# New Comparability Profit Sharing

Many retirement plans are designed to allow the employer to make a profit sharing contribution each year. 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 determining what portion of the contribution goes to each employee.

The new comparability method allows different groups of employees to receive different contribution levels. This method offers the greatest flexibility and opportunity to target profit sharing contributions for a specific group of employees, like owners or senior 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 best.
- **Compensation gap:** The compensation of the targeted group should be higher than the other employees. The higher the better.
- **Employee family members:** Family members working at the company can have a negative impact on the new comparability's success.

### EXAMPLES OF IDEAL BUSINESS STRUCTURES:

**HCEs**

1-2 older physicians

**NHCEs**

- 8–10 young nurses
- Building maintenance staff

**HCEs**

1-2 older dentists

**NHCEs**

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

**HCEs**

1-2 older attorneys

**NHCEs**

- 8–10 young paralegals
- Building maintenance staff

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

Keeping the right employee mix is key to the ongoing success of a new comparability plan. Since it is normal for the employee mix to change from year to year, the effectiveness of the new comparability method can fluctuate from year to year. Separating employees into proper groups is also essential for a successful new comparability plan.

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

## What are the technical details?

1. There is a special minimum 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 lower of the following:

   - Five percent of compensation
   - One-third of the highest percentage contribution allocated to any HCE

   For example, if the highest HCE contribution percentage is less than 15%, the gateway minimum will be one-third. If the percentage is 15% or higher, the gateway minimum will be 5%.

| 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 gateway, a popular plan design is a safe harbor 401(k) with a 3% employer contribution. The 3% safe harbor contribution would help satisfy the gateway contribution.

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

   The general test uses **cross-testing** to show that the new comparability plan does not discriminate. 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 plan to be 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 the each HCE's equivalent benefit accrual rate (EBAR). If each rate group passes a cross test, the contributions are nondiscriminatory. If not, adjustment will be needed.

## What would an example look like?

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

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

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

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

### 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% 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 of $2,500, since that is  the 5% gateway minimum (5% is lower than one-third of 20%).

### Second: Cross test

After satisfying the gateway minimum, the contribution must also be nondiscriminatory. Under the cross-testing method, Jennifer's $55,000 contribution would provide an annual income at retirement* of $14,410. This is 5.24% of her income. For Mark, his $2,500 contribution would provide an annual income at retirement* of $2,625. This is 5.25% of his income. Since Mark's income replacement value (5.25%) is higher than Jennifer's (5.24%), the contributions pass the cross test and are not discriminatory and no additional contributions are needed for Mark.

## What happens if you fail discrimination testing?

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

1. Lower the contribution for the targeted group.
2. Increase the contribution for the non-targeted group.
3. Give all the groups the same amount.
4. Not make the 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 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%

## Additional profit sharing options

In addition to new comparability, there are three other main options for profit sharing on 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 exceed the Social Security 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 of profit sharing. 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.

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