Cross-Testing Allocation: Why isn't it working?

Cross-testing allocation is a type of discretionary profit-sharing calculation. Cross-tested plans are designed to benefit those closer to normal retirement age with larger contribution amounts. This type of allocation works best when staff members are at least 15 years younger than the people you're targeting for larger contributions.

Age and Compensation

Cross-testing generally looks at two variables: the difference in age, and the difference in compensation between the key group (Owners/Family Members/Highly Compensated Employees) and the staff.

Family members of owners and Highly Compensated Employees can often create problems with passing the testing and can prevent the owners from maximizing contributions. This can be especially problematic when these family members are many years from retirement age, for example, young adult children working at the business. These problems occur because certain family members of owners are considered Highly Compensated Employees for purposes of testing, even though they may be working part-time or drawing a low salary. Having young, Highly Compensated Employees can cause issues with age-based testing.

Another issue is with an owner's spouse, who typically receives less in compensation than the owner. Generally, an owner's spouse maximizes their salary deferral deductibles, which ends up being a rather large percentage of their pay. The higher the percentage of contributions that the Highly Compensated Employees receive, the higher the percentage of contributions that the staff must receive. Therefore, giving an owner's spouse profit sharing may not be possible, or their deferral contributions my need to be limited.

Plan Provisions

Cross-testing can also be impacted by a plan's allocation provisions. If the plan has allocation requirements of hours and/or the last day worked, this will also impact the ability to maximize the benefit for the owner. If an individual is terminated or worked less than the hours required during the year, then the participant would not be eligible for profit-sharing contributions. This could result in a low percentage or 0% benefit from the plan, and the testing will automatically fail for not providing certain minimum contribution levels to employees.

Considerations

Cross-testing allocation can be a powerful tool in maximizing an owner's contributions to a plan. However, a plan's demographics greatly influence how successful the testing can be. Changes in compensation, deferrals, hours, terminations, et cetera, all have an impact on the calculations and testing. What works in one plan year may not work in the next plan year. Preliminary calculations can be misleading. We recommend that plan sponsors work with their Relationship Manager as part of the annual administration work to find a solution that best works for them using accurate plan information.