Today’s Menu

- What are cross-tested plans?
- History
- Cross-testing “recipe”
- Plan designs
- Other uses
- What works well
- What to avoid
- How to use cross-tested plans with 401(k)s
What are Cross-Tested Plans?

- Plans that don’t fit into IRS pre-approved designs
- Or...a group of non-identical plans
- Show nondiscrimination by converting contributions into benefits (**cross**) and testing the benefits (**testing!**)
History of Cross-Testing

- IRC §401(a)(4): “if the benefits or contributions provided under the plan do not discriminate in favor of highly compensated employees...” [18 words]
- Revenue Ruling 81-202: “comparability” of plans
- §410(b) & §401(a)(4) regulations early 1990s [200+ pages]
- “New Comparability” (class allocation) based on new regs.
- Threats to outlaw cross-testing during 1990s
- Gateways effective 2002
- Now, even prototypes include class allocation option
Cross-Testing Recipe

- Quick “recipe” for defined contribution (DC) plans
  - Check the gateways:
    - Broadly available allocation rates (not used often)
    - Gradual age or service schedule (sometimes)
    - Minimum allocation rate: 5% or 1/3 highest HCE (used often)
  - Accumulate the contribution at 8½% interest to testing age (65)
  - Divide by an annuity factor (we’ll use 10) to get an annual benefit
  - Divide the result by pay to get a benefit **accrual rate**
  - A **rate group** includes an HCE & everyone with a higher accrual rate
  - Test each rate group to see if it passes the §410(b) coverage test
    - 70% ratio percentage test, or
    - Average benefit test
Cross-Tested Plan Designs

- Common designs include:
  - Age-weighted: guaranteed to pass
  - Service-weighted
  - Class allocation (aka “new comparability”)
  - DB/DC, usually cash balance & profit sharing
  - Examples for Dr. F & his faithful servants...
## Cross-Tested Plan Designs

- **Age-weighted profit sharing plan**
  - Always passes §401(a)(4) test, but not very flexible
  - Gateway is gradual age or service schedule
  - One rate group covers HCE (Dr. F) & all NHCEs, ratio % = 100%

<table>
<thead>
<tr>
<th>Age</th>
<th>Service</th>
<th>Pay</th>
<th>PS %</th>
<th>PS $</th>
<th>Benefit Accrual Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Frankenstein</td>
<td>60</td>
<td>40</td>
<td>$255,000</td>
<td>20%</td>
<td>$51,000</td>
</tr>
<tr>
<td>Igor</td>
<td>40</td>
<td>10</td>
<td>50,000</td>
<td>3.91%</td>
<td>1,955</td>
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<tr>
<td>Olga</td>
<td>30</td>
<td>5</td>
<td>30,000</td>
<td>3%*</td>
<td>900</td>
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</table>

* Age-weighted formula produces 1.73%, but 3% top-heavy minimum applies.
Cross-Tested Plan Designs

- Service-weighted profit sharing plan
  - Rewards loyalty, not very common
  - PS in this example is $\frac{1}{2}\%$ of pay per year of service
  - Gateway is gradual age or service schedule
  - One rate group covers HCE (Dr. F) & all NHCE’s, ratio %=100%

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</tr>
<tr>
<td>Igor</td>
<td>40</td>
<td>10</td>
<td>50,000</td>
<td>5%</td>
<td>2,500</td>
</tr>
<tr>
<td>Olga</td>
<td>30</td>
<td>5</td>
<td>30,000</td>
<td>3%*</td>
<td>900</td>
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* Service-weighted formula produces 2.5%, but 3% top-heavy minimum applies.
Cross-Tested Plan Designs

- Class allocation (aka “new comparability”) profit sharing
  - Very common, even prototype documents include this option
  - Gateway is minimum allocation 5% or \( \frac{1}{3} \) of highest HCE rate
  - One rate group covers HCE (Dr. F) & all NHCE’s, ratio \%=100\%

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<th>PS %</th>
<th>PS $</th>
<th>Benefit Accrual Rate</th>
</tr>
</thead>
<tbody>
<tr>
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<td>60</td>
<td>40</td>
<td>$255,000</td>
<td>20%</td>
<td>$51,000</td>
</tr>
<tr>
<td>Igor</td>
<td>40</td>
<td>10</td>
<td>50,000</td>
<td>5%</td>
<td>2,500</td>
</tr>
<tr>
<td>Olga</td>
<td>30</td>
<td>5</td>
<td>30,000</td>
<td>5%</td>
<td>1,500</td>
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**Cross-Tested Plan Designs**

- **DB/DC combo: cash balance & profit sharing**
  - Common for professional firms
  - Enables large deductible contributions for owners
  - Gateway here is 7½% DC; Igor & Olga get 3% cash balance credits
  - This example is for a PBGC-covered plan, Frankenstein Mfg. Inc.
    - A PBGC-exempt professional firm may need to limit DC ER contrs. to 6%

<table>
<thead>
<tr>
<th></th>
<th>Age</th>
<th>Pay</th>
<th>Cash Balance Credit</th>
<th>PS &amp; 3% Safe Harbor</th>
<th>401(k) &amp; Catchup</th>
<th>Total</th>
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</thead>
<tbody>
<tr>
<td>Dr. F’stein</td>
<td>60</td>
<td>$255,000</td>
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<td>5,250+401k</td>
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<tr>
<td>Olga</td>
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<td>30,000</td>
<td>900</td>
<td>2,250</td>
<td>whatever</td>
<td>3,150+401k</td>
</tr>
</tbody>
</table>
Other Uses for Cross-Testing

- Case study: parent & acquisitions, 25,000 total ees

- Combine all the plans and test on a benefits basis
- Can apply this for any group of non-identical plans
Cross-Testing—What Works, What to Avoid

- What works great
  - Profit sharing/cash balance combination
    - PS projected at 8½% interest
    - Cash balance at interest crediting rate (usually much lower)
    - Better results than pure DB or pure DC
    - Effect is known as

TURBO charging!
## Cross-Testing—What Works, What to Avoid

### What works great
- **401(k) 3% safe harbor**
- **You get a triple dip**
  - Free pass for ADP & ACP tests
  - Covers DC top-heavy requirement
  - Counts for cross-testing base & gateway
- **A few issues**
  - Notice required >30 days before plan year starts
  - 100% vesting
  - Can’t impute “permitted disparity” (FICA recognition) for testing
- **Add profit sharing, if needed to meet gateway**
Cross-Testing—What Works, What to Avoid

- What to avoid
  - Unfavorable demographics
    - HCEs younger than others
    - Usually a solution, but it’s tricky
  - Inflexible plan designs
    - Contribution rates specified in plan document
    - Even prototypes now all each participant in own class
Cross-Testing—What Works, What to Avoid

- What to avoid
  - Failing the §401(a)(4) test!
  - Causes
    - Demographic changes, especially new young HCEs
    - Inflexible plan designs
  - Prevention
    - Test before contributing
    - Flexible plan designs
  - Cure
    - §1.401(a)(4)-11(g) corrective amendment
    - Can provide extra contributions for a targeted group of NHCEs
    - Must be done within 9½ months after end of year
Cross-Testing—What Works, What to Avoid

What to avoid
- 401(k) matching contributions (even safe harbor)
- Really?
- Deferrals & match don’t count for 1st stage of §401(a)(4) test
- You can still match, but it’s an extra expense
- What can you do?
  - Convert match to 3% safe harbor, with advance notice
  - Add profit sharing for gateway & cross-testing base
Using Cross-Tested Plans with 401(k)’s

- Get top people within deferral range of §415 DC maximum
  - In 2013, that’s $51,000-$17,500 = $33,500 (13.14% of pay)
- Cover the gateway for NHCEs
  - If HCE’s are at 13.14%, NHCEs need to be at ⅓ of that: 4.38%
- Use 3% non-matching safe harbor
  - That leaves only 1.38% needed for NHCE profit sharing
  - Frees HCEs to maximize 401(k) deferrals
Take-Out Menu

- Cross-testing is the most powerful testing tool there is!
- It’s simpler than you may have thought
- You can structure plans to fit business needs
- It makes some amazing plan designs possible