GREENLEAF® TRUST

Perspectives

A Greenleaf Trust Newsletter

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President
Chief Executive Officer

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Greenleaf Day of Caring

I know that many of you have heard me speak about the importance of the four "Cs" to Greenleaf Trust. The four Cs represent what is most important to us. They are the driving force of our business. They are our purpose. They are what inspire us to do the work that we do. They are our "Why." The four Cs for Greenleaf Trust are Clients, Colleagues, Culture, and Community.

The four Cs are interrelated. We are in business to serve our clients. To make a difference in their lives. We do this with a talented team of colleagues. We support, grow, engage, and inspire that team with our unique culture. We do this together within communities whose vibrance impacts all of our lives and therefore, like our culture, require continuous nurturing.

There are no days off from the focus on our four Cs; however, there are days where we focus a little bit more on some. The third Monday of February is a day for the last eight years that we have specifically focused on Community. With the capital markets closed in observance of Presidents' Day, we created a day for our teammates to give back to the communities in which we live, work, and play. We call this day our Day of Caring.

Each teammate is encouraged to take that day and volunteer their time and talents to causes close to their hearts in their respective communities. The message is simple. Don't come into the office, but instead go out as leaders and help within your community. This year our volunteers provided over 300 hours of service in one day within their respective communities and helped more than 25 different non-profit institutions.

The day provides both external and internal benefits; what often happens is that groups of teammates volunteer together at a common non-profit institution. By doing so, they are able to give back to their communities and build relationships with each other. For instance, teammates in our Birmingham, Michigan office volunteered at Brilliant Detroit community centers in the city. Teammates in our Grand Rapids, Michigan office volunteered at Kent County Habitat for Humanity. Our Midland, Michigan office team volunteered at Arc of Midland and our Northern Michigan team got together to make fleece blankets for patients at a local cancer center. Our Kalamazoo team was mostly spread out throughout the community, except

Greenleaf Day of Caring, continued

for our Retirement Plan Division and Operations Division which spent their day at Kalamazoo Loaves and Fishes.

Our Day of Caring is something we Greenleafians all look forward to and enjoy each and every year. There are a lot of smiles on that day for sure. We recognize though that it's not just about volunteering for a single day, but instead it's a commitment we all have to give back and make our communities better. That commitment lasts throughout the entire year and is why Greenleaf Trust teammates volunteered more than 1750 hours of their time and talents in 2022. No days off from the focus on our four Cs.

Nicholas A. Juhle, CFA®
Chief Investment Officer

Just Put It on Our Tab

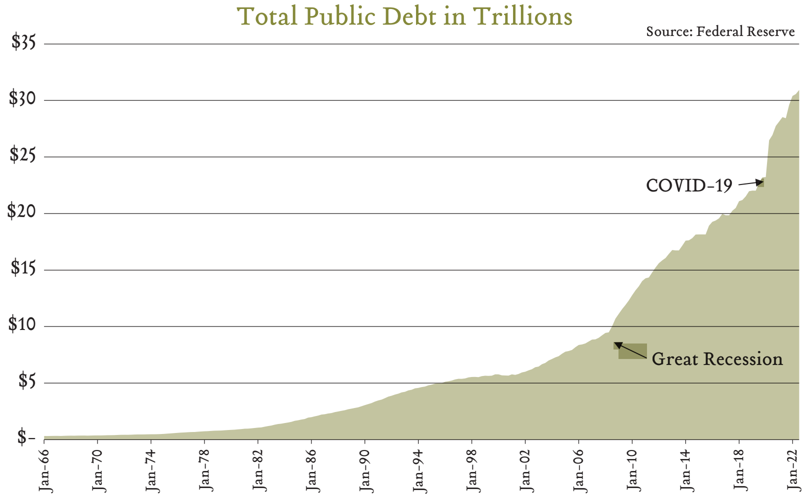
Our national debt has garnered a lot of attention this year, both for its absolute size and for the possibility that our elected friends in Washington might fail to raise its ceiling. In a way, it's funny. In the same breath we voice concern over the amount of debt and even more concern that we won't be allowed to take on more. Obviously, there are two issues at hand. The first is short-term in nature: Will Congress raise (or suspend) the debt ceiling and prevent the economic catastrophe that would accompany a US default? The second is longer-term: Is the country over-extended? Is $31.4T in debt too much?

"As with any business or household, when spending exceeds income, debt is incurred to cover the difference."

Full Faith and Credit

As with any business or household, when spending exceeds income, debt is incurred to cover the difference. The federal government is no different. According to the Congressional Budget Office, in fiscal year 2022 the US government spent approximately $6.3T (about $200K per second!) but only received about $4.9T in revenue, primarily from individual income taxes and payroll taxes. We borrowed the $1.4T deficit, adding to the national debt.

Total Public Debt in Trillions



Since the onset of the pandemic, the national debt has increased by $7.3T or about 30%. Congress limits the total amount of money the government can borrow with a so-called debt ceiling, which stands at $31.4T. We reached this debt ceiling in January, which means the US government is currently unable to borrow incremental funds to cover debt service and government-funded programs. Fortunately, it doesn't have to… yet.

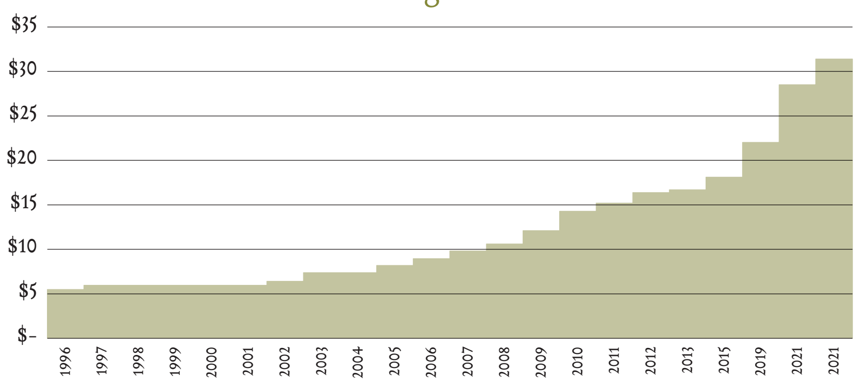
For now, the US Treasury is using "extraordinary measures" to buy some time until Congress can reach a deal to increase the debt ceiling. These extraordinary measures are really just accounting maneuvers that enable the government to pay bills with cash it already has on hand, even if said cash was earmarked for other purposes. US Treasury Secretary Janet Yellen has estimated that the X date, or the date the Treasury runs out of options and a default occurs, is somewhere around June of this year. Meanwhile, the Congressional Budget Office (CBO) projects a default date sometime between July and September, if not earlier based on the actual amount of tax revenue received in April. Congress will need to raise (or suspend) the debt ceiling prior to the X date in order to avoid a default on our nation's debt.

> "…on average the debt ceiling has been renegotiated every ten and a half months, more than once per year, since 1960."

Brinksmanship

Renegotiations of the debt ceiling are historically common and typically have not been very contentious. According to the US Department of the Treasury, Congress has acted 78 separate times since 1960 to permanently raise, temporarily extend, or revise the definition of the debt limit. This means that on average the debt ceiling has been renegotiated every ten and a half months, more than once per year, since 1960.

Debt Ceiling in Trillions



Source: Congressional Research Services

So why all the hubbub this time? Heightened concern stems from doubt that a divided Congress will be able to reach a compromise. Following the 2022 mid-terms, Democrats continue to control the Senate, while Republicans now control the House. House Republicans, seeking concessions on spending from Democratic legislators, are using the debt ceiling as leverage. Democrats,

Just Put It on Our Tab, continued

for their part, have publicly stated that they are not willing to negotiate and that the fate of the nation's full faith and credit depends on Republicans' willingness to drop the debt ceiling as a bargaining chip. With both sides talking past one another, it is no surprise that we find ourselves in this predicament.

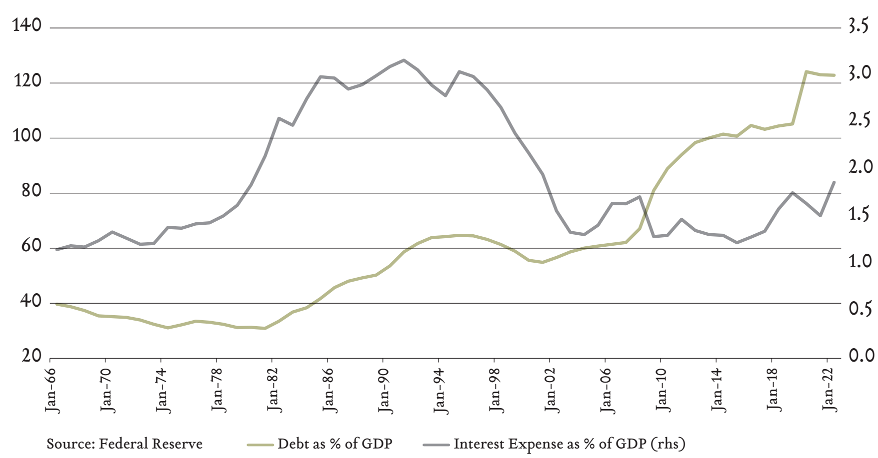
In the worst-case scenario, neither party concedes, the debt ceiling does not get renegotiated, and the US government defaults on its liabilities. This would obviously be catastrophic for financial markets and the broader global economy. Historically, and in spite of a few close calls, Congress has always managed to find common ground on this issue. Based on the stakes, Congress and the president have every incentive to avoid this worst-case scenario, and it is for this reason that we believe a deal will be struck prior to the X date.

In addition to raising the debt ceiling before the worst comes to fruition, we also predict a fair amount of political grandstanding by legislators and dire warnings from news pundits over the next few months – all of which should be taken with a grain of salt. While the risk of a default by the US government is real, the probability of it occurring at this juncture is small in our opinion. Instead of taking jabs at one another, we would prefer to see both parties put their differences aside and come to the table sooner rather than later to get this issue resolved.

"Now let us turn our attention to the slower-moving, longer-term $31.4T elephant in the room."

Up to Our Eyeballs?

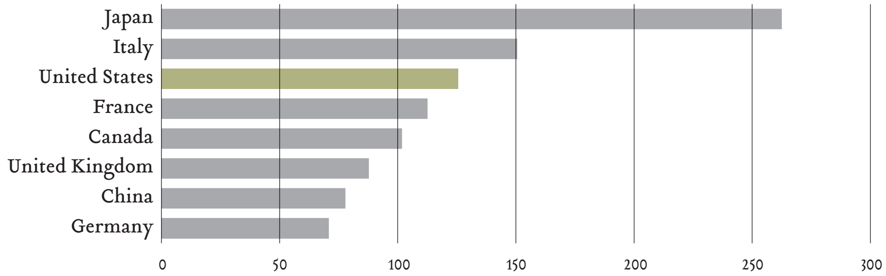
Now let us turn our attention to the slower-moving, longer-term $31.4T elephant in the room. As illustrated in the first chart, US debt has grown from $320 billion in 1966 to over $31 trillion today - a 9,000% increase. These are large numbers, but they ignore two important factors. The first being the growth of the overall economy, and the second being the government's ability to pay the interest on its debt. The accompanying graph shows how the debt has grown in relation to the size of the economy, as measured by Gross Domestic Product (GDP). The graph also shows how the debt servicing costs have changed over the years in relation to GDP. We use GDP here as a measure of the US economy, which is directly linked to the ability of the US government to generate revenue through taxation.



The level of debt in relation to the size of the economy has risen from 40% of GDP to 120% of GDP. However, the cost for the government to service its debt in relation to GDP, while higher than it was in 1966, is actually lower today, roughly 2% of GDP, than it was in the 1980s and 1990s. This illustrates that the US is not overly burdened by debt service costs at this time; however, with the rise in interest rates we expect to see the servicing costs increase in future periods.

If we zoom out and view the US government debt in relation to the G7 nations plus China we see that our position is not unique. Increasingly, governments around the globe have grown their balance sheets in order to finance social benefits, combat recessions, and bolster military spending.

Debt as Percentage of GDP



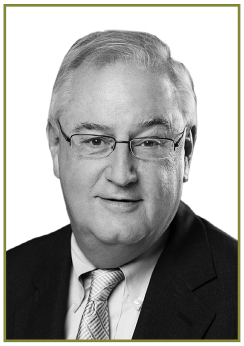
Source: International Monetary Fund, World Economic Outlook Database, October 2022

The US government has many advantages compared to its global peers. The US is the world's largest economy. It is also the sole issuer of the world's reserve currency. These advantages, in our opinion, provide the US with flexibility to address its debt challenges before they become a significant economic concern. This is a slow-moving problem at the moment. However, should the US experience economic stagnation, high interest rates, and a similarly large expansion of debt over the next 60 years, our opinion would be subject to change.

"For the time being, we believe national debt levels are manageable in the context of our nation's GDP and ability to make interest payments."

Conclusion

In the short term, the US government has reached the borrowing limit imposed by Congress. While brinksmanship and grandstanding will likely fill the air time between now and the eventual X date, realistically, we view the likelihood of a US default as a distant tail risk. For the time being, we believe national debt levels are manageable in the context of our nation's GDP and ability to make interest payments. Longer term, there is a limit to how much money our government can borrow, but it will likely be determined by market forces, not necessarily by Congress.



George F. Bearup, J.D.
Senior Legal Trust Advisor

Incentive Trusts – Do They Actually Work?

"The parent who leaves his [child] enormous wealth generally deadens the talents and energies of the [child] and tempts [them] to lead a less useful and less worthy life than [they] otherwise would." – Andrew Carnegie

Most estate plans skip the idea of using incentive distribution provisions to induce behavioral changes in the estate beneficiaries. A common estate distribution regime uses milestone ages, e.g., 25% at age 25, 50% at age 30, and the balance to be distributed at age 35. While this distribution pattern is easy to understand, some individuals still worry that the scheduled distribution of an inheritance will act as a disincentive towards work, savings, or unwittingly expose the distributed inheritance to the beneficiary's creditor claims or loss in a future divorce.

Other individuals who worry about their estate being distributed "too much, too soon" will tend to view the distribution of their wealth on their death as an opportunity to incentivize work, force disciplined savings, or simply use a trust to protect large inheritances from attacks by creditors or former spouses. These individuals are thus more interested in using an incentive trust to distribute their wealth to their loved ones.

"[Some] individuals… will tend to view the distribution of their wealth on their death as an opportunity to incentivize work, force disciplined savings, or simply use a trust to protect large inheritances…"

Incentive trusts can be used in a variety of situations to alter the behavior of a beneficiary. Common topics that are associated with an incentive trust might include: (i) to encourage educational pursuits, e.g., reward a college or advanced degree with an accelerated trust distribution; (ii) to promote industry or employment, e.g., encourage work by matching the beneficiary's earned income with a trust distribution; (iii) to adopt religious beliefs, or to marry another who follows a specified religion, e.g., pay for a wedding or honeymoon if the spouse is of a particular faith; and (iv) to inculcate morals, family values or healthy living habits, e.g., address the abuse of drugs, alcohol, gambling, or other abusive or addictive behaviors by using trust distributions to provide treatment and rehabilitation.

Examples of various trust provisions that are used to incent specific behaviors in beneficiaries, or lifestyle changes, include:

- Direct the trustee to distribute money to pay for a wedding or accelerate distributions when a beneficiary marries;
- Direct the trustee suspend trust distributions if the beneficiary is in a divorce;
- Authorize only discretionary distributions by the trustee to prompt the beneficiary to wait to marry until the beneficiary reaches a specified age;
- Reward a beneficiary with an increased trust distribution who marries a

person of a particular religious faith;

- Authorize trust distributions to charities identified by the beneficiary, or authorize distributions for the beneficiary's philanthropic work, e.g., the beneficiary is employed by a charity;
- Authorize extraordinary distributions by the trustee to enable the beneficiary to start his or her own business, contingent upon the beneficiary furnishing the trustee with a viable business plan that the trustee deems likely to succeed; or
- Reward a beneficiary with an enhanced distribution based on the hours worked by the beneficiary for a charity.

However, problems also come with using an incentive trust and its administration.

- An income matching provision might encourage a beneficiary to seek the highest grossing employment and demonstrate productivity, but the same provision would also discourage socially beneficial work, like working as a teacher, missionary, or serve the ministry, professions that serve the community at large, or punish a parent who stays home to care for a disabled child.
- An income matching provision might discourage a beneficiary from starting his or her own business, which often results in low earnings while the business is just starting.
- A new parent beneficiary would never receive a distribution if that beneficiary chose to stay home and raise and care for children rather than become employed and obtain a matching distribution from the trust.
- An incentive trust provisions direct the trustee to only make distributions if the beneficiary is "gainfully employed." This provision sometimes encourages the beneficiary to engage in 'gamesmanship' to work a short time solely for the purpose of satisfying the condition to receive a distribution, then quitting employment. This type of distribution condition is also difficult for a trustee to verify, particularly if the beneficiary resides far from the trustee's place of business.
- What kind of monitoring does an incentive trust require by the trustee? Periodic inquiries from the trustee often provoke a hostile response by the beneficiary.
- Incentive trusts often tend to be viewed by the beneficiary as punitive. Some trusts provide that if the beneficiary does not change their behaviors or the repeatedly fail to meet the conditions imposed, the trust's income is either added to trust principal, or the income is paid instead to a charity. In some cases, if the condition is not met, then the trust terminates with its assets distributed to other beneficiaries.
- Often subjective terms are used to describe the situation, behavior, or event that is incented. The use of vague terms like necessary or appropriate are

"Incentive trusts can be used in a variety of situations to alter the behavior of a beneficiary."

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Incentive Trusts – Do They Actually Work?, continued

susceptible to differing interpretations that can lead to disagreements between the trustee and the beneficiary. Tensions between the two can escalate when it is necessary that the trustee and beneficiary must work well with each other for an extended period of time. Clear descriptions or examples of behaviors (good and bad) are critical for an incentive trust's effectiveness.

- An incentive trust must also clearly spell out the consequences if a beneficiary refuses to cooperate with the trustee to determine if preconditions to an incentive distribution are met. This requires fairly negative trust provisions in order to address those situations. What happens if the beneficiary refuses to submit to a blood test? What happens if the beneficiary refuses to "go into rehab"? What happens if the beneficiary does not provide a copy of his or her income tax return to the trustee? If one consequence is that the beneficiary's trust share passes to another family member on a failure to meet a condition, that then creates resentment among the family members, especially if a family member who acts as the trustee that makes this "forfeiture" decision.

"While many positives can be achieved through the use of an incentive trust, there are an equal number of drawbacks to them."

The trustee of an incentive trust carries enormous responsibilities to manage the assets held in trust, including the duty to investigate whether the beneficiary meets the trust creator's expectations. The trustee needs to have the capacity to be able to say 'no' to a beneficiary, and also the ability to challenge a beneficiary who attempts to manipulate their situation or deceive in order to apparently satisfy a condition to their distribution.

While many positives can be achieved through the use of an incentive trust, there are an equal number of drawbacks to them. Most parents and grandparents do not want to punish trust beneficiaries for circumstances beyond their control, which is why an incentive trust needs to include some flexibility for the unexpected. For example, a parent does not want to penalize a child who has a learning disability. They would rather encourage their child to get a B instead of an A. The key point is that if an incentive trust is contemplated, it is important to not over-engineer the incentive terms which can result in inflexibility for the trustee charged with administering the trust.

Marching Away from the Madness

Alyssa Kole, CFP®
Wealth Management Advisor

It's that time of year – spring is around the corner, and spirits are high with anticipation of watching the top teams battle it out in the NCAA March Madness Tournament in a few short weeks. Whether you are an avid basketball fan, or just enjoy listening to the many theories around who will win, you've likely heard of the event. Sixty-eight teams play in a single elimination tournament that lasts three weeks in an attempt to win the men's Division I Championship. Another aspect of the tournament is the creation of brackets where individuals try to guess which teams will continue to win through the Sweet Sixteen, Elite Eight, Final Four and all the way to the Championship game. You're probably wondering, "What on earth does March Madness have to do with finance?" All of this excitement around picking the "right" teams may seem like harmless gambling, but what about when you are watching the stock market trying to pick the "right" stocks that will keep "winning," or increasing in value, for your investment portfolio? These tendencies to choose an investment, because you are familiar with the company or prefer their product(s), are types of behavioral biases.

Behavioral biases are beliefs or behaviors that can unconsciously influence our financial decision-making. One example is loss aversion, where the pain of losing (money) is more powerful than the pleasure of gaining. This is why many investors panic and sell investments when a single stock declines, but are disappointed in a 4% portfolio gain because it's "below average." Most of what behavioral biases are boil down to emotions and not looking at the big picture. It's easy in today's world to focus on the immediate and now, but taking a step back to make decisions based on long-term goals is what can give you peace of mind. Would you stop rooting for your favorite basketball team because they lose one regular season game? Probably not. Would you pick all the same teams that made it to the Final Four last year? I doubt it. What worked in the past won't necessarily work again. This also applies to choosing investments that did well in a previous year; it does not predict future performance. Would you place all of your retirement savings into a single investment? Hopefully not! Your long-term goals might look different from your neighbor's, friend's and even family member's, but the process to determine those goals is quite similar.

> "Behavioral biases are beliefs or behaviors that can unconsciously influence our financial decision-making"

What does this process look like? Consider doing the following: Determine when you want your retirement to start – do you want to retire at 50, or 65? Calculate how much you need to save to live your ideal

Marching Away from the Madness, continued

“In many ways, advisors can serve as a financial “coach,” to leave the emotions on the sidelines…”

lifestyle – do you plan to spend $70,000 a year, or $300,000? Invest your portfolio, while avoiding taking unnecessary risks – should you invest in a 60% equity portfolio, or an 80% equity portfolio? These topics are a small sampling of what we talk to our clients about when creating their personalized wealth management plan. In many ways, advisors can serve as a financial “coach,” to leave the emotions on the sidelines when volatility returns to the market. You want the same values in a coach on the court that you have for your finances – educated, strategic, and trustworthy.

Though not a comprehensive list of the steps necessary to prepare yourself successfully for 20 to 40 years of life, post-career, it’s a great starting point. And while it’s highly unlikely for someone to fill out a perfect bracket (more specifically, 1 in 120.2 billion), you can sleep soundly knowing you’re on track for your goals. Not every year in the market will be championship worthy, but having a financial coach and a well-thought out financial plan will ensure you can stay in the game for the long-term.

Secure Act 2.0 – More Changes to the Rules

Wendy Z. Cox, J.D., CTFA
Director of Personal Trust
Chief Fiduciary Officer

On December 29, 2022, President Biden signed the Consolidated Appropriations Act, 2023. The legislation contains significant retirement provisions in what is called the SECURE 2.0 Act of 2022 ("the Act"). The new Act contains a number of provisions that are aimed at encouraging retirement savings and charitable giving. Some provisions become applicable immediately and some in 2024 and beyond.

Contributions to Retirement Plans

In 2023, those over age 50 can make annual "catch up" contributions of up to $7,500, in addition to the standard $22,500 deferral, to 401(k), 403(b) and 457(b) retirement plans to help increase their retirement savings. Starting in 2025, this catch-up contribution limit increases to $10,000 for individuals who are age 60 through 63.

Beginning in 2024, catch-up contribution to retirement plans for employees whose wages exceed $145,000 (as indexed) must be made on a Roth basis. This is mandatory for any plan that makes catch-up contributions available. This provision does not apply to SIMPLE IRAs or SEP IRAs.

IRA owners over age 50 can currently contribute an additional $1,000 in "catch-up contributions" each year. Beginning in 2024, the Act provides that the $1,000 catch-up limit is indexed for inflation.

> "The new Act contains a number of provisions that are aimed at encouraging retirement savings and charitable giving."

Required Minimum Distributions ("RMD")

The Act affects how and at what age you must take required minimum distributions, also known as RMDs, from your tax-favored retirement accounts.

In 2023 or later, the age at which you must begin taking RMDs will rise to age 73 instead of the current age of 72. Starting in 2033, the age will rise again to age 75. The Act also reduced the penalty for a failure to take an RMD in any year to 25% (from 50%), and further to 10% if the failure is corrected in a timely manner.

We also have final clarification on the 10-year rule for Inherited IRAs. If the account owner was past the required beginning date for taking RMD, the beneficiaries must take RMD each year and the account must be fully distributed by the end of the 10 years following death of the account owner. If the individual dies in 2023, the individual or the individual's beneficiaries take the individual's 2023 RMD. Beginning in 2024, the beneficiaries must take an RMD and do so every year thereafter with final distribution in 2033.

If the account owner was before the required beginning date, then the

Secure Act 2.0 – More Changes to the Rules, continued

inherited IRA beneficiary does not have an RMD but the account must still be fully distributed by the end of 10 years following the death of the account owner. The beneficiaries may take distributions from the time they inherit the account, but they are not required. The account must be fully distributed by 2033.

One of the exceptions to the 10-year rule is where a qualified retirement account is paid to or for disabled or chronically ill beneficiaries. The new ACT provides additional clarity and flexibility when planning for disabled or chronically ill beneficiaries.

- ABLE (Achieving a Better Life Experience) accounts are tax-advantaged savings accounts that do not impact asset-tested government benefits received by special needs beneficiaries.
- The ACT increases the ability to open an account for those whose disability occurred before age 46, instead of the current age limit of 26.
- For a special needs trust that is a beneficiary of a retirement account, the Act also specifies that the special needs trust can have a charitable beneficiary that receives the trust funds after the disabled or chronically-ill beneficiary's death. Moreover, adding a charitable beneficiary will not compromise a special needs beneficiary's ability to use life expectancy time for payout of the retirement account and payment of the taxes.
- Prior to this provision, adding a charitable beneficiary would have subjected the retirement account to a much shorter payout period after the account owner's death, often five years.
- Clients with special needs beneficiaries often wish to provide for charities who have helped the beneficiary along the way and this provision makes it easier for the client to give back to those charities.

"The new ACT provides additional clarity and flexibility when planning for disabled or chronically ill beneficiaries."

Qualified Charitable Distributions are Expanded

Qualified Charitable Distributions ("QCDs") are distributions made directly from your IRA to a charity. QCDs are excluded entirely from your gross income and can be applied toward your RMD for that year. The annual $100,000 QCD limit is now indexed to inflation, meaning that the QCD limit will increase each year with inflation.

Historically, QCDs must go directly to a charity. A provision of the new act allows donors to make a one-time QCD of $50,000 to a split-interest charitable entity, such as a charitable remainder trust or charitable gift annuity. A "split interest" entity has both charitable and individual beneficiaries permitting Grantors to benefit both family members and charities with a one-time QCD of $50,000.

529 Plan Rollovers are Now Available

Starting in 2024, beneficiaries of a 529 Plan can roll the funds to a Roth IRA in certain circumstances. Previously, if the 529 Plan had funds remaining after the beneficiary had exhausted eligible educational expenses, the only options were to 1) roll the 529 Plan over to another beneficiary who still had eligible educational expenses or 2) withdraw the account and incur the income tax and 10% penalty. Allowing for the rollover to the Roth provides the beneficiary with an opportunity to start a nest egg that can grow tax free for decades to come. Unused 529 funds may be rolled over directly to a Roth IRA, subject to the following conditions:

- The 529 account must have been open for at least 15 years.
- Any contributions made within the previous five years are ineligible for rollover.
- The transfer must be made directly from the 529 Plan to the Roth IRA custodian and into an account with the same name as the 529 beneficiary.
- The eligible rollover amount is limited to the annual IRA contribution limit, less any other IRA contributions made for the same year. The annual limit for Roth IRA contributions is $6,500 in 2023.
- The income limitation for direct Roth contributions (currently $153,000 for a single taxpayer) does not apply to these rollovers.
- The maximum allowable rollover amount is $35,000 during the beneficiary's lifetime.

To make certain that your planning optimizes your goals, we recommend that you consult with your estate planning counsel, your accountant and your team at Greenleaf Trust and Greenleaf Trust Delaware.

"Qualified Charitable Distributions (QCDs) are distributions made directly from your IRA to a charity.... The annual $100,000 QCD limit... will [now] increase each year with inflation."

Is Cross-Testing Appropriate For Your Defined Contribution Plan?

Katie Mallette, QPA®, QKA®, ERPA
Senior Recordkeeping Analyst
Team Lead

Hot Cross...Testing?

"Hot cross buns, hot cross buns, one a penny, two a penny, hot cross buns..." Now that the famous nursery rhyme "Hot Cross Buns" plays in your mind, I want to take a few minutes to discuss the hot topic of cross-testing!

Cross-testing is a calculation method used for allocating employer discretionary profit-sharing contributions. This is often used alongside 401(k) and safe harbor contributions to maximize annual contribution limits (usually targeted to owners or highly compensated employees) at the lowest overall cost to the company.

Not all profit-sharing contributions are the same. There are four main ways to allocate a profit-sharing contribution: Pro-Rata (all employees receive the same rate in terms of a percentage of their salary), Integrated with Social Security (allows employers to contribute different amounts to employees based on their Social Security tax levels/taxable wage base), Age (equate contributions to equivalent benefits at retirement age), and Cross-Testing (creating separate benefit groups with each group having their own contribution rate).

As a refresher, qualified plans are required to be tested each year to show the plan does not discriminate in favor of highly compensated employees (HCEs). For the 2023 calendar testing year, a highly compensated employee is a term given to an employee who meets one of two criteria: someone who owns, or deemed to own via attribution rules, over 5% of the company during 2022 or 2023, or someone who earned $135,000 or more in wages in 2022. An employee who does not fall into one of those two criteria is considered a "non-highly compensated employee" (NHCE).

In a defined contribution plan (DC plan), providing an employer contribution for a year, based on a uniform percentage of all participants compensation, is not discriminatory in favor of HCEs. For example, a 401(k) plan that provides a profit-sharing contribution on a pro-rata basis utilizing compensation, is not discriminatory, such as providing everyone 10% of eligible compensation as a profit-sharing contribution.

"Cross-tested plans are able to put employees into different classes or groups... assigning each class or group a different allocation percentage or dollar amount."

Similarly, a defined benefit plan (DB plan) that provides a promised benefit at retirement that is based on a uniform percentage of compensation is also not discriminatory.

However, there often is a desire for a business to maximize profit sharing contributions to the older, higher paid owners and key employees, while minimizing allocations to younger employees. This is where cross-testing comes in!

A cross-testing setup works particularly well when the HCEs are older in comparison to the rest of the staff. Usually, the older employees are the ones who need the boost in savings, requiring and desiring a larger contribution to their retirement account.

The advantage of a properly structured cross-tested plan is the allowability of substantially larger contributions to be made for older participants than for the younger participants. In some cases, the employer might be able to make a 20% contribution for those older HCEs and only a 5% contribution for all other employees.

When cross-testing, those differing contribution amounts are converted to a projected retirement benefit (Equivalent Benefit Accrual Rate, or EBAR), and then reviewed to see if the projected benefit amounts are discriminatory.

Cross-tested plans are able to put employees into different classes or groups (rather than using age or a uniform percentage) and assigning each class or group a different allocation percentage or dollar amount. Each employee may be setup in their own class so that benefits can vary by person. Although the benefit dollars right now may differ, these plans are designed to pass IRS non-discrimination testing.

How does this theory work? Suppose a company has two employees, both making $50,000. One is age 60 and one is age 30. If we apply a uniform percentage of compensation to both employees, they would both receive the same dollar amount of contributions. But, if the goal is the ensure that each employee receives the same projected benefit at normal retirement age, then a larger contribution must be made to the 60-year-old than to the 30-year-old. This is because the 30-year-old has 35 years for the money to accumulate growth and earnings until retirement age; whereas the 60-year-old only has five years. We can provide the 60-year-old with a larger contribution amount today utilizing cross-testing.

So, how does a plan get to use this cross-testing benefit?

Before we can consider using this methodology, a minimum contribution (known as the gateway test) must be satisfied for all NHCEs. The NHCEs must receive an allocation for the year equal to the lesser of 5% OR one-third of the highest contribution rate provided to any HCE.

For example, if the highest HCE contribution rate is 12%, all NHCEs must receive 4%. If the highest HCE rate is 18%, all NHCEs must receive 5%.

Contributions already provided to the NHCEs throughout the year, such as profit-sharing contributions, top heavy contributions, safe harbor 3% non-elective contributions, forfeitures used as nonelectives, and qualified non-elective contributions all count toward the gateway minimum required.

Contributions of employer match, deferrals, or safe harbor matching do NOT count for this gateway minimum.

Let's say the current plan setup is a 3% safe harbor non-elective contribution and it is determined that the gateway needed is 5%. The employer would provide an additional 2% profit sharing to get up to the required 5% amount.

Once an employer has provided the gateway contribution to all NHCEs, the plan is able to then enter the world of cross-testing to maximize contributions to HCEs. Instead of following the nursey rhyme's methodology of pennies, this hot cross-testing could turn into thousands of dollars more to those who will need it the soonest!

"Although the benefit dollars right now may differ, these plans are designed to pass IRS non-discrimination testing."

Stock Market Pulse

Index	2/28/2023	Total Return Since 12/31/2022
S&P 1500	911.51	4.00%
Dow Jones Industrials	32,656.70	-1.13%
NASDAQ	11,455.54	9.61%
S&P 500	3,970.15	3.68%
S&P 400	2,600.84	7.23%
S&P 600	1,249.23	8.13%
NYSE Composite	15,428.97	1.94%
Dow Jones Utilities	906.99	-5.68%
Barclays Aggregate Bond	2,057.16	0.41%

P/E Multiples	2/28/2023
S&P 1500	18.5x
Dow Jones Industrials	19.1x
NASDAQ	44.5x
S&P 500	19.0x
S&P 400	14.3x
S&P 600	16.5x

Key Rates

Fed Funds Rate	4.50% to 4.75%
T Bill 90 Days	4.67%
T Bond 30 Yr	3.92%
Prime Rate	7.75%

Current Valuations

Index	Aggregate	P/E	Div. Yield
S&P 1500	911.51	18.5x	1.72%
S&P 500	3,970.15	19.0x	1.72%
Dow Jones Industrials	32,656.70	19.1x	2.12%
Dow Jones Utilities	906.99	19.4x	3.68%

Spread Between 30 Year Government Yields and Market Dividend Yields: 2.20%

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