** (also known as "new comparability")?

1) It is a method of showing that a qualified retirement plan does not discriminate in favor of Highly Compensated Employees (HCEs) by looking at the <u>retirement benefit</u> attributed to this year's contribution instead of looking at the contribution itself.
2) For example, consider a two-employee plan covering the owner of a business and one other employee. Assume we choose to give owners a significantly higher percent contribution than non-owners.

	Highly Compensated Employee	**Non-Highly Compensated Employee**
Annual Pay:	$245,000	$25,000
Age:	55	30
Annual Contribution	$49,000	$1,250
Allocation as a % of Pay	**20%**	**5%**
Assumed Investment Yield	8%	8%
Projected Accumulation at Age 65	$105,787	$18,482
Expressed as a Percent of Today's Pay	43%	74%

This passes the non-discrimination tests because the projected accumulation, <u>relative to today's pay</u>, is actually a higher percent of pay for the lower paid employee than for the owner.

B) **<u>What kind of employer makes the best candidate</u>** for using cross-testing in order to justify additional contributions for the HCEs?

1) Typically, not all the lower paid employees are going to be younger than all the HCEs. So testing gets to be much more difficult; but here are some basic rules of thumb. If an employer meets all three of the following criteria, we can usually justify contributions for the HCEs which are *significantly* larger than under the other traditional methods.
   a) The company has at least 12 to 20 employees eligible for a qualified plan (the more the better --- some cross-tested plans have hundreds of participants).
   b) The average age of the HCEs is at least 8 to 12 years above that of all other eligible employees.
   c) There are no HCEs among the youngest third of all eligible employees.
2) Even if a company is close on items (a), (b), and (c) above, sometimes cross-testing is still worthwhile.
3) Remember that a Highly Compensated Employee (HCE) for a given year is generally defined as one who owns over 5% of the company (including spouses, sons, and daughters of such owners), or made over $105,000 pay in the prior year.