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

Updated for 2025

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

It is a method of demonstrating that a defined contribution plan is not discriminatory in favor of Highly Compensated Employees (HCEs) by analyzing the <u>retirement benefit</u> generated by the annual contributions for the HCEs to the retirement benefit generated by the contributions to the non-HCEs (rather than looking at the contribution itself).

For example, consider a two-employee plan covering the owner of a business and one other employee. Assume we choose to give the owner a significantly higher percent contribution than the non-owner.

	Highly Compensated Employee	**Non-Highly Compensated Employee**
Annual Pay:	$350,000	$25,000
Age:	55	30
Annual Contribution	$70,000	$1,250
Allocation as a % of Pay	**20%**	**5%**
Assumed Investment Yield	8%	8%
Projected Accumulation at Age 65	$151,125	$18,482
Expressed as a Percent of Today's Pay	43%	74%

This passes the nondiscrimination testing 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 higher contributions for the HCEs?

1) Typically, not all the lower paid employees are going to be younger than all the HCEs, which makes passing the testing more difficult. But there are some basic rules of thumb that can be applied. If an employer meets all three of the following criteria, we can usually justify contributions for the HCEs which are *significantly* larger than under other traditional contribution 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), or (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 who earned over $155,000 pay in the prior year.

C) **<u>Gateway test</u>** Cross-tested plans must meet a gateway test. Under the gateway test, the lowest permissible allocation rate for any non-HCE is one-third of the highest allocation rate for any HCE who benefits. However, as long as each non-HCE receives an allocation of at least 5% of compensation, the gateway is deemed satisfied.