



CROSS-TESTED 401(K) PLANS: THE SMALL FIRM EDGE

A CROSS-TESTED 401(K) PLAN TAKES FULL ADVANTAGE OF THE FLEXIBILITY NOW ALLOWED IN THE ALLOCATION OF A COMPANY'S PROFIT SHARING CONTRIBUTION AMONG PLAN PARTICIPANTS. UNLIKE MANY LARGER COMPANIES, SMALL TO MID-SIZE COMPANIES HAVE THE ABILITY TO TAKE FULL ADVANTAGE OF THIS FLEXIBILITY TO TARGET THEIR PROFIT SHARING CONTRIBUTION TO MAXIMIZE THE BENEFIT FOR THE COMPANY OWNERS OR OTHER KEY PERSONNEL.

When designed properly, your 401(k) can provide a benefit not only to your employees but to company owners and targeted groups as well. If you are currently making a traditional profit sharing contribution to your 401(k), you know that your ability to strategically target those contributions is fairly limited. Traditional pro-rata profit sharing contributions enable you to allocate your contribution as a percentage of compensation, but that percentage must be the same for all participants. Traditional integrated or age-weighted profit sharing contributions provide you some additional flexibility, but the allocation is ultimately based on age, which may or may not meet your needs. A cross-tested profit sharing contribution, in contrast, can mimic these types of allocation formulas, but can also provide additional flexibility as well. If you would like to make more targeted contributions either to the owners, key personnel, or other groups, a cross-tested design may be your answer.

What can a cross-tested plan design do for you? Most important, it allows you to specify different allocation percentages to different pre-defined groups of participants. Those groups may be determined by a variety of criteria including salary, service, position, ownership, or any combination of these categories. You may even choose to specify that each employee represents their own group for ultimate flexibility in the allocation of your profit sharing contribution. Depending on your company's demographics, the owners or other targeted group may be able to receive a much larger allocation as a percentage of pay than other plan participants. In some circumstances, the owner or other targeted group may receive as much as \$45,000 per participant into the plan on an annual basis. For many companies, but especially for small-business owners, the flexibility to target company contributions can be a powerful strategic benefit, potentially saving thousands in corporate and personal taxes.


Target Your Employer Contributions

How does it work?

Unlike a traditional profit sharing contribution that uses a fixed allocation formula, a cross-tested contribution allows you to separate company employees into different allocation groups and to specify a different allocation percentage to each group. The allocation must pass discrimination testing that compares the benefit received by your Highly Compensated Employees (HCEs) relative to the benefit received by your Non-Highly Compensated Employees (NHCEs). These tests, however, are based on projected benefits at retirement for a given participant rather than reviewing the contributions allocated to a participant's account each year. Since the projected benefit of \$1 to a 25 year old is much greater than the projected benefit of that same \$1 to a 55 year old, the use of projected benefits enables you to provide different allocation percentages to different groups and still qualify as non-discriminatory.

While a cross-tested plan will always provide more flexibility than a traditional profit sharing plan, the flexibility is greatest if the targeted group is, on average, older than most of the other employees. Since the owners of the company are often older than their average employee, this design often works particularly well if the owners are attempting to minimize their own taxable income while providing a deduction for the business.

Share with your Employees -- not with the IRS

 If they're lucky, the owners of a small business find themselves with a small problem at the end of the year -- profits. While profits mean cash, profits also mean taxes. For most small business owners, considerable effort is undertaken to minimize how much of their cash needs to be shared with Uncle Sam. A cross-tested profit sharing contribution to your company's 401(k) plan can help.

The company in Table 1 has the "problem" of having \$52,000 in cash at year-end. For some owners, this means that they must declare additional salary. Since company owners pay both sides (corporate and personal) of the payroll tax (typically 15.3%), the income received by the owner would be reduced from \$52,000 to \$44,044. This income would then be subject to the owner's personal income tax. Assuming a 30% tax bracket, the owner's personal income tax liability would be \$13,213, leaving him with only \$30,830 of the original \$52,000. If the owner is able to take the cash as an S-Corp distribution rather than as salary, he could by-pass the payroll taxes, but would still need to declare an additional \$52,000 as earned income. At his 30% tax bracket, he would have to pay taxes of \$15,600, leaving him with only \$36,400.

There is another choice. Rather than share the profits with the IRS, the owner can choose to share the profits with his employees. With the right plan design, not only are the employees better off, but the owners are as well. If the profits were allocated using a traditional pro rata profit sharing contribution, each employee, including the owner, would receive 16% of the money. With a cross-tested design, however, the owner can target the contribution much more effectively, retaining 87% of the \$52,000 profit sharing contribution in his own 401(k) account. Not only has the owner avoided taxable income for this year, but the company has realized a \$52,000 tax deduction. If the 5% profit sharing contribution made to his employees is made in lieu of year-end bonuses, the owner has saved even more money.

Table 1: Targeting Your Contribution for the Owners

OWNER/EMPLOYEE	AGE	SALARY	TRADITIONAL PROFIT SHARING ALLOCATION	% OF SALARY	CROSS-TESTED PROFIT SHARING ALLOCATION	% OF SALARY
Owner	60	\$180,000	\$28,800	16%	\$45,000	25%
Employee	33	\$33,000	\$5,280	16%	\$1,650	5%
Employee	34	\$31,000	\$4,960	16%	\$1,550	5%
Employee	54	\$29,000	\$4,640	16%	\$1,450	5%
Employee	42	\$23,000	\$3,680	16%	\$1,150	5%
Employee	43	\$24,000	\$3,840	16%	\$1,200	5%
Totals		\$320,000	\$51,200		\$52,000	
<i>Owner's % of Allocation</i>			<i>56%</i>			<i>87%</i>

Be Strategic with Compensation

What else can you do with a cross-tested 401(k) plan? While cross-tested 401(k) plans are most frequently used to provide additional benefits to the owners or to other highly compensated employees, this plan design can also be useful to companies that are trying to provide different compensation packages for different groups among their non-highly compensated employees. One irony of the law is that companies can discriminate as much as they want among their non-highly compensated employees. If you, like many employers, are looking for ways to motivate select groups within your organization, a cross-tested profit sharing plan may work particularly well for you. By carefully designating employee groups among your non-highly compensated employees, you can provide the benefit to each group that makes the most sense for your business and for your budget.

In Table 2, the company has three different groups of employees. This company finds it particularly difficult to attract and retain qualified managers. As a result, they have set up their plan so that they can offer a particularly lucrative compensation package to those hard-to-get managers. This can be a particularly effective method of providing additional compensation to these employees because, not only is this contribution **NOT** subject to payroll taxes, but it **CAN** be subject to a vesting schedule. So if the employee does leave you before becoming fully vested, they don't take all of the money with them!

Table 2: Targeting Your Contribution for Select Groups

EMPLOYEE	GROUP	AGE	SALARY	CROSS-TESTED PROFIT SHARING ALLOCATION	% OF SALARY
Manager	1	45	\$75,000	\$7,500	10%
Manager	1	60	\$80,000	\$8,000	10%
Office Staff	2	45	\$45,000	\$1,350	3%
Office Staff	2	34	\$50,000	\$1,500	3%
Office Staff	2	54	\$47,000	\$1,410	3%
Line Worker	3	42	\$23,000	\$230	1%
Line Worker	3	43	\$24,000	\$240	1%
Line Worker	3	26	\$25,000	\$250	1%

* If highly compensated employees receive any benefits, your ability to allocate different amounts among your non-highly compensated employees will be more limited.



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