

# New Comparability Profit Sharing

Many retirement plans are designed to allow the employer to make an annual profit sharing contribution. Certain regulations allow profit sharing contributions to be “discretionary,” meaning the employer has the flexibility to decide whether or not to make a profit sharing contribution each year, and if so, how much to contribute. These regulations also allow a variety of methods for employers to use when determining how much of the total profit sharing contribution will be assigned to each employee.

The new comparability method offers employers the greatest flexibility and opportunity to assign a greater portion of the total annual profit sharing contribution to certain groups of employees, like owners or highly compensated employees (HCEs).

## Is the new comparability method right for your business?

The answer to that question depends upon the demographics of your workforce.

- **Age gap:** The age of the targeted group should be higher than the other employees—10–15 years is most beneficial.
- **Compensation gap:** The compensation of the targeted group should be higher than the other employees (usually non-highly compensated employees (NHCEs))—the higher the better.
- **Employee family members:** Family members working at the company can have a negative impact on the effectiveness of using the new comparability method.

## EXAMPLES OF IDEAL BUSINESS STRUCTURES

### HCEs

1–2 older physicians

### NHCEs

- 8–10 younger nurses
- Building maintenance staff



### HCEs

1–2 older dentists

### NHCEs

- 8–10 younger hygienists
- 3–5 technicians
- Building maintenance staff



### HCEs

1–2 older attorneys

### NHCEs

- 8–10 younger paralegals
- Building maintenance staff



## How can you ensure the success of this method?

The effectiveness of using the new comparability method can fluctuate from year to year due to changes in employee demographics. Separating employees into proper groups is also essential for a successful new comparability profit sharing plan.

Careful consideration should be given to setting up the allocation groups. This might be as simple as setting up two allocation groups such as HCEs and NHCEs, or multiple groups such as owners, non-owner managers, and other employees. The definition of each group must be spelled out in the plan document.

## What are the technical details?

1. There is a special required contribution, called a **gateway minimum**, for the non-targeted group.

A gateway minimum protects the non-targeted employees from receiving too small a contribution in comparison to the targeted group. The gateway minimum contribution is the lesser of:

- Five percent of compensation for a non-targeted group member, or
- One-third of the highest percentage contribution allocated to any HCE.

For example, if the highest HCE allocation percentage is less than 15 percent, the minimum gateway allocation for NHCEs will be one-third of the HCEs allocated percentage. If the allocation rate is 15 percent or higher, the gateway minimum will be five percent of the NHCE's compensation.

| Highest HCE contribution | Gateway minimum |
|--------------------------|-----------------|
| 6%                       | 2%              |
| 9%                       | 3%              |
| 12%                      | 4%              |
| 15%                      | 5%              |
| 18%                      | 5%              |

Since all employer contributions except match will count toward the minimum gateway, a popular plan design is a safe harbor 401(k) with a 3 percent nonelective contribution. The safe harbor 3 percent nonelective contribution would help satisfy the gateway contribution.

2. New comparability plans require a more complicated test, called the **general test**, to prove contributions favor a targeted group within certain limits.

The general test uses **cross-testing** to determine if the allocation of profit sharing contributions falls within nondiscriminatory limits. The test involves taking dollars contributed today, projecting what they would be worth at retirement, and then converting that value to a lifetime annual income amount.

For the profit sharing contributions to be considered nondiscriminatory, the projections, rather than the actual dollars contributed, are compared. This comparison is done by dividing employees into groups called **rate groups** based on each HCE's equivalent benefit accrual rate (EBAR). If each rate group passes a cross test, the allocations of profit sharing contributions are considered nondiscriminatory.

## What would an example look like?

Take Jennifer's dental practice as an example. Jennifer only employs one individual—Mark, a hygienist.

Jennifer wants to make a profit sharing contribution of \$55,000 for herself, which is 20 percent of her income.

### First: Gateway minimum

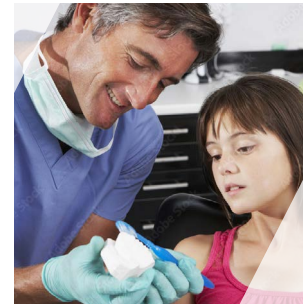
Under the typical profit sharing plan, Jennifer would also have to make a \$10,000 contribution for Mark since that is 20 percent of his income. But if Jennifer had a new comparability plan with an HCE group and NHCE group, she only has to give Mark a contribution up to the minimum gateway, or \$2,500 (the lesser of 5 percent of the HCEs allocation or one-third of 20 percent) since that is the 5 percent gateway minimum (5 percent is lower than one-third of 20 percent).

### Second: Cross test

After satisfying the gateway minimum, the contribution must also pass nondiscrimination testing. Under the cross-testing method, Jennifer's \$55,000 contribution would provide an annual income at retirement\* of \$14,410. This is 5.24 percent of her income. For Mark, his \$2,500 contribution would provide an annual income at retirement\* of \$2,625. This is 5.25 percent of his income. Since Mark's income replacement value (5.25 percent) is higher than Jennifer's (5.24 percent), the allocations pass the cross test.



**Jennifer, dentist**  
**Age: 56**  
**Income: \$275,000**



**Mark, hygienist**  
**Age: 39**  
**Income: \$50,000**

## What happens if you fail nondiscrimination testing?

It is unlikely that a new comparability plan fails nondiscrimination testing. Instead, what usually happens is the employer has a desired contribution that, when tested, does not pass testing. When this happens, the employer has four options:



1. Lower the contribution for the targeted group.



3. Allocate the same amount to all of the groups.



2. Increase the allocation for the non-targeted group.



4. Choose not to make a profit sharing contribution.

**NOTE:** If you plan on establishing a 401(k) for the prior year and want to make an employer contribution, you are only permitted to make a profit sharing or safe harbor 4 percent nonelective contribution. In the current plan year, the employer and employees would be able to make contributions to the plan.

\* Annual income at retirement assumes retiring at age 65 and an interest rate of 8.50 percent.



## Additional profit sharing options

In addition to new comparability, there are three other methods to allocate profit sharing contributions to a 401(k) plan.

**Salary ratio:** Participants receive the same percentage of pay or a dollar amount which is divided among the employees based on the ratio of an employee's pay to total pay of all employees in the plan (also known as pro-rata).


**Integrated:** Participants whose pay exceeds the Social Security taxable wage base receive higher contributions to compensate for lack of salary representation in their expected Social Security benefits.

**Age weighted:** Participants receive a profit sharing contribution based on age and compensation, with older participants getting a higher percentage. The age weighted method typically has an associated cost to the employer.

Profit sharing can be an effective way to reach your employer contribution limit as a business owner, but the method that fits your plan, your business, and your financial situation can require some consideration. Speak with your financial advisor to learn more about whether new comparability makes sense for you.

---

## Contact us to learn more.

 800-345-6363

 [ascensus.com](https://ascensus.com)

Ascensus, LLC provides administrative and recordkeeping services. It is not a broker-dealer or an investment advisor and does not provide tax, legal, or accounting services. Ascensus® and the Ascensus logo are registered trademarks of Ascensus, LLC. Copyright ©2024 Ascensus, LLC. All Rights Reserved. 1914494-RET-1914495 (10/2024)

For plan sponsor use only. Not for distribution to plan participants or the public.