WELLS FARGO Advisors

New comparability plans

A retirement plan alternative that favors key employees

A new comparability plan may provide a way for business owners to make more substantial contributions that favor higher-paid workers and key employees.

If you're looking for a retirement plan with the tax advantages of a qualified plan along with the ability to skew employer contributions toward key and highly compensated employees (HCEs), you may be frustrated by the apparent lack of alternatives available. The regulations governing qualified retirement plans generally stipulate that a plan cannot be designed to discriminate in favor of HCEs,* as defined by the IRS. However, you may find what you're looking for in a new comparability plan, also referred to as a cross-tested plan.

What is a new comparability plan?

New comparability is a type of defined contribution allocation method that lets an employer designate different contribution percentages to select groups of employees. This allocation method is one of the few ways a plan sponsor can allow select employee groups to potentially receive the maximum employer contribution and contribute up to the annual employee contribution limit while reducing the amount of employer contributions going to rank-and-file employees.[†]

How new comparability works

"Cross-testing" separates new comparability from other contribution-allocation methods in defined contribution plans. Cross-testing is when an allocation for a plan participant is converted into a projected benefit at retirement. When determining the allocation for a particular year's contribution, the business must establish a desired projected benefit at retirement (typically age 65). A plan is not considered discriminatory as long as when the contributions are cross-tested—converted into a projected benefit—each individual has the same projected retirement benefit.

When performing the cross-testing calculation, employees are divided into defined groups according to business justifications. For example, a plan sponsor can separate its employees into HCEs and non-highly compensated employees (NHCEs) or by specific job classifications, such as owners, sales, and clerical. The employer can then make separate contributions with respect to each group.

Cross-testing is more commonly used with defined contribution plans, such as profit sharing plans, or as a profit-sharing contribution to a 401(k).

* If it's determined that a plan does discriminate, the plan cannot take advantage of the favorable tax treatment available to qualified retirement plans.
[†] Nondiscrimination testing and gateway minimum testing apply.

Benefits of cross-testing

Once the plan has defined the groups of employees, a cross-tested plan will allow for a larger contribution percentage to the group with a higher average age, compared to the group classifications with a younger average age. Larger contributions are usually made for older employees because there's less time for them to potentially accumulate and reach the desired projected benefit at retirement.

Challenges of cross-testing

Cross-testing is complex. Although you are not required to employ an actuary (as you would with a defined benefit plan) to perform the cross-testing calculations, employers are strongly encouraged to hire a third-party administrator that specializes in new comparability plans. Typically, the new comparability feature will add to the plan's administrative costs. However, for many businesses, the employer or key employees receive an increased share of the plan's contributions, which can offset the additional costs (depending on employee demographics).

Is new comparability right for you?

New comparability is clearly not for every employer. Unless your employees' ages happen to conveniently break down so that you can create the desired groups, the plan will not generate the intended results. However, when employee demographics do work out and the employer is willing to pay the additional costs, new comparability can be a viable retirement plan solution.

New comparability versus traditional profit sharing

As an example, Sam's business has four employees (including Sam). He is 55 years old and the business's only HCE. As a result, Sam can be in a "group" by himself. As the table below shows, by using new comparability versus traditional profit sharing, a significantly larger portion of the business's contribution would go to him rather than the other employees.

Eligible employees	Age	Salary	Traditional profit sharing	New comparability profit sharing
Sam	55	$100,000	$25,000	$25,000
% of salary			25.0	25.0
% of contribution			54.05	85.47
Beth	35	50,000	12,500	2,500
% of salary			25.0	5.0
% of contribution			27.03	8.55
John	33	35,000	8,750	1,750
% of salary			25.0	5.0
% of contribution			18.92	5.98
Holly (part-time)*	28	15,000	$0	$0
% of salary			0.0	0.0
% of contribution			0.0	0.0
Eligible total		**$200,000**	**$46,250**	**$29,250**

Example assumes 1) The business is incorporated and 2) the plan uses a one-year-of-service eligibility provision.
* Works less than 1,000 hours

You can count on us

With all the alternatives available, selecting the right type of retirement plan for your business can be challenging. To help you decide, your financial advisor can provide more information on employer retirement plans.