

### What is a cross-tested plan?

A cross-tested plan is a defined contribution plan that uses a certain testing method to show that the plan does not discriminate in favor of highly compensated employees. In order to be entitled to favorable tax treatment, a qualified retirement plan cannot discriminate in favor of highly compensated employees (HCEs). An individual is generally a highly compensated employee for a particular year if the individual earned over a certain dollar amount in the preceding year (e.g., \$120,000 in 2017) or was a "more than 5% owner" in the current or prior year.

In a defined contribution plan, providing an allocation for a year based on a uniform percentage of all participants' compensation is not discriminatory in favor of HCEs. Likewise, a defined benefit plan that provides a promised benefit at retirement that is based on a uniform percentage of compensation is also not discriminatory.

Cross-testing is the term used to describe a technique where an allocation in a defined contribution plan for a year is converted to a projected benefit at retirement. Then, the projected retirement benefits for all participants in the plan are tested to ensure that the plan does not discriminate in favor of HCEs. If all the projected benefits at retirement are a uniform percentage of compensation for all participants, then the plan is not discriminatory. Even if the projected Benefits are not a uniform percentage of compensation for all participants, a plan may still be considered nondiscriminatory depending on the level of benefits provided to the non-highly compensated employees.

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### What is the advantage of a cross-tested plan?

The advantage of cross-testing a plan to demonstrate that allocations under the plan are not discriminatory is that it permits substantially larger contributions to be made for older participants than for the younger participants. In some situations, the employer might be able to make a 20% contribution for the HCEs and only a 5% contribution for all other employees.

The reason for this difference can be explained by a simple example. Suppose a company has two employees who each earn \$50,000. One is age 60 and the other is age 30. If a uniform percentage of compensation is to be allocated under the plan, then each individual will receive the same contribution. But, if the goal is to ensure that the contribution each individual receives will provide the same projected benefit at normal retirement age (generally age 65), then a larger contribution must be made for the 60-year-old employee than for the 30-year-old employee. This is because the older employee has fewer years for the contribution to accumulate before the employee reaches age 65 (i.e., there will only be 5 years for the contribution to accumulate earnings).

The contribution for the younger employee will accumulate earnings for 35 years, thus a smaller current contribution needs to be made. When the contributions are "cross-tested" or converted to a projected retirement benefit, each individual will have the same projected benefit at age 65.

### What types of defined contribution plans may use crosstesting?

A profit sharing or a money purchase plan may be designed to use cross-testing. However, in most cases, a profit sharing plan is used because contributions are not required to be made each year. In a money purchase plan, a contribution is required to be made each year.

### May a 401(k) plan use cross-testing?

Yes. A 401(k) plan is a profit sharing plan that permits pre-tax and/or Roth employee contributions. Cross-testing can be used to demonstrate that any profit sharing contribution made to a 401 (k) plan is nondiscriminatory.

### **Must an employer make a contribution to a cross-tested plan every year?**

A cross-tested money purchase pension plan would have a fixed contribution requirement. However, contributions to a cross-tested profit sharing plan are discretionary.

### **If cross-testing is used, is there a minimum level of contributions that must be made?**

If a contribution is made for HCEs in a plan year, then certain minimum contributions may need to be made for the other participants. Generally, the non-highly compensated employees must receive an allocation for the year equal to the lesser of (1) 5% of compensation, or (2) 1/3 of the highest contribution rate provided to any HCE.

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### **If a cross-tested plan is tested like a defined benefit plan, why not just establish a defined benefit plan?**

An employer that wants to design a plan that favors older employees could establish a defined benefit pension plan. One of the key advantages of a defined benefit plan is that the contributions made to the plan may be significantly higher than the contributions that may be made to a defined contribution plan. However, there are certain disadvantages of establishing a defined benefit plan. Defined benefit plans have a funding requirement that must generally be made each year. This contribution fluctuates based on employee demographics and the investment performance of the assets in the plan. In addition, the annual operating cost may exceed the cost of maintaining a defined contribution plan. In many cases, an actuary must be retained and insurance premiums must be paid to insure the benefits promised under the plan.

A defined contribution plan is also more easily understood by participants. The separate accounting feature allows participants to see the immediate value of their benefits under the plan. In addition, a defined contribution plan can be designed to allow participants to exercise control over how their account is invested, which will ultimately affect their retirement benefit.

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### **How is a cross-tested plan designed?**

Generally, a cross-tested plan is designed by dividing the employees into two or more groups (e.g., highly compensated employees and non-highly compensated employees). The employer is then permitted to make a separate contribution with respect to each group.

### **How is the contribution allocated within the separate groups?**

Although the rules do not specify a method for allocation, generally, the plan allocates the contribution uniformly among employees within each group. In other words, the employer will make a contribution to a group and then allocate it proportionately based on the compensation of all participants in that group. The separate contribution made for each of the other groups is allocated in the same manner (i.e., based on the compensation of all participants in the group).



## Do the cross-testing rules impose a limit on the number of groups that can be established in a cross-tested plan?

No, Generally, an employer will place the employees that it wants to receive the highest allocations in one group (e.g., Highly compensated employees) and the other employees in the other group (non-highly compensated employees,). However, the employer may want to benefit certain classifications of employees differently. In such a case, the employer would establish another group by specifying characteristics that are unique to that group of employees (e.g. Highly compensated employees who are owners, highly compensated employees who are not owners, paralegals, etc.). Although the cross-testing rules do not impose any requirements for defining groups, the employer may not use criteria such as race, religion, or gender.

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## How is the contribution for each group determined?

The process begins by determining the contribution that is desired to be made for a specific group, typically the owner or other HCEs. For Example, the maximum allocation that may be made to an individual in 2017 is generally \$54,000. If this is the contribution that is desired to be made to the HCEs for the year, then the amount to be contributed for the other participants is the amount necessary to satisfy the nondiscrimination test.

## If a contribution amount passes the test in one year, will the same contribution pass the test in the subsequent year?

Not necessarily. Because of the employee attrition, new hires and the fact that employees grow older each year, a contribution that passed the nondiscrimination test in one year might not satisfy the test in the subsequent year. Therefore, the proposed contribution for each year must be tested in order to determine whether it would pass the test.



## Are cross-tested plans subject to any other special rules?

No. Generally, the same rules that apply to any other defined contribution plan apply to a plan using cross-testing. Thus, the same reporting and disclosure requirements apply. In addition, the same rules regarding deductions, eligibility, vesting, distributions and maximum allocations for a year apply.

## In a cross-tested plan, must the HCEs be older than all of the non-highly compensated employees in order for the plan design to work?

No. Although a cross-tested plan is age sensitive, a cross-tested plan may still be viable even though some of the non-highly compensated employees are older than some of the HCEs. The best way to determine the economics of a plan contribution is to test a hypothetical contribution.

## What is an age-weighted (or, age-based) plan?

An age-weighted plan is a cross-tested plan where the allocations under the plan are designed to result in projected benefits that are a uniform percentage of compensation for all participants. As stated earlier, if the projected benefit at normal retirement age for all participants is a uniform percentage of compensation, then the plan is not discriminatory.

### **What are the disadvantages of an age-weighted plan compared to a plan that uses the general cross-testing rules?**

An age-weighted plan is completely age-sensitive meaning that the contribution for each participant is directly tied to the participant's age. For example, an employer may have two HCEs earning the same compensation. However, if the two employees are of different ages, each will receive a different contribution for the year. If the general cross-testing rules are used, it may be possible to design the plan so that each of the HCEs receives the same dollar contribution (or same percentage of compensation). Also, in an age-weighted plan, an older non-highly compensated employee will make the plan less advantageous for the HCEs. If the general cross-testing rules are used, it is possible that an older non-highly compensated employee might not negatively affect the plan design for the HCEs.

### **Can an existing profit sharing plan be amended to take advantage of cross-testing?**

Yes. However, there are rules that may impact whether an amendment can be made during a current year or whether the amendment must be made effective with respect to the following plan year.

### **In what circumstances, might a cross-tested plan be advantageous?**

If the goal is to maximize contributions for HCEs and minimize contributions for all other employees, then cross-testing should be considered. In particular, cross-testing should be considered when there is a large age difference (e.g., 10 years) between the HCEs and the non-highly compensated employees.

### **If cross-testing is used, may a plan provide contributions for a participant who works beyond normal retirement age?**

Yes.



**Do you have more questions about cross-tested plans that weren't answered here?**

**Let us know!**