"F" Off -

Funds, Fiduciaries & Friendships in the Cross-Tested Profit-Sharing Space

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Whether it's a professional baseball team or your business, higher revenues allow owners to acquire and retain top players, positively impacting competitiveness, profitability, and overall success.

If you could name the most successful Major League Baseball (MLB) franchises in the past – well – ten years, the Baltimore Orioles, Tampa Bay Rays, or the Oakland Athletics probably wouldn't come to mind. Notably, these three teams had the **lowest opening day payrolls** going into the 2023 season.

The Yankees, the Dodgers, or the Braves, on the other hand? These teams are among the top-performing MLB teams over the last decade, boasting some of the **highest 2023 opening-day payrolls.** As **Billy Beane** of the Oakland A's famously said, "We can't do the same things the Yankees do. Given the economics, we'll lose." Well, that "moneyball" analysis holds true – most of the time.

Let's take a look at the 2023 New York Mets, with the highest payroll going into the 2023 season of any MLB team. The Mets' payroll rang in at **$374.7 million**, topping the previous high of $291.1 million by the 2015 Los Angeles Dodgers. Unfortunately, this spending didn't help the Mets' season this past year, as they finished with a **75-87 losing record,** putting them solidly in 4th place in the National League East.

More money doesn't automatically mean more success, as exemplified by the 2023 Mets. But, employers know that attracting and retaining top talent – specifically owners and key employees – is critical to business success. So, how do you attract and retain these key players without facing a losing season?

Cash flows and consistent profits allow you to offer competitive salaries, ownership tracks, and robust employee benefit packages. ,. However, understanding how and when to spend your money – including cash balance/profit-sharing contributions to your organization's retirement plans – is critical to your overall company's success.

What if you could maximize discretionary profit-sharing/cash balance contributions to higher-paid owners and key employees while minimizing allocations to younger employees – all while getting the blessing of the Internal Revenue Service (IRS)?

Sounds too good to believe? **Go on...........**

Why Should My Organization Consider a Cross-Tested Profit-Sharing Plan?

A typical qualified retirement plan, such as a 401(k), caps contributions at the lesser of 100% of the participant's compensation or $66,000 (for 2023) or $69,000 (for 2024), while generally increasing annually. Under the Internal Revenue Code (IRC), this contribution cap includes employer contributions, employee contributions, and forfeitures allocated to plan participants.

If this Section 415 limit is exceeded, then the excess amount must be returned to the plan participant (typically an owner, highly-compensated employee, or key employee) within 2.5 months after the end of the plan year. This refunded excess is taxed at regular income tax rates, and any matching contributions are forfeited.

If refunds are made after the 2.5 months, then the participant must pay an additional 10% excise tax on the refund amounts – potentially causing the higher paid employee to pay north of 40% in individual tax rates.

That hurts.

First, participants face a limitation on how much can be contributed and a potential tax (and a high tax at that) on any excess. Additionally, if the retirement plan is considered "top-heavy" (meaning that 60 percent of the plan's assets are attributable to key employees), then you, as the plan sponsor, must make a corrective contribution (plus lost earnings) to all non-highly compensated employees – another costly mistake.

Let's pivot to a solution: a cross-tested profit-sharing cash balance Combo plan. A cross-tested profit-sharing/cash balance plan is a type of retirement plan (such as a 401(k) plan) designed to skew employer contributions in favor of older, higher-paid employees.

This is a way to reward (and retain) your team stars – not your role players.

Not for Everyone: How to Identify If a Combo Plan Is Right for You and Your Team

Cross-tested Combo plans aren't for every organization. To understand if your team would benefit from this type of plan, read on.

What is a cross-tested combo plan?

A cross-tested Combo plan is a defined benefit plan that uses a specific plan design that does not discriminate in favor of highly-compensated employees. But what does that mean?

Discrimination under the IRC is different from other types of legal discrimination. Here, in the case of retirement plans, the IRS does not permit employers to offer more favorable benefits to highly-compensated employees than to non-highly compensated employees.

A highly-compensated employee (or HCE) is an employee:

Who owns more than 5% of the company at any time during the current or previous year

OR

Earns more than $150,000 (in 2023) or $155,000 (in 2024), regardless of ownership.

Don't forget certain employed family members as they may be considered HCEs as well.

For example, in a defined contribution plan (such as a 401(k) plan), if the employer contributes an amount based on a uniform percentage of all participants' compensation (such as 3%), the IRS does not consider this discriminatory – even though higher-paid employees will receive a larger contribution than other employees based on their pay. Because the allocation is the same percentage for everyone (regardless of compensation), the IRS says that this is not discriminatory.

In a cross-tested Combo plan, the allocation of the employer contribution is converted to a project benefit amount at retirement. Those projected amounts are tested to ensure that the plan does not violate the IRS's discrimination rules. If, when tested, all projected benefits equal a comparable benefit for both highly-compensated and non-highly compensated employees (NHCEs), then the plan is not discriminatory. Even if the projected benefits are not comparable, the plan may still satisfy the nondiscrimination rules depending on the level of benefits provided to non-highly compensated employees.

How can a Combo plan benefit us?

Cross-tested plans permit substantially larger contributions for older participants than younger participants, allowing employers to reward their key players. In some instances, the employer may be able to make a 20% contribution for these older employees while only making a 5% contribution for all other employees.

Basic example of how this may work:

Suppose a company has two employees, each earning $100,000. One employee is 62, and the other employee is 32. If each employee received a uniform contribution (such as 3 percent of compensation), then both employees would receive the same contribution amount ($3,000 each if using the 3% uniform allocation example).

However, if the employer wants to ensure that each employee receives that same projected benefit at retirement age (usually age 65), then the employer would make a larger contribution to the 62-year-old than the 32-year-old. This is because the 62-year-old has fewer years to retire than the younger employee. The 32-year-old employee has more years for contributions (and earnings) to accumulate.

When the contributions are cross-tested (meaning, they are converted to the projected retirement benefit), then each employee would have comparable projected benefits at 65.

A cross-tested Combo plan works best when there is a large age difference (such as ten or more years) between its older, highly-compensated employees versus all other employees. Put simply, having a mix of rookies and all-stars is the best line-up for cross-tested Combo plans.

Because these allocations can often be complex depending on your employee makeup, it's best to work with a qualified advisor – one who specifically understands (and has significant experience in) cross-tested Combo plans.

Without a qualified plan advisor on deck, employers could lose money, time, and taxable deductions if these plans aren't set up and administered properly.

This ain't tee-ball. Bring in the big dogs.

The cross-tested Combo space isn't for the faint of heart. Your plan advisor must understand the rules governing these plans – from their design to their compliance with federal law. There's no room for a generalist, a wealth manager, an insurance agent, or a friend who has been "helping" you with your organization's retirement plan.

In the industry, we call this the "buddy" approach. Your buddy, who may have a couple of insurance or financial certifications, says – "Hey, I can help you with your retirement plan. No big deal."

However, this could be a very big deal to you, your co-owners, and your employees. And if your buddy (or generalist, wealth manager, or insurance agent) messes up? Their mistake falls on your shoulders as the plan's sponsor under the Employee Retirement Insurance Security Act of 1974 (ERISA) as well as the IRC.

You don't need someone who can offer the bare minimum in the profit-sharing space. You need a pro.

Retirement plan law – under both ERISA and the IRC – has evolved tremendously over the past five decades. Considering Congress just recently passed the largest piece of retirement plan legislation in more than 17 years, it's safe to say that retirement plan compliance keeps getting more complicated. You need a specialized team on your side to help you navigate this space while providing the best retirement benefits for your team.

Case Study: An Argument for an Expert Over a Dabbler

Imagine you have a dental practice group. The group's retirement plan is managed by the owner's golf partner (another example of the " buddy" approach). The golf buddy advises on a handful of small, vanilla 401(k) plans but primarily focuses on individual wealth management. He's never helped structure a cash-balance profit-sharing (Combo) plan, but how hard can it be? You just need to make some small adjustments to the contribution allocation.

"Not so fast" – in the words of Lee Corso.

In his attempt to structure a Combo plan, the golf buddy ignored the IRS's testing requirements (applying to compensation limits, minimum gateway contribution limits, and/or deferrals limits). This leaves you open to IRS penalties and possibly excise taxes for non-compliance. In fact, these mistakes could even disqualify your retirement plan, meaning all taxable benefits for you and your employees are negated back to when the mistakes were made.

Putting a cherry on top of the situation, they failed to perform the cross-testing analysis over the previous years to determine the best plan design – specific to your team's needs. This oversight may cost you unbudgeted dollars in inflated employer contributions to your employees.

Ask the question, is that good enough?

Having a qualified and experienced team around you can help you provide the best retirement benefits to your employees while you focus on what you do best – running your business.

Your Plan's Training Camp: A Necessary Evil

Not typically fun – training camps are a necessary evil for a successful season. It's always important to go back to the basics – whether it's for pitching, batting, or, well, your retirement plan.

Basic training for your retirement plan revolves around plan documents and design. And, let me tell you, the devil is in the details.

After all, your retirement plan document governs. It is the playbook. And, it must be followed to the T.

Let's look at some document and design specifics that are a must in any retirement plan training camp:

Why your plan documents matter ?

Your retirement plan documents will typically include a basic (or prototype) plan document and an adoption agreement. The basic document contains the pre-approved IRS language applicable to all qualified plans.

The adoption agreement tailors the retirement plan to your organization. For example, it will specify employee eligibility, entry, vesting, distribution types, employer contribution formulas, among other pertinent provisions, giving you flexibility while helping the experts solve the cross-testing puzzle.

Adherence to these documents falls under your ERISA fiduciary and IRC duties. In other words, if you don't follow these documents, you could face compliance issues with both the Department of Labor (DOL) and the IRS.

Yikes.

This is why it's best to have a Combo plan expert guide the design and installation process. The adoption agreement is a strategic opportunity to design your plan to satisfy organizational goals.

Why your plan design matters

Preparation for your Combo plan is vital to your employee attraction and retention success. Like a good scouting report, keep these Adoption Agreement design decisions top of mind:

1. Eligibility

Similar to other types of retirement plans, Combo plans have specific eligibility standards. Here are four top requirements related to eligibility:

Age restrictions: You may exclude anyone under age 21 from eligibility. Depending on your team, you may want to include employees younger than 21 to balance your nondiscrimination testing for younger and older employees. Additionally, age can impact your maximum annual contribution limits, vesting schedules, and earned benefits at retirement.

Minimum hours: You can limit plan participation to those employees who have completed more than 1,000 hours of service.

One-year service requirement: You may require one year of service before an employee may participate. This requirement is ideal if you commonly have a high turnover rate.

Entry dates. You can specify when employees may enroll in the plan once they meet the eligibility requirements. Companies with high turnover may want to choose semi-annual entry dates, limiting administrative tracking while promoting the desegregation of employees.

2. Cash Balance Benefit Basics

Although a Combo plan is a type of defined benefit plan, each participant receives a hypothetical account reflecting their plan balance (which is similar to a defined contribution plan, like a 401(k) plan). However, like defined benefit plans, the cash balance component provides a guaranteed benefit to their participants. Because cash balance plans have elements from both defined contribution and defined benefits plans, they are often referred to as “hybrid” plans.

Each year, benefit and interest credits are added to a covered participant’s account. However, it’s important to note that these hypothetical accounts will be adjusted by an actuary, based on economic, age, years of service, and other assumptions.

For cash balance plans, the IRS 415 contribution rules don’t limit annual additions as they do in 401(k) and other defined contribution retirement plans. Instead, they are limited as to the ultimate benefit paid at retirement (like traditional pension plans).

Participants in a cash balance plan can enjoy allocations that are significantly higher than those in other retirement plans – up to $345,000 for 2024 ($330,000 for 2023). This will, however, depend on the participant's age and years to retirement.

Let's look at an example:

You implement a cash balance plan in 2024 that provides a crediting formula of 28% of compensation for owners and 5% of compensation for non-owners.

Employee	Age	Salary	Contribution Amount
Executive A	59	$340,000	$95,200
Executive B	53	$280,000	$78,400
Executive C	28	$75,000	$3,750

Remember, these accrued benefits must be compared for nondiscrimination testing, as further discussed below. This is one reason why cash balance plans are so complex. Several analyses must be performed before settling in on a contribution schedule. As such, the above represents only a starting point of what could be.

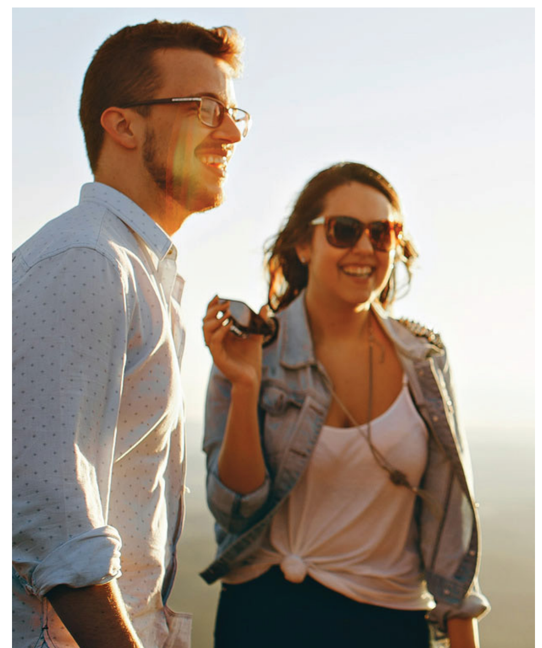
3. Pay crediting rates

Your plan's contribution level is determined by your chosen pay crediting rates. In other words, your pay crediting rates reflect how much you (as the employer) will contribute annually to each covered participant's hypothetical account.

These pay crediting rates may be a flat dollar amount or a percentage of the participant's compensation. Some examples:

- $7,500 for each plan participant
- 5% of compensation
- $2,500 for each year of service

Whatever chosen methodology, , have it analyzed for costs and administration; ensuring that it meets the organization's goals.



4. Interest crediting rates

In addition to pay credits, your employees' hypothetical accounts will be credited with an interest factor. Your crediting factor determines the guaranteed rate of return within the hypothetical account.

Typically, your interest crediting rate is based on a formula including a fixed and/or variable interest rate. Like other plan terms, your chosen interest crediting rate must be reflected in the plan documents; more specifically in the adoption agreement. Depending on your chosen methodology and other economic factors, your interest crediting rate may vary from year to year.

In simple terms, the Cash Balance account formulas is written as such:

(Compensation x Pay Crediting Rate) + (Account Balance x Interest Crediting Rate) = Accrued Benefit

5. Vesting

Although plan participants receive contributions, as reflected in their hypothetical accounts, they are not entitled to receive these amounts until they are vested. Vesting essentially means ownership. Your plan document (specifically your adoption agreement) specifies your chosen vesting terms, which can be measured from the date of hire or the plan year itself.

There are three types of vesting schedules for the cash balance component:

Immediate vesting: Here, an employee has immediate ownership of their cash balance account funds when contributed. If they leave the company, they get to take 100% of their account with them.

Cliff vesting: In this type of vesting, the cash balance participant will be fully vested once they reach three years of service. It's essentially all or nothing. Three years is the maximum number of years of service that employers may use.

Cliff Vesting Schedule	
Years of Service	**Vesting %**
1	0%
2	0%
3	100%

Graduated (or graded) vesting: In this type of vesting, the cash balance participants gain ownership in their funds gradually based on their years of service. Six years is the maximum number of years of service that employers may use. Here is an example of a 6-year graded vesting schedule.

6-Year Vesting Schedule	
Years of Service	Vesting %
1	0%
2	20%
3	40%
4	60%
5	80%
6	100%

If an employee terminates employment before satisfying their vesting schedule, that employee forfeits any unvested amounts back to the plan. The employer may then use those forfeitures to pay administrative plan expenses or reduce future contributions per the adoption agreement. However, the good news here is that the company still gets a tax deduction for the initial contribution, whether that contribution eventually becomes vested or not.

6. Safe harbor designs.

Many cash balance plans are combined with traditional 401(k) profit-sharing plans, in other words, a **"Combo plan,"** providing employers with the utmost in retirement plan flexibility maximizing benefits for the employer.

The Pension Protection Act of 2006 (PPA) made these "Combo" plans even more flexible. For example, before the PPA, an employer's maximum taxable deduction to all retirement plans had to equal the greater of:

- The defined benefit plan's required contribution or
- 25% of total participants' eligible compensation.

However, under the PPA rules, as of 2006, an employer can contribute up to 6% of participants' eligible compensation to a defined contribution plan (e.g., the 401(k) plan) in addition to the required defined benefit contribution (e.g., the cash balance contribution), even if this amount exceeds the 25% limit. Employee deferrals do not count towards the 6% or 25% limits.

With this additional flexibility, employers can take advantage of these combined plans; however, you'll need to analyze the 401(k) safe harbor design options available to you.

A safe harbor 401(k) plan automatically satisfies most of the IRS's nondiscrimination and compliance tests required for most retirement plans. These safe harbor plan designs simplify administration and compliance while allowing business owners to maximize their contributions.

Combine that design with a cash balance plan; it's a win-win.

A. Safe Harbor Basic Match

In a safe harbor basic match plan, the employer must match 100% of the first 3% deferred by each participant, plus 50% of the next 2% deferred. So, if an employee defers at least 5% of their compensation to the plan, they'll receive a 4% matching contribution from their employer.

These safe harbor basic match contributions are subject to 100% immediate vesting.

This type of match is best for younger employee populations or owners with limited cash flow (not necessarily the best candidate for a combined cash balance 401(k) profit-sharing plan).

B. Safe Harbor Non-Elective Contribution

In a safe harbor non-elective (SHNE) 401(k) plan, the employer must contribute a minimum of 3% to all eligible non-highly compensated participants in the plan, regardless of whether the employee decides to defer.

The SHNE contributions are 100% immediately vested. However, you can exclude HCEs from this type of contribution, potentially helping you pass nondiscrimination testing (as further discussed below). Instead, design the plan to provide HCEs with a profit-sharing contribution equal to the safe harbor non-elective contribution, saving the company the required 3% SHNE of cash flow during the year.

In most cases, this plan design allows HCEs to receive a 6% profit-sharing contribution in addition to the 3% safe harbor non-elective contribution (without making any additional contributions on behalf of the rest of the team). This is subject to testing, so make sure the pros are involved.

This type of safe harbor design appeals to employers who are likely to make a profit-sharing contribution annually, and the team demographics support the cross-testing design (meaning that the profit-sharing contribution can favor older, higher-earning employees while still complying with IRS nondiscrimination rules).

C. Qualified Automatic Contribution Arrangements.

A qualified automatic contribution arrangement (QACA) is another type of safe harbor 401(k) allocation formula where the employer can combine a safe harbor contribution strategy with the ability to automatically enroll their employees.

Although the safe harbor arrangements are like those above, there are some slight changes when you combine these with automatic enrollment features.

In a QACA safe harbor basic match, the employer matches 100% of the first 1% of compensation deferred by an employee, with an additional 50% on any deferrals above 1% and up to 6% of the employee's compensation.

This results in an overall maximum contribution of 3.5%, which is lower than the standard safe harbor basic matching contribution. Unlike most safe harbor matches, QACAs permit employer matching contributions to be vested up to a 2-year cliff vesting schedule.

Further, the automatic deferral rate must start at 3% and is automatically increased each year by 1%, increasing to at least 6% but no more than 15%. Beginning in the 2025 plan year, employers must auto-enroll participants at an initial contribution amount between 3% and 10%, increasing by one percentage point each year until it reaches 10% to 15%. This does not impact plans established before December 29, 2022, and new companies in business for less than three years with ten or fewer employees.

This QACA option is ideal for employers who want to focus on retention with the 2-year cliff vesting option.

Understanding the Tests:
How the IRS Influences Your Plan Design

Combo plans – like all qualified retirement plans – must comply with the IRS's nondiscrimination tests, ensuring that benefits don't unintentionally favor highly-compensated employees over non-highly compensated employees. Failing to comply with these nondiscrimination requirements can lead to penalties, excise taxes, and potential plan disqualification.

So what are the tests?

What non-discrimination tests does the IRS require?

A. Section 410(b) Coverage Test

Annually, the Combo plan's contribution formula must pass an "average benefits test." This test calculates the percentage of eligible HCEs to eligible NHCEs benefitting under the plan. The Section 410(b) coverage test contains two separate tests – the ratio percentage test and the average benefits test.

Under this nondiscrimination test, each contribution type – whether an employee deferral, an employer matching contribution, or a profit-sharing contribution – is analyzed separately.

Before we dive into the details of this nondiscrimination test, we should highlight the difference between being "eligible" for or "benefiting" under the plan. Eligible employees are those employees who have met the plan's minimum age and service requirements. "Benefiting" under the plan refers to any participant who is receiving contributions.

B. Ratio Percentage Test.

To satisfy the ratio percentage test, you must:

- Calculate the ratio of HCEs and NHCEs who are benefiting under the plan for each contribution source.
- Then, you'll compare the ratio of the HCEs and NHCEs to find the ratio percentage.
- If the ratio percentage is 70% or higher, then your plan passes the ratio percentage test and the Section 410(b) coverage test as a whole.

- If the ratio percentage is lower than 70%, then your plan fails the ratio percentage test, and you must move on to the Average Benefits Test to see if your plan passes the Section 410(b) coverage test as a whole.

Note, actual demonstrations of any of the nondiscrimination testing are beyond the scope of this resource. Contact a qualified cross-tested profit-sharing plan advisor to dig into the details.

C. Annual Benefits Test.

To satisfy the annual benefits test, you must satisfy two additional parts: the nondiscriminatory classification test and the average benefits percentage test. Both tests must be passed to pass the Section 410(b) coverage test as a whole.

D. Nondiscriminatory Classification Test.

This test has a couple of components. First, the classification of employee categories must be "reasonable" and established under objective business criteria. Second, this test compares the ratio percentage you previously obtained to a **table of "safe harbor and unsafe harbor" percentages.** If your plan's ratio percentage is greater than the plan's safe harbor percentages from the table, then your plan passes the classification test.

E. Average Benefits Percentage Test.

Next, we move on to the average benefits percentage test. Similar to the ratio test, this average benefits percentage test compares the ratio of HCEs to NHCEs, which must be at least 70% to pass. However, instead of comparing the number of participants benefiting, this test compares the actual benefits percentages of compensation received.

All non-excludable employees are considered for this test, even if they aren't benefiting under the plan.

If you fail this Section 410(b) coverage test, you'll need to take corrective measures to bring the plan into compliance or potentially face IRS penalties, excise taxes, or plan disqualification.

We're going to pause here for just a minute . . . do you see why you need a specialist? These tests are not for your brother-in-law or golf buddy, that's for sure.

F. Meaningful Benefits Test

A second nondiscrimination test that you need to satisfy is the "meaningful benefits test." Unlike the Section 410(b) coverage test, this test does not compare HCEs to NHCEs. Instead, it looks at how many employees are covered and which of these employees are getting a meaningful benefit from the plan.

IRS guidance indicates that if 40% of employees are receiving a meaningful benefit in the cash balance plan, then this test is satisfied. But, what the hell is a "meaningful benefit"?

If you have 20 people on your team, then at least eight employees must receive a meaningful benefit from your retirement plan. For cash balance plans, you would need to project all hypothetical account balances (with earnings) to each employee's normal retirement age (which is typically age 65). Then, you would convert that projected amount into an annuity.

If that annuity amount equals at least .50% of each of your current compensation employee's compensation, then the IRS claims that that is a meaningful benefit. However, if you have less than three employees participating in the plan, then that 40% requirement shifts to 100%. Therefore, if you have one or two employees participating in the plan, then 100% of your participants must receive a meaningful benefit.

G. Gateway Contribution Test

A third nondiscrimination test within the cross-tested plan space is the "gateway contribution test."

But what does this mean?

The gateway contribution test – or the minimum allocation gateway – is satisfied for a defined contribution plan if each NHCE in your plan receives:

- at least one-third of the allocation rate for the one HCE with the highest allocation rate or, alternatively,
- Each NHCE receives an allocation percentage of at least 5% of that NHCEs' compensation.

If you choose to utilize cross-testing and a safe harbor, then the owner would receive an 18% cross-tested profit-sharing contribution, and other eligible employees would receive a 5% contribution. This contribution strategy would satisfy the required gateway since the NHCE receives the lesser of 5% or one-third of 18% (which would be 5.4%).

If you have an aggregated Combo plan, then each NHCE must have an aggregate normal allocation rate (ANAR) meeting the following requirements:

Highest HCE ANAR	ANAR for NHCEs
Less than 15%	At least 1/3 of the HCE rate
15% to 25%	5%
25% to 30%	6%
30% to 35%	7%
Above 35%	7.5%

Again, we thought we'd pause. . . Do you see why you need a specialist? Hopefully, by now, you're convinced. This stuff can make your head spin if you don't know what you're doing.

H. Top-Heavy Test

A final nondiscrimination test that needs to be performed is the "top-heavy" test. A top-heavy retirement plan is one in which a small group of HCEs hold a large percentage of benefits or assets. But, how would a cash balance plan pass a top-heavy test?

A retirement plan is considered top-heavy if:

- HCEs hold 60% or more of the total value of the plan's assets or
- Key employees hold 60% or more of the total account balances in the plan.

As a reminder, a highly-compensated employee (or HCE) is an employee:

- Who owns more than 5% of the company at any time during the current or previous year or
- Earns more than $150,000 (in 2023) or $155,000 (in 2024), regardless of ownership.

Remember Certain family members of company owners may be considered to be HCEs as well.

On the other hand, a "key employee" is an employee who:

- Owns 5% or more of the company through direct ownership or family attribution rules
- Owns 1% or more of the company, generating over $150,000 for the fiscal year, or
- Is an officer with a compensation more than $220,000 (2024), up from $215,000 (2023)

If a plan is top-heavy, the IRS rules provide that certain mandatory employer contributions must be made to the NHCEs to ensure that the plan is fairly providing benefits. Additionally, the rules may require that certain vesting schedules be accelerated.

For a cash balance plan, its "top heaviness" is determined by comparing the aggregate account balances of the HCEs to the aggregate account balances of all other plan participants without considering the benefits provided under the plan.

If the cash balance plan is top-heavy, then IRS rules will direct the employer to make certain contributions to the NHCEs. The rules may also require the implementation of accelerated vesting schedules.

How does a combined cash-balance, safe-harbor 401(k) profit-sharing plan impact testing?

When you add on the layer of the safe-harbor 401(k) profit-sharing plan, you'll need to adhere to certain IRS rules when it comes to nondiscrimination testing. However, since many cash balance plans can't pass IRS testing as standalone plans (because of the favorability to HCEs), adding the safe-harbor 401(k) component eases testing, making it a more cost-effective way to remain compliant.

Let's look at an example:

Suppose you have a Combo plan with a safe harbor non-elective option (which is often the most cost-effective choice). Further, let's assume that a plan sponsor must provide a 7.5% gateway allocation to pass the IRS's nondiscrimination testing.

If the plan provides a 3% safe harbor non-elective contribution, then the employer must kick in another 4.5% to satisfy the gateway. However, if the plan provides a safe harbor match of 4% of compensation for any plan participant deferring 5% of compensation, then that match does not count towards the gateway test. The gateway test would need to be satisfied outside of the 4% matching contributions, thus almost doubling the required amount owed by the employer.

Another consideration is whether a safe harbor plan can become top-heavy. If a safe harbor 401(k) plan only has elective deferrals and safe harbor matching contributions, then it is generally exempt from the top-heavy testing requirements, unless an exception applies.

A safe harbor 401(k) matching contribution isn't exempt from the top-heavy test if:

- The retirement plan permits a discretionary non-elective contribution, and one is made.
- Forfeitures are allocated to plan participants in the same manner as non-elective contributions.
- Plan participants are permitted to immediately defer but aren't eligible for matching contributions for another 12 months.

For safe harbor non-elective plans (making a 3% contribution to all plan participants), these plans automatically satisfy the top-heavy contribution requirement.

Should we ask? No, you know a specialist is necessary here to help you design a plan that can pass nondiscrimination testing.

Here are some best practices to keep in mind when designing your plan related to the non-discrimination testing:

- Keep eligibility at age 21 with a one-year of service requirement. The one-year of service requirement helps weed out "short-term" employees.
- Incorporate semi-annual entry dates for the non-elective profit-sharing contribution.
- Adopt a safe harbor non-elective feature; however, exclude the HCEs
- Change your profit-sharing allocation method to individual groups under the new comparability rules. In other words, each plan participant should be in their own group, providing you with the flexibility to target contributions to satisfy testing. By doing this, you can more readily (and efficiently) fit those cross-tested plan puzzle pieces together. Subsequently, as the employer, you can provide different contribution percentages for different groups of employees.

- Remove continuing allocation conditions, such as an "employed on the last day of the year to receive a profit-sharing contribution" requirement. Although this requirement is common in traditional profit-sharing plans, it does not play nicely with a cross-tested plan.

Continuing Allocation?

Suppose that Allan terminates employment mid-year but has more than 1,000 hours of service under his belt. He is also entitled to a cash balance benefit. This safe harbor non-elective plan also permits profit-sharing contributions.

If this employer had a non-cash balance, stand-alone 401(k) plan, the employer must provide Allan with a 2% profit-sharing contribution on top of his 3% non-elective safe harbor contribution to satisfy the gateway requirement.

Most Combo cash balance/401(k) plans will require a larger minimum contribution to satisfy the gateway test. For example, the top-heavy percentage rises from 3% to 5%, and the minimum gateway often rises to 7.5%.

So, Allan must receive a 4.5% profit-sharing contribution on top of the 3% non-elective safe harbor contribution. However, the 401(k) plan has a "last day" requirement to receive any profit-sharing contributions. So, now what?

Allan must receive the profit-sharing contribution to help the plan pass its nondiscrimination testing, but the plan says that Allan is not entitled to it since he was not employed on the last day of the year.

To fix this, the employer will need to adopt a corrective amendment removing the "last day" requirement so that Allan may receive his profit-sharing contribution.

Trust me, it would be a lot simpler (and cheaper) to account for this on the front end. A specialist can help you design your plan so you don't run into these potential compliance issues.

Checking Your Ownership: Who's In and Who's Out?

The IRS doesn't make things easy – that's an understatement. It doesn't stop there. The IRS's insistence on complex rules holds true when it comes to determining who's an owner and who's not.

Under IRS rules, companies must determine whether they are a controlled group or an affiliated service group before finalizing any type of retirement plan – cash balance or not. This directly impacts your ownership determination as well as which employees must be allowed to participate in the plan.

So, although you may already have some top players in mind, let's ensure they can make the final cut.

What is a controlled group?

A controlled group is a set of companies (think subsidiaries, for example) with shared ownership. These companies are treated as a single company for purposes of employee benefits, including retirement plans.

There are three different types of controlled groups, which we'll just touch on briefly here.

- Parent-child controlled group: A parent-child controlled group exists when a parent company owns at least 80% of a subsidiary. For example, if Company A owns 85% of Company B, then both of these organizations are a controlled group and must be treated as one company for purposes of your retirement plan – meaning employees from Company A and Company B must be covered.
- Brother-sister controlled group: This type of controlled group is a little more complicated as you're analyzing whether the same five or fewer persons hold at least 80% total ownership of all companies within the group. Additionally, you may need to determine if "effective control" exists, meaning that the same five or fewer persons hold at least 50% total ownership of all companies within the group. Talk about whiteboarding Xs and Os – this test is complex.
- Combination controlled group: You guessed it, a combination of a parent-child and brother-sister controlled group. Want your head to spin?

Controlled groups don't just impact which employees must participate – they also impact nondiscrimination testing. Each company within the controlled group must be tested as one, even if each entity has its own retirement plan.

For example, employees of companies within the controll group must pass the coverage nondiscrimination test, meaning that at least 70% of all NHCEs are benefiting under the plan. If there are multiple retirement plans within the controlled group, this can get complicated quickly, potentially causing unforeseen (unbudgeted) contributions across several plans.

And, we're not even touching potential ERISA fiduciary liability here. You may find yourself liable for some fiduciary actions (or inactions) of another company within the controlled group.

Even though the details of controlled groups are way beyond this resource, we do urge you to consult with a qualified professional, such as an ERISA attorney, when making these determinations – you get into the weeds pretty quickly with these analyses as they are a compliance hotbed.

What is an affiliated service group?

Now, let's look at affiliated service groups. Unlike the controlled groups , affiliated service group analyses don't depend on ownership percentages; they are facts-and-circumstances determinations, making them much muddier than controlled group determinations.

Affiliated service groups are groups of companies connected via (often) commonly owned, service-oriented companies that provide services to one another. For example, several independently-owned dental practices that own a scheduling company (which in turn provides scheduling to each dental practice) are more than likely an affiliated service group.

Like controlled groups, if a group of companies qualifies as an affiliated service group, then those companies are treated as one employer for purposes of a retirement plan. Yep, you guessed it – this impacts employee eligibility and participation, contributions, and nondiscrimination testing, just as discussed above.

Do controlled and affiliated service groups impact safe harbor retirement plan designs?

One simple word – yes. You'll have to consider how safe harbor retirement plan designs are impacted by jointly-owned or related entities.

For example, if the controlled group or affiliated service group has more than one retirement plan, but they share the same plan-year end, and all have the same type of safe harbor design, then these retirement plans can be aggregated for coverage testing, making testing easier and more efficient.

However, if the plans have different safe harbor designs, or one or more is a safe harbor plan and one or more isn't, or if the plans have different plan-year ends;, then the plans must be tested separately, making it easier to fail one or more of the required discrimination tests.

Further, if you qualify as a controlled group or affiliated service group, you'll need to address you're the plan design, taking into account eligibility, participation, vesting, contributions and permissable distributions under the plan, ensuring you don't run afoul of the nondiscrimination rules.

For instance, different types of matching contributions within the plans may violate discrmination testing, since all employers are deemed a single employer. If there are multiple plans, you may need to exclude HCEs from any type of matching contribution so that they don't get a higher matching rate than NHCEs. However, if you exclude HCEs from matching contributions, you may be able to permit different groups of NHCEs to have different match levels, enabling employers to reward different locations or classifications of employees.

A retirement plan expert can help you navigate this maze, providing you with proactive design solutions at the forefront – not after compliance issues arise.

Finalize Your Roster: Reward and Retain Your Team Stars

Now that we've run through our cash-balance profit-sharing Combo plan playbook, it's time to finalize your roster. Take in these points to consider when attracting and retaining your list of starters.

Attract the Right Team.

We know that you want to attract the right team – especially for your higher-paid, more experienced players. Adding the cash balance plan to a Safe Harbor 401K is one way to do this.

According to a 2023 national recordkeeper study, cash balance plans now make up 50% of all defined benefits plans, showing their mass appeal. Additionally, these plans:

- Have grown 6% from 2019 to 2020, compared to a 3% growth for new 401(k) plans.
- Have assets exceeding $1.2 trillion.
- Include 9.4 million retirement plan participants.
- Growth is primarily driven by small businesses, with companies with nine or fewer employees making up 60% of all cash balance plans.

A cash balance plan, distinguishs your company by offering increased benefits while , rewarding classes of employees. Compensationg the sales team different than the manufacturing team.

There are so many options when structuring a Combo plan, as long as it satisfies discrimination testing and other IRS and ERISA rules.

Retain Your Starters.

You didn't work this hard to attract the right talent just to see them leave you in two years. Retention is often more critical than attraction itself, as it boosts productivity, keeps knowledge in-house, and reduces costly turnover.

According to Gartner, employee turnover is still high, with projections forecasted to be 50% - 75% higher than employers have previously seen. Additionally, it's taking 18% longer to fill roles than it was before the pandemic, making employee retention more critical than ever.

Combo plans can help employers reward employee longevity and loyalty. While boosting company culture, producing higher employee engagement and increasing profitablity.

That's hard to beat.

A Cash Balance Playbook Example.

Small business owners (and their employees) are drawn to Combo plans because of “their ability to help catch up on delayed retirement savings as well as attract and retain top talent.”

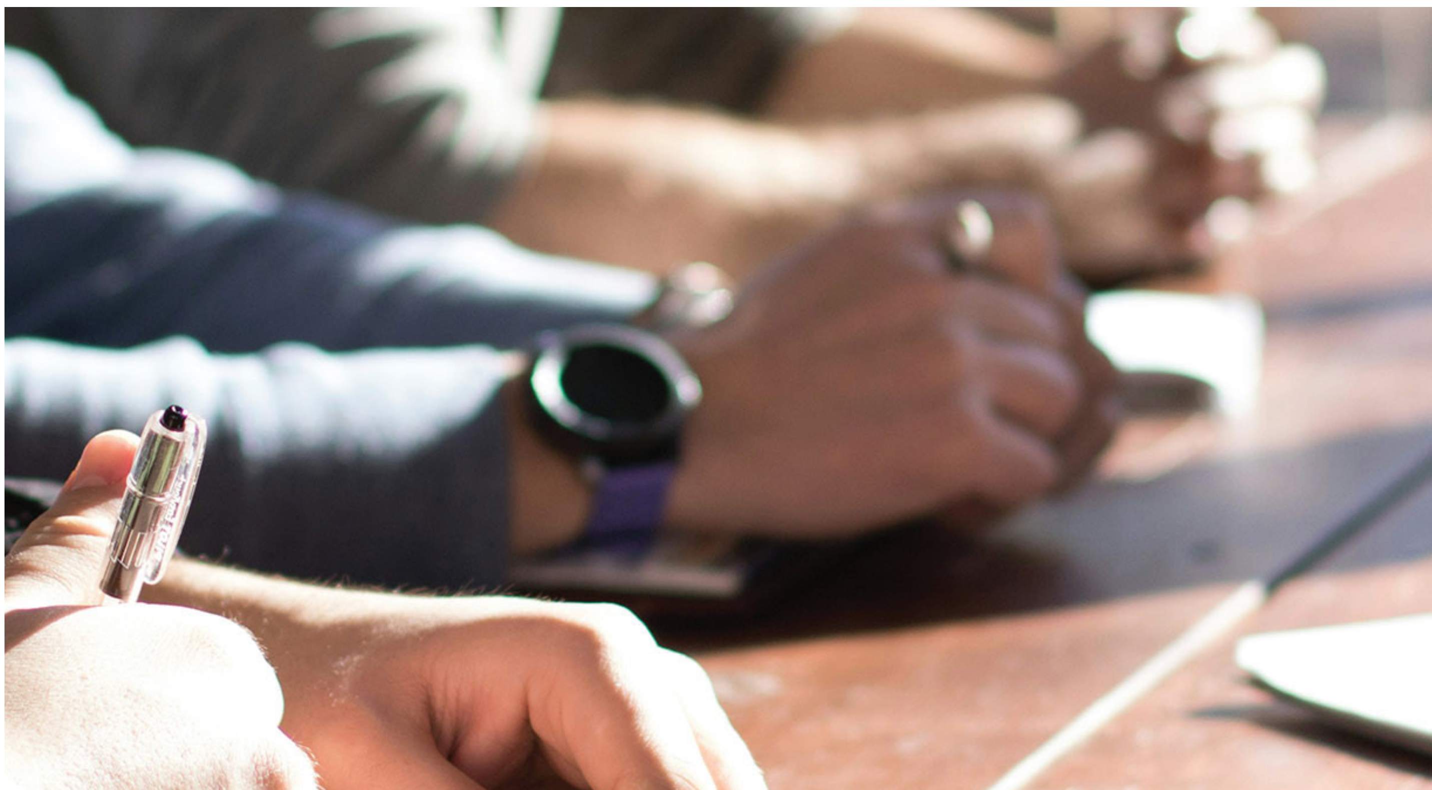
Let’s look at a small dental practice example highlighting the benefit of offering a cash-balance 401(k) plan.

Suppose a small Minnesota dental practice has a net income of $1,200,000 It has a staff of 8 people, of which two being 50 year old owner-HCEs. The total payroll for the staff is $650,000 annually. Both HCEs are in the 32% marginal tax bracket, married filing jointly. Additionally, each HCE has pass-through income of $50,000, generating $16,000 in tax liability while pocketing $34,000.

The Combo plan offers a safe harbor non-elective contribution of 3% per payroll ($650,000 x 3% = $19,500). Through the cross-testing feature of the plan, the practice can contribute $43,500 to the plan for each HCE. To meet the gateway nondiscrimination test, the practice must contribute an additional 2% of payroll ($650,000 x 2% = $13,000, making this $3,000 less than each HCE’s tax liability).

This additional $13,000 contribution creates an additional opportunity for a taxable deduction for the owner-HCEs, helping to mitigate their personal tax obligations of $16,000 while accumulating out-of-the-park retirement savings.

Having a specialist on your team enables you to run several play options, specifically tailoring the design of your cash-balance profit-sharing plan to your needs and goals.



Post-Season Interviews: What Worked and What Needs to Be Tweaked?

A Combo plan needs to be attended to throughout the year, including in-depth end-of-season exit interviews. Here are some questions you need to ask yourselves, your employees, and your team of retirement plan specialists:

- Did your Combo plan produce the intended results for ownership, key employees, and the rest of your team?
- If not, do you need to revise your employee groupings?
- Do you need to amend your profit-sharing allocation formula? For example, do you need to move to a salary proportional (or pro rata) method or a permitted disparity (or Social Security integration) method? Or is your new comparability (or cross-testing) method producing the results you expected?
- Is your plan passing nondiscrimination testing? If not, do you need to amend the plan as to participation, eligibility, or contributions?
- Are you planning to merge with or acquire another company in the near future? Or perhaps be acquired? This may impact whether you keep your plan moving forward or, on the other hand, have new employees join your plan (think controlled group or affiliated service group).

Simple list of things to consider as you look back at the plan year, with an eye towards the next one.

Hire the Right Coach

Having the right coaching staff is critical to your season's success – whether you're the Yankees, the Oakland A's, or a small professional practice wanting to reward your employees and sock some additional money away for retirement.

No matter if it's professional sports or business, not all coaches are the same. In the retirement plan space, you'll find lots of "coaches" with a trail of letters behind their names. Not all letters designate expertise in the retirement plan industry. However, here are some that should perk your interest:

- CRPS: Chartered Retirement Plans Specialist
- AIF: Accredited Investment Fiduciary®

Industry-recognized coaches with these professional designations demonstrate knowledge and expertise in retirement plans while showing a commitment to the industry as a whole. Further, these designations demonstrate that these coaches have met the educational, competence, and ethical standards when serving the best interests of their clients.

When it comes to Combo plans, your coach needs to have experience in designing and helping companies oversee these plans, as they're not simple. After all, you wouldn't hire a batting coach to work with your pitchers, would you?

Hiring the right coach – one who holds the right designations and can get in the mud with you on designing your Combo plan – is critical to your success at your company and in retirement.

When it comes to Combo plans, your coach needs to have experience in designing and helping companies oversee these plans, as they're not simple. After all, you wouldn't hire a batting coach to work with your pitchers, would you?

To learn more about whether a cash-balance profit-sharing plan is right for you and your team,
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