TRISTAR PENSION CONSULTING

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New Comparability After EGTRRA

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Ben, after many years of working for a contractor that did not sponsor a retirement plan, decided to start his own construction company. Due to his many contacts in the industry, his business grew very quickly. In order to attract and retain quality employees, Ben realized that he must offer a comprehensive benefits package that includes a 401(k) plan.

Ben is age 51 and has not had an opportunity to save a significant amount for retirement. Therefore, he would like to adopt a qualified plan for the 2004 year that allows him to achieve the following goals:

- Maximize his ability to save for retirement.
- Control the costs for his employees.
- Provide flexibility so that he is not required to make a contribution if his business experiences a downturn.

Understanding the following concepts will assist Ben in developing a retirement program that achieves his goals.

ALLOCATION OF PROFIT SHARING CONTRIBUTIONS

There are three common techniques used to allocate profit sharing contributions. These techniques, known as pro-rata, permitted disparity and new comparability or cross testing, are described below.

PRO-RATA AND PERMITTED DISPARITY

Under the pro-rata method, an employer's contribution is allocated in the ratio that each participant's compensation bears to the total compensation of all eligible participants. The permitted disparity method is very similar to the pro-rata allocation, except that generally individuals earning more than the FICA wage base will receive a contribution amount that is a higher percentage of compensation than those under the FICA wage base. These two allocation techniques are considered to be safe harbor formulas and deemed to be nondiscriminatory under the Internal Revenue Code (IRC).

NEW COMPARABILITY OR CROSS TESTING

New comparability or cross testing allows a profit sharing contribution to be allocated using nondiscrimination testing requirements under Section 401(a)(4) of the IRC. IRS regulations define the methodologies used to determine if a qualified retirement plan discriminates in favor of highly compensated employees (HCEs). Generally, for the 2004 year, an HCE is an employee who earned more than $90,000 in 2003 or owned more than 5% of the plan sponsor in 2003 or 2004.

The regulations under IRC Section 401(a)(4) allow a plan to test its profit sharing allocation as though it were providing monthly benefits from a defined benefit plan. The cost of providing an annuity of $1 per year at age 65 is much greater for older employees. In order to receive the same annuity at retirement, an older participant would require a larger contribution than a younger participant. Therefore, the nondiscrimination testing rules under IRC Section 401(a)(4) allow a discretionary profit sharing plan to demonstrate that relatively large contributions for older

employees are equivalent to much smaller contributions for younger employees if these contributions are used to purchase annuities at age 65.

In order to target the individual(s) who are to receive varying contribution levels, new comparability allocations create multiple allocation groups based on distinguishing characteristics, such as job title or ownership. Some plans have established a separate allocation group for each participant.

The table below shows the profit sharing contributions required to maximize Ben's (the only HCE) contribution under the three allocation methodologies discussed above:

Participant	2004 Compensation	Age	Pro-Rata	Permitted Disparity	Cross Tested
Ben	$205,000	51	$41,000	$41,000	$41,000
Employee 1	$80,000	55	$16,000	$13,395	$4,000
Employee 2	$60,000	45	$12,000	$10,046	$3,000
Employee 3	$50,000	35	$10,000	$8,372	$2,500
Employee 4	$45,000	32	$9,000	$7,535	$2,250
Employee 5	$35,000	30	$7,000	$5,860	$1,750
Employee 6	$30,000	25	$6,000	$5,023	$1,500
Total	$505,000		$101,000	$91,231	$56,000

REVIEW OF PROFIT SHARING ALLOCATIONS

- As a result of EGTRRA (2001 tax act which became effective in 2002), the maximum contribution limits for a participant in a defined contribution plan increased to the lesser of $40,000 (previously $35,000) or 100% (previously 25%) of the participant's compensation. As a result of cost of living increases, this limit increased to $41,000, and the compensation limit increased to $205,000 for 2004.

- EGTRRA also increased the employer tax deductible contribution limit for profit sharing plans from 15% of total participant compensation to 25% of total participant compensation. Prior to EGTRRA, Ben would not have been able to receive a maximum profit sharing allocation under the pro-rata or permitted disparity methods since that would have required a nondeductible contribution in excess of 15% of compensation.

- Cross tested plans that allocate contributions based solely on compensation are subject to minimum contribution requirements. In order to satisfy these requirements, each non-highly compensated employee (NHCE) must receive an allocation that is the lesser of (1) one-third of the highest allocation rate provided to an HCE or (2) 5% of compensation.

- In order to take advantage of the new comparability or cross tested allocation technique, it is not necessary for all of the NHCEs to be younger than the HCEs. The number of younger employees required to pass the nondiscrimination testing is a function of the percentage of NHCEs in the entire eligible group.

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ADDING A 401(K) FEATURE

Prior to EGTRRA, there were two significant issues that could make it difficult to add a 401(k) feature to a cross tested profit sharing plan. The first issue was that the maximum employer tax deduction limit was 15% of total participant compensation. Included as employer contributions in applying this limit were the employer profit sharing contributions as well as the participant salary deferrals. Therefore, if the employer made a profit sharing contribution that approached 15% of total compensation, it was not possible to add a tax deductible 401(k) feature.

EGTRRA provided two solutions to this problem. As mentioned above, the employer tax deductible limit for defined contribution plans was increased to 25% of participant compensation. In addition, participant salary deferrals are no longer included in applying the 25% limit.

The second issue that impacted the addition of a 401(k) feature to a profit sharing plan was the individual maximum contribution limit. Prior to EGTRRA, contributions from all sources (employer and salary deferrals) were limited to the lesser of $35,000 or 25% of a participant's compensation. If the HCE was earning far less than the compensation limit (i.e. $100,000), the cross tested profit sharing allocation may have used the entire 25% of compensation limit, leaving no room for a salary deferral contribution.

EGTRRA solved this problem as well. As mentioned above, the maximum contribution limit increased to the lesser of $40,000 ($41,000 in 2004) or 100% of a participant's compensation. Therefore, if an HCE's profit sharing allocation does not approach the $41,000 limit, the 100% of compensation limit will not prohibit the addition of a 401(k) feature.

EGTRRA also permits individuals who are 50 years of age or older during a calendar year to make additional salary deferrals called catch up contributions. The catch up contribution limit for 2004 is $3,000. Catch up contributions are not included in applying the $41,000 contribution limit for 2004. Therefore, a 50-year-old participant can potentially receive total contributions of $44,000 during 2004. Without a 401(k) feature, that same participant would be limited to total contributions of $41,000.

Let's look at what Ben's plan will look like with a salary deferral feature in addition to the cross tested profit sharing contribution.

Participant	2004 Compensation	Age	Salary Deferral	Cross Tested	Total Allocation
Ben	$205,000	51	$16,000	$28,000	$44,000
Employee 1	$80,000	55	$8,000	$3,642	$11,642
Employee 2	$60,000	45	$3,000	$2,732	$5,732
Employee 3	$50,000	35	$2,000	$2,276	$4,276
Employee 4	$45,000	32	$0	$2,049	$2,049
Employee 5	$35,000	30	$0	$1,593	$1,593
Employee 6	$30,000	25	$0	$1,366	$1,366
Total	$505,000		$29,000	$41,658	$70,658

REVIEW OF 401(K) AND PROFIT SHARING ALLOCATIONS

- Since Ben deferred the maximum salary deferral ($13,000 deferral limit plus $3,000 catch up contribution) for 2004, a profit sharing contribution of only $28,000 was required to achieve a maximum allocation. The $28,000 contribution was 13.66% of Ben's compensation. The resulting minimum contribution that must be provided to the NHCEs is one-third of Ben's (the only HCE) allocation rate or 4.55%. The addition of a 401(k) feature allowed Ben to make the $3,000 catch up contribution and decreased his contribution requirement to the employees.
- Salary deferral contributions made to 401(k) plans are subject to annual discrimination testing. The salary deferrals above would fail the required test. However, Ben could have established the plan as a safe harbor 401(k) plan that is exempt from annual 401(k) discrimination testing. If the plan meets certain notice requirements and withdrawal restrictions, a cross tested plan can use part of its profit sharing contribution to meet the safe harbor 401(k) contribution requirements. These requirements can be met if a fully vested contribution of 3% of compensation is made annually.

In addition to fully vesting some or all of the profit sharing contribution, there is an additional hurdle to implementing a safe harbor 401(k) feature. The plan cannot impose a conditional requirement in order for participants to receive a contribution. Common features such as requiring a participant to work 1,000 hours during a year or be employed on the last day of a year in order to receive a contribution cannot be imposed on a safe harbor 401(k) plan contribution. Any participant eligible to make salary deferrals must receive the fully vested 3% of compensation contribution.

TOP HEAVY CONTRIBUTIONS

Since new comparability or cross tested plans are successful in providing considerable contributions to owners and officers, they are likely to become "top heavy." A plan is top heavy if more than 60% of plan assets are allocated to certain owners and officers. Top heavy plans are subject to minimum contribution requirements and more rapid vesting.

The top heavy minimum contribution is the lesser of 3% of compensation or the highest allocation rate for any HCE. These minimum contributions can be used in performing the nondiscrimination testing required of new comparability. In fact, a new comparability profit sharing allocation can perform triple duty: (1) meet nondiscrimination testing requirement under IRC Section 401(a)(4); (2) meet safe harbor 401(k) contribution requirement; and (3) meet top heavy minimum contribution requirement.

Ben can control his costs by waiting until he receives his year end bonus to make a 401(k) salary deferral contribution. If at year end he realizes that lack of profits or cash flow will make it difficult to make a top heavy minimum contribution, he can forego making any salary deferral. If he does not make any salary deferral or receive a profit sharing contribution, he will not have any contributions allocated to his account, which will preclude the need to make a top heavy minimum contribution for his employees.

CONCLUSION

The expanded employer tax deductible and individual contribution limits enacted by EGTRRA have provided greater planning opportunities for new comparability plans. In fact, EGTRRA's addition of catch up contributions has made the addition of a 401(k) profit sharing feature to a new comparability plan even more appealing.

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