

## Nondiscriminatory Classification Test

The second requirement of the average benefits test is the **nondiscriminatory classification test**. To satisfy this requirement, the method in which an employer chooses employees to cover under a qualified plan must meet both of the following requirements:

1. The classification must be reasonable and established, based on the facts and circumstances of the business, under objective business criteria that identify the category of employees who benefit under the plan (i.e., hourly or salaried, geographic location), and
2. The classification must be nondiscriminatory. In order for the classification to be nondiscriminatory, the plan must meet one of the following two tests:
  - **Safe harbor test.** A plan satisfies the safe harbor test for a plan year if and only if the plan's ratio percentage is greater than or equal to the employer's safe harbor percentage. The employer's safe harbor percentage is equal to 50 percent, reduced by  $\frac{3}{4}$  of a percentage point for each whole percentage point that the percentage of nonexcludable nonhighly compensated employees exceeds 60 percent of the employer's total employees. (See chart and examples below.)
  - **Facts and circumstances test.** To meet this test the plan's ratio percentage must be greater than or equal to the unsafe harbor percentage and the classification must satisfy a factual determination. The unsafe harbor percentage of an employer is 40 percent, reduced by  $\frac{3}{4}$  of a percentage point for each whole percentage point that the nonhighly compensated employee concentration percentage exceeds 60 percent. However, in no case is the unsafe harbor percentage less than 20 percent. (See chart and examples below.) A classification satisfies a factual determination if and only if, based on all the relevant facts and circumstances, the Commissioner of Internal Revenue finds that the classification is nondiscriminatory. No one particular fact is determinative. Included among the facts and circumstances relevant in determining whether a classification is nondiscriminatory are the following:
    1. The underlying business reason for the classification. The greater the business reason for the classification, the more likely the classification is nondiscriminatory. Reducing the employer's cost of providing retirement benefits is not a relevant business reason.
    2. The percentage of the employer's employees benefiting under the plan. The higher the percentage, the more likely the classification is nondiscriminatory.
    3. Whether the number of employees benefiting under the plan in each salary range is representative of the number of employees in each salary range of the employer's workforce. In general, the more representative the percentages of employees benefiting under the plan in each salary range, the more likely the classification is nondiscriminatory.
    4. The difference between the plan's ratio percentage and the employer's safe harbor percentage. The smaller the difference, the more likely the classification is to be nondiscriminatory.
    5. The extent to which the plan's average benefit percentage exceeds 70 percent.

## NONDISCRIMINATORY CLASSIFICATION TEST

## Must Meet Both Requirements

1. Classification must be reasonable and established based on the facts and circumstances of the business under objective business criteria, and
2. Nondiscriminatory Classification

- **Safe Harbor Test.**

Meets the following test:

$$\frac{\% \text{ of NHC Covered}}{\% \text{ of HC Covered}} \geq \left[ 50\% - \left( 0.75\% \times \left( \frac{\# \text{ of NHC}}{\# \text{ of Eligible Employees}} - 60\% \right) \right) \right]$$

Or

- **Facts and Circumstances Test.**

Commissioner finds the classification nondiscriminatory and it meets the following test:

$$\frac{\% \text{ of NHC Covered}}{\% \text{ of HC Covered}} \geq \left[ 40\% - \left( 0.75\% \times \left( \frac{\# \text{ of NHC}}{\# \text{ of Eligible Employees}} - 60\% \right) \right) \right]^*$$

\* But not less than 20%

## EXAMPLE 3.1

Teddybear Productions has 200 nonexcludable employees, of whom 120 are nonhighly compensated employees and 80 are highly compensated employees. Teddybear Production maintains a plan that benefits 60 nonhighly compensated employees and 72 highly compensated employees.

The plan's ratio percentage is 55.56%, which is below the percentage necessary to satisfy the ratio percentage test.

$$\frac{\% \text{ of NHC Covered}}{\% \text{ of HC Covered}} = \text{Ratio Percentage}$$

$$\frac{(60 / 120 = 50\%)}{(72 / 80 = 90\%)} = 55.56\%$$

Teddybear Production's nonhighly compensated employee concentration percentage is 60 (120 ÷ 200) percent, thus their safe harbor percentage is 50 percent and its unsafe harbor percentage is 40 percent. While the calculations are provided below, the safe and unsafe harbor percentages can be found in Exhibit 3.8.

$$\frac{\# \text{ of NHC}}{\# \text{ of Eligible Employees}} = \text{Nonhighly Compensated Employee Percentage}$$

$$\frac{120}{200} = 60\%$$

$$\text{Safe Harbor Percentage} = \left[ 50\% - \left( 0.75\% \times \left( \frac{\# \text{ of NHC}}{\# \text{ of Eligible Employees}} - 60\% \right) \right) \right]$$

$$\text{Safe Harbor Percentage} = \left[ 50\% - \left( 0.75\% \times \left( \frac{120}{200} - 60\% \right) \right) \right]$$

**Safe Harbor Percentage = 50%**

$$\text{Unsafe Harbor Percentage} = \left[ 40\% - \left( 0.75\% \times \left( \frac{\# \text{ of NHC}}{\# \text{ of Eligible Employees}} - 60\% \right) \right) \right]$$

$$\text{Unsafe Harbor Percentage} = \left[ 40\% - \left( 0.75\% \times \left( \frac{120}{200} - 60\% \right) \right) \right]$$

**Unsafe Harbor Percentage = 40%**

Because the plan's ratio percentage (55.56%) is greater than the safe harbor percentage (50%), the plan's classification satisfies the safe harbor test. Since the average benefit percentage test was also met, the plan will meet the coverage test.

Assume the same facts as above except that the plan benefits only 40 nonhighly compensated employees. Now the plan's ratio percentage is 37.03 percent.

#### EXAMPLE 3.2

$$\frac{(40 / 120 = 33.33\%)}{(72 / 80 = 90\%)} = 37.03\%$$

Under these facts, the plan's ratio percentage (37.03%) is below the unsafe harbor percentage (40%) and is considered discriminatory.

Assume the same facts above except that the plan benefits 45 nonhighly compensated employees. The plan's ratio percentage is 41.67 percent.

#### EXAMPLE 3.3

$$\frac{(45 / 120 = 37.50\%)}{(72 / 80 = 90\%)} = 41.67\%$$

Under these facts, the plan's ratio percentage (41.67%) is above the unsafe harbor percentage (40%) and below the safe harbor percentage (50%). The plan will fail the nondiscriminatory classification test unless the Commissioner determines that the classification is nondiscriminatory after considering all the relevant facts and circumstances.

**NONDISCRIMINATORY CLASSIFICATION SAFE AND UNSAFE HARBOR PERCENTAGES**

**EXHIBIT 3.2**

<b>Nonhighly compensated employee concentration percentage *</b>	<b>Safe harbor percentage</b>	<b>Unsafe harbor percentage</b>
0-60	50.00	40.00
61	49.25	39.25
62	48.50	38.50
63	47.75	37.75
64	47.00	37.00
65	46.25	36.25
66	45.50	35.50
67	44.75	34.75
68	44.00	34.00
69	43.25	33.25
70	42.50	32.50
71	41.75	31.75
72	41.00	31.00
73	40.25	30.25
74	39.50	29.50
75	38.75	28.75
76	38.00	28.00
77	37.25	27.25
78	36.50	26.50
79	35.75	25.75
80	35.00	25.00
81	34.25	24.25
82	33.50	23.50
83	32.75	22.75
84	32.00	22.00
85	31.25	21.25
86	30.50	20.50
87	29.75	20.00
88	29.00	20.00
89	28.25	20.00
90	27.50	20.00
91	26.75	20.00
92	26.00	20.00
93	25.25	20.00
94	24.50	20.00
95	23.75	20.00
96	23.00	20.00
97	22.25	20.00
98	21.50	20.00
99	20.75	20.00

*\* This is the total number of nonhighly compensated employees as a percentage of total eligible employees.*

The nondiscriminatory classification test is designed to guarantee that a plan truly provides benefits to a substantial group of the nonexcludable nonhighly compensated employees. If this nondiscriminatory test were not part of the average benefits test, it would be possible to satisfy the average benefits percentage test by benefiting only a very small group of nonhighly compensated employees with a substantial benefit. For example, if an employer chose to only provide a benefit to the janitors and the executives, the classification would satisfy the general nondiscrimination rule discussed above because it is a classification based on job description. The employer could then provide the janitors with a benefit sufficient enough to satisfy the average benefits percentage test and the plan would be considered qualified. This second nondiscriminatory classification test (the plan ratio percentage) is included to protect against a classification selection such as this by requiring the employer to provide a benefit to at least a certain number of nonexcludable nonhighly compensated employees.

For a plan to satisfy the average benefits test, it must actually satisfy three tests, the average benefits percentage test and the two nondiscriminatory classification tests. If the plan satisfies all three of the average benefits tests, it will satisfy the coverage requirements and it will not be required to satisfy the general safe harbor coverage test or the ratio percentage test. Otherwise, if a plan does not pass the average benefits test, it must pass either the general safe harbor test or the ratio percentage test for it to satisfy the coverage requirement.