New Comparability & Age-Weighted Contributions

In 2001, EGTRRA provided small business owners new tools for allocating contributions to qualified accounts. Until EGTRRA, each employee received an equal share of each profit sharing plan contribution. For example, if a business contributed 10% of payroll, each employee received 10% of their respective salary or total wages.

This straight percentage allocation worked against most business owners and limited the usefulness of profit sharing and 401k plans as a primary retirement source for owner/employees. However, EGTRRA changed the rules and allowed small business owners to allocate a much higher portion of qualified plan contributions to their own personal accounts. Subsequent amendments and regulations have reinforced these changes and provided firm legal grounds for small business owners to garner the majority of their qualified plan contributions for their own personal investment purposes.

The new allocation rules fall into two broad categories:

a) **Age-Weighting, which favors older employees**

b) **New Comparability, which allows employees to be divided into groups or classes. Each class receives a different share of plan contributions.**

Each of these categories takes a different approach in determining which employees will receive preference in a qualified plan's allocations. Together, they inject new flexibility (and complexity) into qualified plan design and operation.

<u>Age-Weighting</u> **recognizes that money in a qualified plan has a time value. A deposit into a qualified plan by a 25 year old, will be worth much more at retirement than a deposit by a 55 year old and the age weighting standards take this into account when calculating whether or not a plan is discriminatory.**

Assuming an age 65 retirement and a 7% compounded annual return, if a 25 year old deposits $1,000 in their 401k plan it will grow to $14,974. An age 55 employee making the same $1,000 deposit will have only $1,967 at retirement. The deposit from the 25 year old is worth more than 7 times that of the age 55 employee. This disparity is caused by the difference in the number of years the earnings on the deposit is allowed to compound.

Additionally, if one assumes that the deposits are made on an annual basis, the 25 year old will be able to put $40,000 to work over the their working years at varying compounding durations. The contributions made at the younger ages, being much more valuable that those make in the employee's later years. By contrast, the age 55 employee, will only have an opportunity to make $10,000 in contributions and only the first contribution will be able to grow to a value of $1,967. The other $9,000 will have shorter compounding duration and therefore grow to a lesser final value.

Historically discrimination tests focused on a percentage of contributions and a 5% contribution by an age 25 year old worker, was considered equal to a 5% contribution by

Copyright 2007 – Capital Strategies Press, Ltd – All Rights Reserved

a 55 year old worker. The age-weighting standards address this inequity and level the playing field, somewhat. The net result is that older age employees can make substantially higher contributions than younger participants without triggering a violation of the discrimination rules.

New comparability **formulas allow the owner to decide which groups of employees will benefit most from plan qualifications. Employees can be grouped by a number of different criteria including: job type, salary level, length of service or combinations of these. Discrimination testing is done between groups in a new comparability plan. The new comparability guidelines can be used to contract profit sharing and 401k plans that are highly favorable to the own/employee group.**

Both the new comparability and the age-weighted standards can be used to favor the businesses owner and/or the executive class without discriminating against rank and file employees. Every plan is different and every business has unique employee demographics, but our design team specializes in finding the solution for works best in your situation. Give us a try. It could save you a bundle of taxes.

Copyright 2007 – Capital Strategies Press, Ltd – All Rights Reserved