Cross-Tested Profit Sharing Plans

A Story Worth Telling

Founded in 1905, The Lafayette Life Insurance Company is headquartered in Cincinnati, Ohio. The company's Retirement Services Department offers access to administrative services for Defined Benefit, Money Purchase, Target Benefit, Profit Sharing and 401(k) Plans. These services include assistance with plan design, funding, trust documents and preparation of government reports. Lafayette Life specializes in providing innovative assistance with plan design, including cross-tested profit sharing plans. An experienced and professional staff is prepared to assist you with your retirement objectives. Lafayette Life markets a portfolio of traditional life insurance in 49 states and the District of Columbia.

Isn't it About Time?

IRS regulations have come to the rescue of the small business. Owners have more flexibility with retirement plans than in the past.

Profit sharing plans have long been the retirement plan of choice for the small business. However, with "traditional" plans, flexibility exists only in the contribution level. Typically, each employee's share of the firm's contribution is identical. If one employee receives an allocation of 10% of salary, all employees receive an allocation of 10% of salary.

Most small business owners would like more options in the amount of their contribution to employees. Flexibility is now available. Section 401(a)(4) of the Internal Revenue Code (IRC) allows profit sharing allocations to be divided differently among employees based upon identifiable classification groups. Not only is the amount of contribution flexible, but there is flexibility in the way it is divided among the employees.

This type of profit sharing plan is referred to as a ***cross-tested profit sharing plan***. There are two formulas:

- Age-weighted plans, in which older employees are favored.
- Classification groups, in which employees are divided into groups, with each group receiving a different share of the contribution.

The cross-tested profit sharing plan allows the owner to decide who will benefit more from the firm's profit sharing contribution based upon objective criteria. For example, the owner may divide employees by job classification and ownership.

Once the desired allocations are decided, the plan is tested for nondiscrimination under Section 401(a)(4) of the Internal Revenue Code. If the projected benefits of the participants are "comparable" according to the IRS guidelines, the plan is deemed to be nondiscriminatory. The age, compensation and contribution amount for each employee will determine whether the plan is discriminatory. These plans generally work well if the owner or key employees are older than most of the other employees.

Maximizing Retirement Plan Effectiveness

The options for classification groups and contribution amounts maximize the effectiveness of the firm's retirement plan using a cross-tested plan design. The example shown on the next page illustrates the difference between the traditional profit sharing allocation and the cross-tested allocation.

Lafayette Life Insurance Company

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DESIGN ADMINISTRATION FUNDING

Questions and Answers

Q. How is a traditional profit sharing plan contribution allocated among the employees?

A. Generally, all employees receive the same percentage of salary as their share of the contribution. No particular employee can be favored because of their salary level, age, length of service or contribution to the profits of the business.

Q. What is a cross-tested profit sharing plan?

A. Cross-tested allocation formulas may be based upon age or classification groups. Nondiscrimination is tested by comparing benefit projections of participants rather than contribution levels. Thus, participants are not allocated the same percentage of salary.

Q. What is a cross-tested age-weighted profit sharing plan?

A. A plan allocating the contribution on the basis of age that favors older employees.

Q. What is a cross-tested classification group profit sharing plan?

A. This type of plan allows more flexibility than an age-weighted plan. Employees are divided into classification groups and each class may receive an allocation different than the others. Two or three groups may be created with each group receiving a different allocation. The advantage of this plan design is the allocation flexibility previously unavailable within a traditional profit sharing plan.

Q. Can a firm change an existing traditional profit sharing plan to a cross-tested plan?

A. **Yes.** Usually the plan can be amended to change the allocation formula to a cross-tested plan. The existing plan is not terminated, only the method of allocation is amended.

Q. Should every existing profit sharing plan change to a cross-tested plan?

A. Whether a cross-tested plan would be appealing to a business depends upon two factors. The objective of the employer is of primary importance. If the owner wants all employees to receive the same percentage of pay as their share of the profit sharing contribution, then a traditional plan will accomplish this. If, however, the owner prefers that not everyone receive the same share, the options available under these plans are significant. >

Comparison of Traditional and Cross-Tested Profit Sharing Allocations[1]

Employee | Age	Salary	Traditional Profit Sharing Allocation	Cross-Tested Profit Sharing Allocation	Cross-Tested Profit Sharing 401(k) Safe Harbor Allocation
Owner | age 55	$350,000	$70,000	$70,000	$77,500
Spouse of Owner | age 52	$55,000	$11,000	$27,000	$57,000
Employee A | age 33	$26,000	$5,200	$1,300	$1,300
Employee B | age 24	$26,000	$5,200	$1,300	$1,300
Total Contribution		**$91,400**	**$99,600**	**$137,100**
Percent to Owner & Spouse		**89%**	**97%**	**98%**

1 The example shown is hypothetical in nature and used for illustrative purposes only. Values as of 1/1/2025.

The options will depend upon the demographics of any specific employee group. The ages and salaries of the employees will determine what type of plan design will pass the IRC nondiscrimination testing. Usually, more desirable options are available if the owner or key employees are older than most of the other employees.

Q. How do I evaluate a cross-tested profit sharing plan for my business?

A. First, you need to meet with a representative from The Lafayette Life Insurance Company. The representative will collect census data and other pertinent information. A retirement plan proposal will be prepared based upon your objectives and funding goals.

Q. Who is included in a profit sharing plan?

A. The eligibility requirements generally are: employees must be 21 years old, and have one year of service that included 1,000 hours. Once employees have met the eligibility requirements, they are included in the plan.

Q. Do profit sharing plans have a vesting schedule?

A. **Yes.** One of the advantages of a qualified retirement plan is the vesting schedule. Most plans use a vesting schedule that requires employees to work for an employer a specified period, such as six years, before they are 100% vested. If a participant's employment is terminated before they are vested, the nonvested portion of their account is forfeited and remains in the plan.

Q. How do I start a profit sharing plan?

A. The steps are:

1. Review the retirement plan proposal presented by your Lafayette Life representative.
2. Adopt the plan by signing the Adoption Agreement.
3. Fund the plan.

Q. Why should I select Lafayette Life?

A. Lafayette Life is not a newcomer to qualified retirement plans. We have been providing services and funding products for over 50 years.

The advantages we offer are:

- One service provider for the plan document, funding, annual valuation and federal filings.
- Consultation and evaluation by an experienced pension staff.
- Your local representative services the account.

Thank you for the opportunity to present the cross-tested profit sharing plan as a retirement option.

The Lafayette Life Insurance Company

With more than 115 years of service to policyholders, The Lafayette Life Insurance Company is a financially strong provider of individual life insurance, annuities, and retirement and pension products and services.

Lafayette Life is a member of Western & Southern Financial Group, Inc., a family of financial services companies whose heritage dates back to 1888. With the strength of our organization and our ongoing commitment to servicing you, your business and your family, The Lafayette Life Insurance Company is a company you can depend on. Find out more about our financial strength and distinguished history at **www.LafayetteLife.com**.

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The Lafayette Life Insurance Company, Cincinnati, Ohio, operates in D.C. and all states except New York, and is a member of Western & Southern Financial Group, Inc.

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