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Cross-tested Profit Sharing Plans: A Valuable Tool for Small to Mid-Size Firms

By Harry Veldkamp

Small to mid-size professional services firms often do not realize one of the significant advantages they enjoy over their larger competitors. Smaller firms have the ability to be flexible in the design of their retirement plans to help retain, reward, and attract prospective employees in a way that larger companies with "normal" plans cannot match.

Large firms' retirement plans tend to be "one size fits all," with everyone generally subject to the same benefit formula or allocation, usually expressed as a percentage of pay. Smaller firms, on the other hand, may treat individuals within the company differently, rewarding them based on a variety of factors most important to the firm.

"Cross-tested" Plans: The Small Firm Edge

There are several types of retirement plans available to professional services firms, such as Defined Benefit, 401(k), and Profit Sharing plans. One type of plan that has been used to great advantage by smaller firms is a hybrid form of a Profit Sharing plan known as a "cross-tested" plan. Cross-tested profit sharing plans, also known as "new comparability" or "multiple-tiered" plans, allow firms to meet the needs of most, if not all employees. In addition, a well-designed cross-tested retirement plan can be a more visible and valued employee benefit than a traditional plan.

A cross-tested plan allows a firm to place each eligible participant into his or her own "tier" and the firm then determines on a year-by-year basis how much is contributed on behalf of each individual or group of individuals. Tiers can be based on a variety of factors, including compensation, longevity on the job, meritorious service, attaining certain sales and/or managerial goals, to name just a few. Using these plans, a business can tailor its total compensation and benefit package to meet individual needs and provide a vastly more meaningful benefit to employees and especially to key individuals.

Companies that have owners with different objectives often use cross-tested plans to meet their needs. Many times the owners have the same overall compensation, but one owner might prefer to contribute less to the retirement plan while another owner choose to put more money into the plan. Often the result is a compromise where each owner is equally dissatisfied. The ideal solution in these situations is to implement a cross-tested plan, because each owner can then achieve his or her desired result, rather than settling for a compromise.

Many management consulting firms favor cross-tested plans because they provide the opportunity to reward certain consultants more than others based on their performance. For example, consultants bringing in more new business than others can be suitably rewarded—instead of or in addition to other incentives—using the cross-tested approach. Similarly, firm partners can have contributions allocated to themselves in the same ratio as, for example, their stock ownership or contributions to the success of the practice.

It is important to note that, while the cross-tested allocation approach would not be a complete replacement for a direct bonus (whatever the tax consequences), it is a welcome contribution that hopefully will yield years of tax-deferred growth for the employees who are focused on planning for retirement.

For example, if an employee receives a \$1,000 bonus, which after taxes amounts to about \$700, it is likely that the bonus will be spent rather than saved. However, \$1,000 contributed to a profit-sharing plan for twenty-five years compounded at 8 percent interest would yield approximately \$73,000. For the business owner, it is not unreasonable for a successful person to personally put away the maximum of \$44,000 per year. Do this for fifteen years at 8 percent interest and you will have some serious money at retirement: approximately \$1.2 million. If you can do it for twenty years, you will have more than \$2 million.

Different Goals, Targeted Benefits

The unique features of cross-tested profit sharing plans can be demonstrated in the following examples involving four hypothetical small to mid-size businesses and the approaches they took.

Consulting Firm A adopted a cross-tested profit sharing plan, with each participant in his or her own tier, for the express purpose of acquiring exceptional personnel for highly technical positions. Normally, relatively older and more experienced personnel would fill these positions, with pay in the \$70,000 to \$85,000 range.

The cross-tested plan provided Firm A with the opportunity to tailor retirement benefits to each qualified applicant, developing different profit-sharing benefits, in its sole discretion, to allow for flexibility in hiring. At the same time, Firm A's larger competitors were required to make the same contribution percentage for all their participants. Note that it was much less costly to Firm A and the participants to have the company make these tax-deductible contributions to the profit-sharing plan than to pay the same amount in taxable bonuses.

Consulting Firm B carried this idea one step further. It was facing a retention problem and wanted to stem the costs of hiring and training replacements for these well-qualified employees. Under the cross-tested approach, certain participants whom Firm B determined were more valuable were granted higher percentage of pay contributions based on both their longevity with the firm and their overall contributions to its success.

A case study: assume Consulting Firm C has one principal and ten non-highly-compensated employees. The principal earns \$220,000 and defers \$15,000 into the Firm's 401(k) Plan. The deferral percentage for the principal is 6.82 percent. Therefore, the other eligible employees defer, on average, 4.82 percent. However, if the principal needs to defer only \$9,000 to reach the full \$44,000 annual addition, the deferral percentage is reduced to 4.09 percent, so the other eligible people need only defer, on average, 2.05 percent, which is much easier to accomplish.

In another instance a tax-exempt entity decided to encourage its employees to contribute to their individual 403(b) plans and to reward them for longevity. Although these employees were not highly paid, they were very valuable to the employer and provided valuable services to the community. It is difficult to obtain such dedicated individuals and, unfortunately, economic pressure forced some of these employees to leave for higher paying jobs.

The solution for the employer was to adopt a cross-tested plan, which allocated the contributions based on a) the amount each employee contributed to the 403(b) program and b) the longevity of the participant. For example, if participant A did not contribute to the 403(b) plan and was with the organization for less than five years, the contribution would be 1.5 percent of pay. If the 403(b) contribution for that same individual were 5 percent of pay, the organization would "match" \$0.50 on the dollar up to 6 percent of pay through the separate tiered-allocation program. The percentage amounts of the "match" would be increased based on the rate of contributions to the 403(b) program and longevity. This program has been in effect for several years and has been expanding.

Conclusion

Cross-tested plans are a great solution for many small to mid-size management consulting firms, but they are not "cookie-cutter" plans and they require experts to establish an optimal plan design and perform the necessary annual plan administration and calculations. Equally important is an annual review to insure that the plan continues to provide its intended results for the firm, its principals, and its employees.

Each business is different and requires an individual analysis. IRS non-discrimination tests must be met, but cross-tested plans feature flexibility that can provide great solutions for small businesses. Cross-tested plans take a little more work to establish, but their benefits can be exponentially greater than those of a "normal" retirement plan.

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Harry Veldkamp is co-owner and CEO of [Polycomp Administrative Services, Inc.](#), a California-based consulting leader in providing customized retirement plans and benefit administration since 1974. He can be reached at hveldkamp@polycomp.net