New Comparability Plan

March 30, 2015
New Comparability Plan

What is it?

In general

A new comparability plan is a qualified profit-sharing plan that can have more substantial contributions for favored employees (usually higher-paid workers and key employees). With this type of plan, contributions are not allocated strictly as a percentage of compensation. Instead, by dividing up plan participants into two or more classes and having different contribution rates for each class, this type of plan allows businesses to maximize plan contributions for certain employees and minimize allocations to other employees. A new comparability plan satisfies nondiscrimination requirements by requiring minimum contributions and then having the plan pass a series of tests to show that the projected benefits for each class meet the coverage requirements.

In general, a new comparability plan is a type of profit-sharing plan that is similar to an age-weighted plan in that both types of plans allow a business to maximize the plan contributions to the older, higher-paid owners and key employees while minimizing allocations to the accounts of younger employees. New comparability plans, however, take this one step further than age-weighted plans by also putting employees into different groups or categories (rather than strictly using age) and each category may have a different contribution formula.

As an employer with a new comparability plan, you may be able to provide yourself and other highly compensated employees a higher percentage of the plan contribution than you could under a traditional profit-sharing plan or even an age-weighted plan. You might also decide to receive the same dollar amount of a contribution as under a traditional profit sharing plan but reduce the overall contribution amount for other employees.

You can maximize your contributions for yourself and other highly compensated employees

With a new comparability plan, the percentage of the plan contribution going to your account and other highly compensated employees can be much higher, while the cost of providing benefits to other employees can be extremely low. Keep in mind, however, that like all profit-sharing plans, the maximum deductible employer contribution you can make is limited to 25 percent of the total compensation of all plan participants (compensation for each employee is limited for this purpose to $265,000 in 2015, $260,000 in 2014).

Example(s): Lou, the 55-year-old owner of the Café, earns $150,000 per year. He is the company’s only highly compensated employee. He employs four non-highly compensated employees: Susan, age 50; Donald, age 35; Ann Marie, age 28; and Joseph, age 25. Susan earns $40,000 per year, Donald earns $25,000, Ann Marie earns $20,000, and Joseph earns $20,000. Lou would like a profit-sharing plan with as much as possible allocated to his account and with as little as possible allocated to Susan’s, Donald’s, Ann Marie’s, and Joseph’s accounts. The following table shows how the Café’s contribution of $46,250 (a little over 18 percent of eligible pay) could be allocated within a traditional profit-sharing, age-weighted plan and a new comparability plan:

<table>
<thead>
<tr>
<th>Age</th>
<th>Annual Salary</th>
<th>Traditional Profit-Sharing Plan</th>
<th>Age-Weighted Profit-Sharing Plan</th>
<th>New Comparability Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Contribution Allocated</td>
<td>% of Pay</td>
<td>Contribution Allocated</td>
</tr>
<tr>
<td>Lou</td>
<td>55</td>
<td>$150,000</td>
<td>$27,206</td>
<td>18.137%</td>
</tr>
<tr>
<td>Susan</td>
<td>50</td>
<td>$40,000</td>
<td>$7,255</td>
<td>18.137%</td>
</tr>
<tr>
<td>Donald</td>
<td>35</td>
<td>$25,000</td>
<td>$4,535</td>
<td>18.137%</td>
</tr>
<tr>
<td>Ann Marie</td>
<td>28</td>
<td>$20,000</td>
<td>$3,627</td>
<td>18.137%</td>
</tr>
<tr>
<td>Joseph</td>
<td>25</td>
<td>$20,000</td>
<td>$3,627</td>
<td>18.137%</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$255,000</td>
<td>$46,250</td>
<td>18.137%</td>
</tr>
</tbody>
</table>

*May require minimum 3 percent contribution if top-heavy
Example(s): While all three plans are nondiscriminatory under the law, the new comparability plan gives Lou a much bigger share of the annual plan contribution. Under the new comparability plan, Lou has almost 89 percent of the plan’s contributions allocated to his own account ($41,000 for him out of a total of $46,250 in contributions), while under the age-weighted plan, he has 81 percent allocated to his account and only 59 percent allocated under the traditional profit-sharing plan. In addition, under the new comparability plan, Lou will receive $13,794 more than under the traditional plan while the cost of providing benefits for his employees will be $13,794 less.

Test to see if benefits are nondiscriminatory

With this type of plan, once minimum contributions levels are satisfied, it is the equivalent benefits, not the actual contributions, that are tested ("cross-tested") each year to demonstrate that the plan is not discriminatory in favor of highly compensated employees. There are several steps to this process.

The employees are divided into separate groups usually with highly compensated employees (HCEs) and other key employees in one group and everyone else (non-highly compensated employees, known as NHCEs) in another group.

Then, the projected retirement benefits are expressed as a percentage of compensation (the "equivalent benefit accrual rate," or EBAR); EBARs for all participants are compared and assigned to testing groups (called "rate groups").

Note: With age-weighted plans, the EBARs are the same for all participants. That's not the case with new comparability plans.

The regulations prescribe additional rules for testing defined contribution plans that are aggregated with defined benefit plans for purposes of Sections 401(a)(4) and 410(b).

Tip: State and local government plans are exempt from discrimination testing.

Why new comparability plans can be nondiscriminatory

You might be concerned as to whether a new comparability plan violates the nondiscrimination principles that prohibit highly paid employees from benefitting more from a qualified plan than lesser-paid employees. Note that contributions aren't the only way to make a comparison for nondiscrimination purposes--the IRS regulations permit benefits to be compared, too.

Technical Note: IRC Section 401(a)(4) provides that for a plan to be qualified, the "contributions or benefits provided under the plan [must] not discriminate in favor of highly compensated employees." The IRS has issued detailed regulations describing how qualified employer plans can prove they are nondiscriminatory. Two basic approaches are permitted by these regulations--either a plan can be designed to meet a safe harbor (thereby trading design flexibility for nondiscrimination certainty), or a plan can have a non-safe harbor design, requiring regular testing ("rate group testing") under the "general nondiscrimination rules." The general nondiscrimination rules allow defined contribution plans to be tested either by examining the current dollar contribution made to employees each year, or by converting those contributions into equivalent benefits, essentially looking at the benefit a particular dollar contribution today would provide at the plan's normal retirement age using certain actuarial assumptions. This latter approach is referred to as "cross-testing." That is, contributions are converted to equivalent benefit accrual rates (EBARs), which are then tested for nondiscrimination in a manner similar to the testing of defined benefit plans. Additional final regulations issued in 2001 provided specific guidance for plans using the cross-testing approach, and require that new noncomparability plans provide a minimum allocation to non-highly compensated employees (the "gateway" test) as a prerequisite for using cross-testing.

In sum, a new comparability plan can be nondiscriminatory because it provides at least required minimum contributions and it is viewed and evaluated for nondiscrimination purposes by comparing the projected retirement benefit at retirement, not at the current contribution level.

Participants are divided into classes

With new comparability plans, employees in a profit-sharing plan are grouped into two or more categories and each category may have a different contribution formula. The purpose of adopting a new comparability plan is to provide more for certain groups than others. Typically, substantial contributions are made for a favored and, on average, older group, with lower contributions for the other employees. Groups could be, for example, highly compensated employees, professional staff, clerical staff, officers, employees under age 50 (or some other age) and employees over age 50 (or some other age).

The gateway test
Under the final regulations, a defined contribution plan can test on a benefits basis if it:

1. Provides broadly available allocation rates, or
2. Provides age-based allocations, or
3. Passes a "gateway" requiring allocation rates for all non-highly compensated employees to be at least 5 percent of pay or at least one-third of the highest allocation rate for highly compensated employees

A plan satisfies the gateway test if each NHCE (non-highly compensated employee) has an allocation rate (determined using IRS Section 414(s) compensation) that's at least 1/3 of the highest allocation rate of any HCE (highly compensated employee) participating in the plan (the "1/3 test"). Alternatively, a plan is deemed to satisfy the gateway test if each NHCE receives an allocation of at least 5 percent of the employee's IRC Section 415 compensation (the "5 percent" test). Therefore, a plan that's designed to provide a minimum allocation to NHCEs of at least 5 percent will always be eligible to use cross-testing to establish nondiscrimination.

Example(s): The highest allocation rate for any HCE participating in the XYZ Profit-Sharing Plan is 21 percent. The Plan can satisfy the gateway test, and use cross-testing to establish nondiscrimination, if each NHCE receives an allocation of at least 1/3 of 21 percent (7 percent) of Section 414(s) compensation. Alternatively, the gateway test is satisfied if each NHCE receives an allocation of at least 5 percent of IRC Section 415 compensation.

Caution: There are different definitions of compensation for each part of the 5 percent or one-third gateway test. For the one-third test, the plan's definition of compensation must satisfy IRC Section 414(s). For the 5 percent test, IRC Section 415(c)(3) compensation, a broader compensation definition, is used. This means that a new comparability plan must use the top heavy definition of compensation (IRC Section 415(c)(3)) to determine whether that plan satisfies the 5 percent minimum allocation gateway and may not use the IRC Section 414(s) compensation definition that is usually required to test for nondiscrimination under the IRC Section 401(a)(4) nondiscrimination rules. The net effect of this is to increase the required employer contribution for eligible NHCEs participating in new comparability plans using the 5 percent gateway test.

Calculating equivalent benefit accrual ratios (EBARs)

Once a new comparability plan has satisfied the 5 percent or one-third gateway test, the next step is to calculate the EBARs of each participant. To calculate an EBAR, each participant's annual allocation is converted into a projected retirement benefit in a process called "normalizing the benefit." That is, the participant's current contribution is converted to an annual benefit payable as a single life annuity at the plan's normal retirement age (typically age 65) using actuarial factors. This projected retirement benefit is divided by the participant's compensation to determine the participant's EBAR. It is these EBARs, not the actual current dollar contributions, of participants that are compared (cross-tested) to determine whether a plan is nondiscriminatory.

Identifying the rate groups

Once EBARs have been calculated for each participant, the next step is to establish the testing groups ("rate groups"). The non-highly compensated employees (NHCEs) with an EBAR equal to or greater than the EBAR for a particular highly compensated employee (HCE) are grouped together as rate groups.

Meeting the coverage requirements

After the rate groups are determined, each rate group must satisfy the coverage requirements of IRC 410(b) by passing either (1) the ratio percentage test or (2) the average benefits test.

• The ratio percentage test: To pass this test, the employees in a rate group must have a coverage ratio of at least 70 percent. The number of NHCEs in a rate group is divided by the total number of NHCEs (including those not covered by the rate group) to determine the NHCE ratio. Then, the number of HCEs in a rate group is divided by the total number of HCEs (including those not covered by the rate group) to determine the HCE ratio. The NHCE ratio is divided by the HCE ratio--if the coverage ratio is at least 70 percent, the rate group passes the ratio percentage test.
• The average benefits test: If any group fails the ratio percentage test, then the rate group is tested under the more complicated average benefits test which consists of a nondiscriminatory classification test and an average benefit ratio test.
When can it be used?

*Generally, any employer is eligible to set up a new comparability plan*

While just about any employer can set up a new comparability plan, it is most suitable for businesses with owners and principals who:

- Want the contribution flexibility of a profit-sharing plan, and
- Are older, on average, than their other employees and
- Want the biggest possible share of the plan contributions allocated to their own accounts

*Example(s):* A CPA firm has 10 senior partners, 20 junior partners, and 50 administrative staff. The senior partners want a profit-sharing plan that allows maximum allocations to their own individual accounts, with much lower amounts for the junior partners and other staff. If the highly compensated senior partners are significantly older on average than the junior partners and staff, a new comparability plan with not two but three participant classes: senior partners, junior partners, and administrative staff members, could be the right plan for this firm.

How do you implement it?

A number of complex rules govern new comparability plans. Consequently, you will need a pension specialist to help you develop and maintain a plan. In setting up and maintaining the plan, you will need to:

- Determine the plan features most appropriate for your business
- Have calculations done each year to determine the correct allocation of contributions
- Choose the plan trustee
- Choose the plan administrator
- Submit the plan to the IRS for approval
- Adopt the plan during the year in which it is to be effective
- Provide a copy of the summary plan description to all eligible employees
- File the appropriate annual report with the IRS

Strengths

*You can maximize your contributions for yourself and other highly compensated employees*

Because of the way a new comparability plan is tested for nondiscrimination, it is generally possible to allocate a higher portion of contributions to owners, highly compensated employees, and key employees. This is particularly true if these participants tend to be older than other employees.

*Your contributions are flexible*

Unlike money purchase, target, and defined benefit plans, a new comparability plan, like other profit sharing plans, allows you the flexibility to determine each year how much or how little you want to contribute to the plan each year (subject to maximum contribution limitations as well as the requirement that, overall, contributions must be recurring and substantial). Consequently, if your business is not doing well, you can decide not to contribute one year and if business turns around down the road, you can decide to make a contribution for that year and subsequent years.

*Your contributions are tax deductible*

You may deduct any contributions you make to the plan up to 25 percent of the compensation paid to plan participants (in calculating payroll, an individual's compensation is limited to $265,000 in 2015, $260,000 in 2014).

*Your contributions are tax deferred for your employees*

Your contributions to the plan are not taxable to plan participants until withdrawn.
Tip: Your employees may generally defer taxation by rolling over distributions (other than required minimum distributions, hardship distributions, and certain periodic payments and corrective distributions) to an IRA or to certain other employer retirement plans.

Caution: When considering a rollover, to either an IRA or to another employer's retirement plan, your employees should consider carefully the investment options, fees and expenses, services, ability to make penalty-free withdrawals, degree of creditor protection, and distribution requirements associated with each option.

**Investment earnings accrue tax deferred**

Investment earnings accumulate tax deferred and are not taxed to your employees until the benefits are paid.

**Distributions from your plan may be eligible for special tax treatment**

If a plan participant elects to take a lump-sum distribution, the participant's distribution may be eligible for special tax treatment.

**Tradeoffs**

**Annual additions to each participant's account are limited**

Like any other defined contribution plan, the annual additions—that is the contributions plus forfeitures—to each employee's account are limited to the lesser of 100 percent of compensation or $53,000 (in 2015, $52,000 in 2014). See Questions & Answers for the definition of “forfeiture.” This limits the relative amount of funding for highly compensated employees. In contrast, a defined benefit plan may allow a much higher level of employer contributions for older employees.

**Your plan is subject to "top-heavy" requirements**

A plan is considered to be “top-heavy” if more than 60 percent of the benefits or contributions in the plan belong to the key employees (generally, the owners and officers of the business). If the plan is top-heavy, you must make a minimum contribution of 3 percent of pay to the accounts of all non-key employees.

**The plan is subject to federal reporting, disclosure, and other requirements**

A new comparability plan is subject to the federal reporting, disclosure, and other requirements that apply to most qualified plans under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code.

Tip: ERISA doesn't apply to governmental and most church retirement plans, plans maintained solely for the benefit of non-employees (for example, company directors), plans that cover only partners (and their spouses) and plans that cover only a sole proprietor (and his or her spouse).

**How to do it**

**Have a plan developed for your business**

Due to the complex nature of the rules governing qualified benefit plans, you will need a pension specialist to develop a plan that meets legal requirements as well as the needs of your business. You will need to:

- Determine the plan features most appropriate for your business: Carefully review your business, looking at factors such as your cash flow and profits, tax deduction needed, and current and future expected employee population (tenure, ages, salaries, turnover), to determine plan features.
- Choose the plan trustee (this may or may not be you): The assets of the plan must be held in trust by a trustee. The trustee has overall responsibility for managing and controlling the plan assets, preparing the trust account statements, maintaining a checking account, retaining records of contributions and distributions, filing tax reports with the IRS, and withholding appropriate taxes.
- Choose the plan administrator: Administering the plan involves many duties, including managing the plan (determining who is eligible to participate in the plan, the amount of benefits, and when they must be paid), and complying with reporting and disclosure requirements. The plan administrator may also be responsible for investing plan assets and/or providing informational and required investment educational services to plan participants. The employer is legally permitted to handle...
these responsibilities in-house, but plan sponsors will frequently hire a third-party firm or financial services company to assist in performing the functions of plan administration.

**Submit the plan to the IRS for approval**

Once a plan is developed, it should be submitted to the IRS. Since there are a number of formal requirements (for example, you must provide a formal notice to employees), a pension specialist should assist you in this task. Submission of the plan to the IRS is not a legal requirement, but it is highly recommended. The IRS will carefully review the plan and make sure that it meets all legal requirements. If the plan meets all requirements, the IRS will issue a favorable “determination letter.” If the plan does not meet all requirements, the IRS will issue an adverse determination letter indicating the deficiencies in the plan.

**Adopt the plan during the plan year in which it is to be effective**

A corporation “adopts” a plan by a formal action of the corporation's board of directors. An unincorporated business should adopt a written resolution in a form similar to a corporate resolution.

**Provide a copy of the summary plan description (SPD) to all eligible employees**

ERISA requires you to provide a copy of the summary plan description (SPD) to all eligible employees within 120 days after your plan is adopted. A SPD is a booklet that describes the plan's provisions and the participants' benefits, rights, and obligations in simple language. On an ongoing basis you must provide new participants with a copy of the SPD within 90 days after they become participants. You must also provide employees (and in some cases former employees and beneficiaries) with summaries of material modifications to the plan. In most cases you can provide these documents electronically (for example, through email or via your company's intranet site).

**File the appropriate annual report with the IRS**

Most qualified plans must file an annual report (Form 5500 series) with the IRS.

**Questions & Answers**

**Which employees do you have to include in your new comparability plan?**

In general, to be "qualified" (i.e., tax exempt), a plan must meet employee coverage tests that demonstrate that the plan does not discriminate in favor of highly compensated employees. This test is met by having a plan that covers any or all highly compensated employees also cover a certain minimum number or percentage of the non-highly compensated employees. Under the most basic minimum coverage test, a plan may cover any or all of the highly compensated employees if it also covers a number of non-highly compensated employees which is at least equal to 70 percent of the percentage of highly compensated employees covered. For example, if the plan covers 100 percent of the highly compensated employees, then the plan must also cover at least 70 percent of the non-highly compensated employees of the employer; or if the plan covers only 50 percent of the highly compensated employees, then the plan must also cover at least 35 percent of the non-highly compensated employees of the employer (70 percent of 50 percent is 35 percent).

With respect to those employees who are designated as eligible to be covered by the plan, the plan cannot impose age or service eligibility requirements longer than age 21 and one year of service. For eligibility purposes, a year of service generally means a 12-month period during which the employee has at least 1,000 hours of service.

Two years of service may be required for participation as long as the employee will be 100 percent vested immediately when the employee enters the plan. For eligibility purposes, one year of service means a 12-month period during which employee has at least 1,000 hours of service. If you want, you can impose less (but not more) restrictive requirements.

**When does plan participation begin?**

An employee who meets the minimum age and service requirements of the plan must be allowed to participate no later than the earlier of:

- The first day of the plan year beginning after the date the employee met the age and service requirements, or
- The date six months after these conditions are met
Example(s): Zoe, age 48, was hired by Big Co. on December 1, 2013. Big Co. has a new comparability plan, and the plan year begins on January 1 of each year. Zoe will have one year of service as of December 1, 2014. She must be allowed to participate in the plan by January 1, 2015. If you want, you can impose less (but not more) restrictive requirements.

What is a highly compensated employee?

For 2015, a highly compensated employee is an individual who:

- Was a 5 percent owner of the employer during 2014 or 2015, or
- Had compensation in 2014 in excess of $115,000 and, at the election of the employer, was in the top 20 percent of employees in terms of compensation for that year. (This $115,000 limit is subject to cost of living adjustments each year.)

How is compensation defined for the gateway test?

It depends. A new comparability plan must use the top-heavy definition of compensation (Section 415(c)(3)) to determine whether that plan satisfies the 5 percent minimum allocation gateway. The plan may not use the other definitions of Section 414(s) compensation that are allowed when testing for nondiscrimination under the Section 401(a)(4) nondiscrimination rules. The net effect of this may be to increase the required employer contribution for eligible NHCEs for new comparability plans using the 5 percent gateway (if the plan would otherwise use a less inclusive definition of compensation for allocation purposes).

However, the Section 415(c)(3) compensation definition does not apply if the alternative gateway (each NHCE receives not less than one-third of the highest allocation provided for any HCE) is met. In this case, the Section 414(s) definition of compensation is used to determine whether the plan is discriminatory under the cross-testing rules.

When do your employees have full ownership of the funds in their accounts?

In general, employer contributions either must vest 100 percent after three years of service (“cliff” vesting), or must gradually vest with 20 percent after two years of service, followed by 20 percent per year until 100 percent vesting is achieved after six years (“graded” or “graduated” vesting).

Caution: Plans that require two years of service before employees are eligible to participate must vest 100 percent after two years of service.

Tip: A plan can have a faster vesting schedule than the law requires, but not a slower one.

What happens if an employee leaves before becoming fully vested in his or her account balance?

The unvested amount (called the forfeiture) is left behind in the plan. Forfeitures can be used to reduce future employer contributions under the plan, or they can be added to remaining participants’ account balances. The IRS requires that forfeitures be allocated in a nondiscriminatory manner. This usually requires forfeiture allocation in proportion to participants’ compensation rather than in proportion to their existing account balances.

Do you need to receive a favorable determination letter from the IRS in order for your plan to be qualified?

No, a plan does not need to receive a favorable IRS determination letter in order to be qualified. If the plan provisions (both the written provisions and as implemented) meet IRS requirements, the plan is qualified and entitled to the appropriate tax benefits. Nevertheless, without a determination letter, the issue of plan qualification for a given year does not arise until the IRS audits your tax returns for that year. By that time, however, it is generally too late for you to amend your plan to correct any disqualifying provisions. Consequently, a determination letter helps to avoid this problem because auditing agents generally won’t raise the issue of plan qualification if you have a current favorable determination letter.

What happens if the IRS determines that your new comparability plan no longer meets the qualified plan requirements?

The IRS has established programs for plan sponsors to correct defects. These programs are designed to allow correction with sanctions that are less severe than outright disqualification. If, however, you are unable to correct the defects in your program
appropriately, your plan may be disqualified. Loss of a plan's qualified status results in the following consequences:

- Employees may be taxed on contributions when they are vested rather than when benefits are paid
- Your deduction for employer contributions may be limited or delayed
- The plan trust would have to pay taxes on its earnings
- Distributions from the plan become ineligible for special tax treatment and cannot be rolled over tax free

**Do you have fiduciary responsibility for your employees’ new comparability plan accounts?**

Yes. You have a fiduciary responsibility to exercise care and prudence in the selection and appropriate diversification of plan investments. However, your liability for investment returns may be significantly reduced if you allow participants to direct the investments of their own accounts. A plan is participant-directed if it:

- Allows participants to choose from a broad range of investments with different risk and return characteristics
- Allows participants to give investment instructions at least as often as every three months
- Gives participants the ability to diversify investments generally and within investment categories
- Gives each participant sufficient information to make informed investment decisions

Note that if you sponsor a participant-directed plan, you assume an additional responsibility--participant education. A balance must be struck between providing not enough--or too much--investment educational support for plan participants. Employee education is an issue to be carefully considered when implementing a qualified retirement plan.

**Tip:** The Pension Protection Act of 2006 created a new prohibited transaction exemption under ERISA that lets certain related parties ("fiduciary advisers") provide investment advice (including, for example, recommendation of the advisor's own funds) to profit-sharing (and other defined contribution) plan participants if either (a) the advisor's fees don't vary based on the investment selected by the participant, or (b) the advice is based on a computer model certified by an independent expert, and certain other requirements, including detailed disclosure requirements, are satisfied. The Act also provides protection to retirement plan fiduciaries where an employee's account is placed in certain default investments in accordance with DOL regulations because the participant failed to make an affirmative investment election.