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Retirement Plans for Your Company

By Paula Calimafde

A profit sharing plan is the most flexible qualified retirement plan an employer can offer to its employees. Contributions are discretionary, and each year the employer can decide whether to make a contribution and, within certain parameters, in what amount. The most simple profit sharing plan allocates contributions among participants pro-rata, based on compensation. Using this "plain vanilla" contribution model, if owners or key employees of a business wanted to have a contribution of 20% of pay, then all other participants must also receive contributions equal to that same percentage.

Integrating a profit sharing plan with Social Security takes into account the fact that an employer is helping to fund both the employees' social security and retirement benefits. This approach can slightly reduce the cost of contributions for staff employees compared with the plain vanilla model. Using integration, for example, highly compensated employees may receive a 20% of pay profit sharing contribution while non-highly compensated participants receive about 16%.

"Cross-testing" or "rate grouping," as it is sometimes called, allows an employer to group employees and determine the contribution level each group will receive, as long as certain IRS discrimination tests are met. These tests are set forth in comprehensive IRS regulations and take into account the ages of the eligible employees.

By using cross-testing, an employer can tailor a plan to meet the retirement goals of key employees while often reducing costs as a whole. Employees may be grouped in many different ways, the most basic of which is by job description, with key employees receiving, for example, a 20% contribution, administrative staff getting 10%, and all others receiving 5%. Another basic option is to use service with the employer; employees with 20 or more years of service could receive 18%, those with 10-20 years could get 10% and those with less than 10 years could be given 3%. Other options include grouping employees by age or a combination of age and service or by location.

Many employers elect to structure a plan that provides varying levels of contribution for different key employees. In a cross-tested plan, highly compensated employees cannot receive a profit sharing contribution which is more than three times the employer contribution for the non-highly compensated employees (the "three times" rule). However, if the contribution for the non-highly compensated employees is at least 5%, then the "three times" rule is eliminated and the highly compensated employees can receive the highest contribution allowed by law and desired by the employer. Let's say some highly compensated employees receive a 20% contribution; it is then possible that other participants may only be required to receive 5-7% of pay. This can produce a significant cost savings for the employer.

Of course, an employer can always choose to make larger contributions than required under the law. In fact, under the plan just described, an employer can change the contribution levels for each group every year, as long as the plan continues to satisfy IRS discrimination tests. A cross-tested approach requires careful calculations to meet the legal requirements governing this type of plan. In addition to proper design at the time the plan is adopted, discrimination testing must be performed annually. The less expensive contributions resulting from a cross-tested plan generally more than offset the increased costs associated with required annual discrimination testing.

The most sophisticated retirement plan available today is the "cash balance" plan, under which contributions may be cross-tested. A cross-tested cash balance plan couples the higher contribution levels found in a defined benefit plan with individual account balances such as those found in a profit sharing plan. Participants are guaranteed investment results, usually in the 5% to 5.5% range. Under a cross-tested cash balance arrangement, a 35-year-old employee can often receive a contribution in the $57,000 range, a 50-year-old might get as much as $123,000 and a 60-year-old can frequently receive a contribution as high as $212,000 a year. This high contribution plan is much more complicated than a profit sharing plan and requires the use of an actuary. It therefore should only be considered if an employer is interested in annual contributions that far exceed the maximum $49,000 contribution per participant currently available under the profit sharing plan. Staff costs may not be much higher than 7.5%

of pay, but administration fees are, as a general rule, much higher than they are with a profit sharing plan.

Layering a cash balance plan on top of a cross-tested profit sharing plan is quite often advisable since that design generally maximizes contributions for key employees.

Paley Rothman's retirement plan team works closely with our clients to ensure their retirement goals are met and is well versed in designing and performing the discrimination testing required of cross-tested profit sharing plans and 401(k) plans.

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