**Chapter 4: Nondiscrimination – Structure and Benefits**

**Q. 4.01: What are the general rules for testing nondiscrimination in a qualified plan?**

The following general rules for testing for nondiscrimination are all based on the definition of a highly compensated employee (HCE):[[1]](#footnote-1)

1. The plan must provide nondiscriminatory coverage under Code Section 410(b) (see **Q**4.03).
2. Benefits and contributions must be nondiscriminatory in amount (see **Q**4.16).
3. The effects of plan amendments, terminations, and grants of past service must be nondiscriminatory on their face and in operation (see Q4.32).
4. The plan must apply the Code Section 401(a)(17) compensation limit to determine contributions or benefits (see Q4.30).
5. The plan must define compensation within the guidelines as set forth in Code Section 414(s) (see Q4.31).
6. The plan must comply with Code Section 401(l) to the extent that it integrates contributions or benefits with Social Security or satisfy the general nondiscrimination testing of Code Section 401(a)(4).
7. The plan must comply with Code Section 414(r) if its coverage and benefits vary by organizational and structural separate lines of business (see Q4.06).
8. The plan must satisfy the minimum participation rules under Code Section 401(a)(26) (see Q4.08).
9. The benefit, rights, and features provided in the plan must be nondiscriminatory in both “current availability” and “effective availability” (see Q4.11).

**Q. 4.02: What are the consequences of failure to comply with any of these nondiscrimination requirements?**

A plan that fails to comply with any of the nondiscrimination requirements, either in form or in operation, loses its qualified and tax-exempt status. Regulations allow the employer to amend the plan retroactively and treat the amendment as if it were effective on the first day of the plan year in which the defect occurred.[[2]](#footnote-2)

**Q. 4.03: What are the methods for testing for nondiscrimination coverage under Code Section 410(b)?**

In order to test whether plan coverage is in fact nondiscriminatory under Code Section 410(b), one of two tests must be used to compare the plan coverage of HCEs and nonhighly compensated employees (NHCEs):

1. the ratio percentage test or
2. the average benefits test.

Generally, one of these two tests must be satisfied each plan year.[[3]](#footnote-3)

**Q. 4.04: How is the ratio percentage test applied to a plan?**

In order to apply the ratio percentage test, the employer must count the number of NHCEs covered in the plan and divide by the number of all NHCEs, whether they are in the plan or not. Also the employer must count the number of HCEs in the plan and divide by the number of all HCEs. If the resulting NHCE ratio is at least 70 percent of the resulting HCE ratio, then the plan passes the ratio percentage test.

**Example 1.** Company A has five HCEs: Owners A, B, and C (more than 5 percent owners and compensation of $115,000 or more in the prior year) and Employees 4 and 8 (compensation of $115,000 or more in the prior year). In order to comply with the Code Section 410(b) ratio percentage test, the percentage of NHCEs covered must equal at least 70 percent of the percentage of HCEs covered. If all Company A’s HCEs were covered by its retirement plan, at least 70 percent of the NHCEs (six NHCEs, 70 percent times 8 employees) would also have to be covered.

For purposes of this example, use the year 2013 HCE and NHCE employee census information listed in Table 4-1. Assume that all employees have satisfied the one-year service requirement and are full-time, i.e., 1,000 hours or more per year.

|  |
| --- |
| Table 4-1. Year 2013 Employee Census Information |
|  | ***2012 and 2013******Compensation*** | ***Age*** | ***Percentage******Ownership*** | ***Job******Description*** |
| **Owner A** | $300,000 | 60 | 45% |  |
| **Owner B** | $180,000 | 45 | 30% |  |
| **Owner C** | $150,000 | 42 | 25% |  |
|  |  |  |  |  |
| **Employee 1** | $45,000 | 37 |  | Clerical |
| **Employee 2** | $75,000 | 54 |  | Office manager |
| **Employee 3** | $22,000 | 28 |  | Clerk |
| **Employee 4** | $115,000 | 48 |  | Sales rep |
| **Employee 5** | $32,000 | 32 |  | Shipping |
| **Employee 6** | $64,000 | 55 |  | Shipping manager |
| **Employee 7** | $18,000 | 29 |  | Shipping |
| **Employee 8** | $115,000 | 51 |  | Sales rep |
| **Employee 9** | $12,000 | 23 |  | Shipping |
| **Employee 10** | $42,000 | 31 |  | Clerk |

If Company A’s plan excluded Employees 4 and 8, it would cover only 60 percent of the HCEs (three out of five). Applying the Code Section 410(b) rule, 70 percent of the HCE percentage of 60 percent equals 42 percent. Therefore, at least 42 percent of the NHCEs must be covered by the Company A retirement plan. Multiplying the 42 percent coverage requirement for NHCEs by eight (the number of NHCEs) means that at least 3.36 employees, rounded to four, must be covered.

If the goal were to minimize the cost for employees, the type of plan to be adopted would dictate which employees to include. If the plan were compensation-based only, the job classes with the lowest paid employees would be chosen. If the plan were age and compensation based, the analysis would be more involved because the lowest cost employees would be affected by both age and compensation. An older employee with low compensation could have a much higher contribution than a young employee with high compensation. In a target benefit pension plan which is an age-weighted money purchase plan, the contribution for an employee age fifty-five would be 7.25 times the contribution for an employee age thirty-five assuming equal compensation (assuming 7.5 percent interest andmortality of 84 years).

**Example 2.** Company A would like its retirement plan to provide maximum benefits to Owner A, who will be retiring in the next five years (see Table 4-1 for employee data for this example). A defined benefit plan accomplishes this nicely .

Unfortunately, with ten other employees of varying ages and compensation, and two other owners, the plan could be extremely costly. Instead, the rules in Code Section 410(b) are used to accomplish the goal by adopting the defined benefit plan covering only the following employees:[[4]](#footnote-4)

|  |  |
| --- | --- |
| **Owner A** |  |
| Employee 3 | Clerk |
| Employee 5 | Shipping |
| Employee 7 | Shipping |
| Employee 9 | Shipping |
| Employee 10 | Clerk |

Using the ratio percentage test, this plan covers 20 percent of the HCEs (one out of five); therefore, it must cover at least 70 percent of 20 percent, or 14 percent of the NHCEs. Because the plan covers five out of eight NHCEs, or 62.5 percent, the test is passed . Even though the other five employees are excluded from the defined benefit plan, the employer could adopt a profit sharing/401(k) plan for all employees in addition to the defined benefit plan. This would give Owners A and B the opportunity to defer some of their compensation and participate in any employer contribution made to the profit sharing/401(k) plan.

**Practice Point:**  Remember the maximum deduction for a combination defined benefit plan and profit sharing plan is the contribution necessary to satisfy the minimum funding standards of the defined benefit plan plus up to a 6 percent contribution to the defined contribution plan. Salary deferrals in a 401(k) plan do not reduce the 6 percent limit to the defined contribution plan. For plan years beginning on or after January 1, 2008, there is no restriction on the contribution to the defined contribution plan other than the standard 25 percent of compensation if the defined benefit plan is covered by the Pension Benefit Guarantee Corporation (PBGC)

**Q. 4.05: What are the requirements of the average benefits test?**

The average benefits test consists of two parts (both of which must be satisfied): the nondiscriminatory classification test and the average benefits percentage test.

The nondiscriminatory classification test must meet the following requirements:[[5]](#footnote-5)

1. The classification of employees covered under the plan must be reasonable and based on valid business criteria, e.g., job categories, type of compensation (salaried or hourly), geographic location, or other similar criteria. This is a facts-and-circumstances determination.

2. The classification of employees benefiting under the plan must not discriminate in favor of the HCEs. This second part of the test involves the following steps:

a. Determination of the NHCE concentration percentage, i.e., the number of NHCEs divided by the total number of employees.

b. The NHCE concentration percentage is then compared to the table in Appendix 4-1 to determine the safe harbor percentage and the unsafe harbor percentage. If the NHCE concentration percentage is equal to or more than the safe harbor percentage, the plan passes this part of the average benefits test.

c. If the NHCE concentration percentage is less than the safe harbor percentage but equal to or more than the unsafe harbor percentage, and the Internal Revenue Service (IRS) finds that the classification of employees benefiting under the plan does not discriminate in favor of HCEs, the plan also passes this part of the average benefits test.

The average benefits percentage test requires comparing the average benefits for the NHCEs to the average benefits for the HCEs. If the result is equal to or more than 70 percent, this part of the average benefits test is passed.[[6]](#footnote-6)

**Example 3.**  In Example 1, there are eight NHCEs out of a total of thirteen employees, or an NHCE concentration percentage of 61.5 percent. The table in Appendix 4-1 shows a safe harbor percentage of 49.25 percent and an unsafe harbor percentage of 39.25 percent. Because the NHCE concentration percentage exceeds the safe harbor percentage, the plan passes this part of the average benefit test.

If the plan covered four out of the eight NHCEs, or 50 percent, and 100 percent of the HCEs, it would satisfy the safe harbor percentage and this part of the average benefit test (equal to or more than the safe harbor percent of 49.25 percent).

**Example 4.** Consider the following plan based on the census information in Table 4-1. All HCEs are covered and four out of eight NHCEs are covered. The plan satisfies part 1(a) of the average benefits test because the employees covered are determined based on job categories. The plan covers 50 percent of the NHCEs so it satisfies part 1(b) of the average benefit test (50 percent is more than the safe harbor percentage of 49.25 percent).

The last part of the average benefit test is illustrated as follows:

|  |  |  |  |
| --- | --- | --- | --- |
|  | ***Salary*** | ***Contribution*** | ***Contribution Percentage*** |
| **HCEs** |  |  |  |
| **Owner A** | $255,000 | $51,000 | 20.000% |
| **Owner B** | $204,000 | $51,000 | 25.000% |
| **Owner C** | $204,000 | $51,000 | 25.000% |
| **EE 4** | $115,000 | $575 | 0.500% |
| **EE 8** | $115,000 | $575 | 0.500% |
| **Average HCE Percentage** | 14.200% |
|  |
| **NHCEs** |  |  |  |
| **EE 3** | $22,000 | $2,187 | 9.940% |
| **EE 5** | $32,000 | $3,181 | 9.940% |
| **EE 7** | $18,000 | $1,789 | 9.940% |
| **EE 9** | $12,000 | $1,193 | 9.940% |
| **Average NHCE Percentage** | 9.940% |
|  |
| **NHCE% divided by HCE%** | 70.000% |
| **Total Owners contribution** | $ 153,000 |
| **Total Nonowners contribution** | $ 9,500 |
|   |

This plan, which clearly favors the three owners, satisfies the coverage requirements because all three parts of the average benefit test are passed. In this example, employee number 4 and employee number 8 receive a contribution of only $575 bringing the average for the HCEs down. A plan can always discriminate against highly compensated employees.

The plan still has to be tested for nondiscrimination in the amount of benefits (see 4.19). Most likely some form of comparability would give the best results.[[7]](#footnote-7)

**Q. 4.06: What is a qualified separate line of business (QSLOB)?**

A “line of business” is a portion of the employer identified by the property or services it provides to its customers. In order to be considered a qualified separate line of business (QSLOB) the following requirements must be satisfied:[[8]](#footnote-8)

1. The line of business must have at least fifty employees;
2. The employer must notify the Secretary of the Treasury that it is treating itself as operating a separate line of business;
3. The separate line of business must pass administrative scrutiny by either:
	1. passing any of the safe harbors in Treasury Regulations Section 1.414(r)-5, or
	2. applying to the IRS Commissioner for a determination letter that the separate line of business satisfies the administrative scrutiny rule.

**Q. 4.07: How is a QSLOB treated for nondiscrimination coverage testing?**

An employer that is operating a QSLOB may apply the coverage requirements of Code Section 410(b) separately to each line of business.[[9]](#footnote-9)

By its nature the nondiscrimination rules regarding QSLOBs apply to very large employers. Although all plans must satisfy the coverage requirements of Code Section 410(b) based on all employees, an employer that is operating a QSLOB may apply those tests separately to each line of business, provided the separate line of business is organized and operated separately from the remainder of the employer.[[10]](#footnote-10)

**Q. 4.08: What are the requirements of the minimum participation rules under Code Section 401(a)(26)?**

The general rule states that a plan must “benefit” the lesser of fifty employees or 40 percent of all employees. The 40 percent rule also requires that no fewer than two employees benefit if the employer employs only two employees, even though 50 percent would be benefiting if only one of the two benefited.[[11]](#footnote-11)

**Example 5.** Consider Example 4, in which a defined benefit plan for one owner and five employees is designed to maximize the benefit for that owner at a minimal cost for the employees:

|  |  |
| --- | --- |
| **Owner A** |  |
| Employee 3 | Clerk |
| Employee 5 | Shipping |
| Employee 7 | Shipping |
| Employee 9 | Shipping |
| Employee 10 | Clerk |

Because the plan covers six out of thirteen employees, or 46.2 percent, it barely satisfies the minimum participation test. However, because the plan covers 62.5 percent of the NHCEs (five out of eight) and 20 percent of the HCEs (one out of five), the plan satisfies the ratio percentage test by a large margin (ratio percentage test = 312.5% versus 70% needed).

**Q. 4.09: How can an employer determine whether employees are “benefiting” from a plan?**

In the case of a defined benefit plan, an employee is treated as “benefiting” under a plan for a plan year if, for that plan year, the employee has an increase in benefits accrued.

In order to determine the number of employees benefiting, the following excludable employees are not counted:

1. Employees who do not meet the plan’s minimum age and service requirement;
2. Employees who are nonresident aliens and do not receive earned income from US sources;
3. Employees who are members of a union in which retirement benefits have been the subject of good faith bargaining;[[12]](#footnote-12) and
4. An employee who terminates employment during the plan year, if all the following conditions are satisfied:
5. The employee does not benefit under the plan for the plan year;
6. The employee is eligible to participate in the plan;
7. The plan has a minimum period-of-service requirement (for example, 1,000 hours of service) or a requirement that the employee be employed on the last day of the plan year (“last-day requirement”) for an employee to accrue a benefit or receive an allocation for the plan year;
8. The employee fails to accrue a benefit solely because of the failure to satisfy the minimum period-of-service requirement or last-day requirement;
9. The employee terminates employment during the plan year with not more than 500 hours of service and is not an employee on the last day of the plan year; and
10. If the exclusion of terminating employees under the minimum participation test is used with respect to any employees, it must be applied to all employees for the plan year.

If an employer is treated as operating qualified separate lines of business for purposes of the minimum participation requirements (see preceding discussion), employees of other qualified separate lines of business are treated as excludable employees in testing a plan that benefits employees of one qualified separate line of business.

For both the minimum coverage and minimum participation rules, an employee may be included in the testing if that employee benefits under the plan(s) being tested or is an active participant who is not benefiting, e.g., one who does not satisfy employment on the last day of the plan year to share in the contribution if required by the plan. An employee benefits if:[[13]](#footnote-13)

1. In a defined contribution plan, an employer contribution or forfeiture is allocated to the employee’s account;
2. In the case of a defined benefit plan, the employee has an increase in his or her accrued benefit;
3. In the case of a 401(k) plan, the employee is eligible to make salary deferrals.

An employee is deemed to benefit under the plan if:

1. The employee does not accrue a benefit due solely to the benefit or contribution limitations as defined in Code Section 415.
2. The employee does not accrue a benefit due solely to a benefit or contribution limit applied to all employees as defined in the plan, e.g., the maximum benefit is $1,000 per month in a defined benefit plan and the employee has already accrued that benefit.
3. The benefit accrual is offset by contributions in another plan.[[14]](#footnote-14)
4. In a target benefit plan, the theoretical reserve is equal to or greater than the present value of the theoretical benefits.[[15]](#footnote-15)
5. The employee has reached normal retirement age as defined in the plan and the plan provides that there are no further contributions or benefit accruals after normal retirement age.

**Q. 4.10: Are defined contribution plans subject to these minimum participation rules?**

No. These rules only apply to defined benefits plans.[[16]](#footnote-16)

**Q. 4.11: What is the nondiscrimination rule regarding the availability of benefits, rights, and features (BRF) in the plan?**

This rule is satisfied if all optional forms of benefits, ancillary benefits, and other rights and features available under the plan are currently and effectively available in a nondiscriminatory manner.[[17]](#footnote-17)

**Q. 4.12: What is the test for being considered “currently available”?**

In order to be considered “currently available” the group of employees to whom a BRF is available must satisfy the ratio percentage test (see Q. 4.04) or the nondiscriminatory classification test ( Q. 4.05) of Code Section 410(b).[[18]](#footnote-18)

**Q. 4.13: What is the test for being considered “effectively available”?**

Whether the BRF is “effectively available” is a facts-and-circumstances determination based on the employee’s current compensation, accrued benefit, job position, individual net worth, and other factors. The group of employees to whom a BRF is effectively available does not substantially favor HCEs.[[19]](#footnote-19)

Rights and features subject to current and effective availability include:[[20]](#footnote-20)

1. plan loans,
2. the right to direct investments,
3. the right to a particular form of investment,
4. the right to a particular class or type of employer security,
5. the right to determine each type of elective contribution under a cash or deferred arrangement,
6. the right to make after-tax contributions to a defined benefit plan that are not allocated to separate accounts,
7. the right to determine each rate of employee contributions to a plan to which matching contributions can be made,
8. the right to an allocation of matching employer contributions,
9. the right to purchase additional retirement or ancillary benefits, and
10. the right to make and receive rollovers or transfers.

Compliance with item 2 above is a common problem. It is not unusual to find a defined contribution plan in which the owners are investing their account balance in equities, including stocks and mutual funds, while they invest the employees’ accounts in bank certificates of deposit. In many cases this is done to “protect the employees.” Regardless of the motivation, this is discriminatory and does not satisfy the nondiscrimination rules for BRF. If this practice is not corrected, the plan could be disqualified on audit. Furthermore, the plan sponsor may be required to correct this plan defect by making up the investment returns for the employees based on what the accounts of the HCEs earned during the period in question.

**Q. 4.14: What is the consequence if a plan’s “optional forms of benefits” do not satisfy the currently and effectively available requirement?**

If the plan’s optional forms of benefits do not satisfy the requirement to be currently and effectively available, the plan must be amended to either expand the group that is eligible for the optional form or eliminate the optional form in accordance with *protected benefits* under Code Section 411(d)(6).[[21]](#footnote-21)

The term “optional forms of benefits” refers to a distribution alternative, e.g., cash or in-kind distribution, distributions available at termination of employment or only at retirement age, eligibility for the distribution alternative (e.g., lump sum), and basis for converting a lump sum to an annuity.[[22]](#footnote-22)

**Q. 4.15: What are protected benefits?**

Protected benefits are those that cannot be eliminated, reduced, or made subject to employer discretion except as permitted by regulations and include accrued benefits, early retirement benefits, retirement subsidies, and optional forms of benefits.

The following benefits are not protected benefits:[[23]](#footnote-23)

1. ancillary life insurance protection;
2. accident or health insurance;
3. Social Security supplements as described in Code Section 411(a)(9);
4. the availability of loans;
5. the right to make before- or after-tax employee deferrals or contributions;
6. the right to direct investments;
7. the right to a particular form of investment, e.g., employer stock;
8. the allocation dates for contributions, forfeitures, and investment earnings;
9. administrative procedures for distributing benefits, e.g., the date by which elections must be made; and
10. rights that derive from administrative and operational procedures, e.g., the mechanics of allocating investment experience among accounts in a defined contribution plan.

The term “ancillary benefits,” as part of BRFs, refers to Social Security supplements and disability benefits, ancillary life and health insurance benefits, death benefits in a defined contribution plan, preretirement death benefits in a defined benefit plan, plant shut-down benefits, and other similar benefits. Social Security supplements provide additional retirement benefits to employees who retire and begin receiving benefits before their Social Security benefits begin and usually continue until the employee is eligible for Social Security benefits. Disability benefits would be those payable in the event of disability to the extent they are in excess of the benefit the employee would otherwise receive on termination of employment for reasons other than disability. Similarly, death benefits in a defined contribution plan and preretirement death benefits in a defined benefit plan would be ancillary benefits to the extent they are in excess of the benefits that the employee would otherwise receive in the event of termination for reasons other than death.

**Q. 4.16: What is the test for nondiscrimination in the amount of benefits and contributions?**

The nondiscriminatory in amount test may be satisfied in any one of the following three ways:[[24]](#footnote-24)

1. safe harbor testing,
2. the general nondiscrimination test, or
3. a new comparability plan, in which contributions are converted to equivalent benefits as in a defined benefit plan.

**Practice Point:** The above alternatives for satisfying nondiscrimination in benefits and contributions may not be used for 401(k) contributions (employee deferrals) or 401(m) contributions (employer matching or employee after-tax contributions). Both 401(k) and 401(m) contributions must satisfy nondiscrimination based solely on the ADP test for deferrals and the ACP test for matching and after-tax employee contributions (see Chapter 6).[[25]](#footnote-25)

**Q. 4.17: What are the safe harbor tests for a defined contribution plan?**

The two alternative safe harbor tests to satisfy the nondiscrimination in amount test for a defined contribution plan are as follows:[[26]](#footnote-26)

1. The uniform allocation formula method is applied by using the same percentage of compensation or the same dollar amount for each participant for the purposes of plan contributions and forfeitures.
	1. This is a common approach used for profit sharing or money purchase plans. (Social Security integration is possible within limits.)
2. The uniform allocation formula weighted for age or service method is available to plans that involve a *point* allocation process.
	1. Points are provided on uniform basis considering age, service or compensation.

After the contribution is allocated, the average of the allocation rates for the HCEs may not be more than the allocation rate for the NHCEs.

**Practice Point:** If a safe harbor test is used to satisfy the nondiscrimination in amount test, annual testing can be avoided.

**Q. 4.18: What are the safe harbor tests for a defined benefit plan?**

The safe harbor tests to satisfy the nondiscrimination in amount test for a defined benefit plan include the following:

1. the unit credit method
2. the unit credit fractional accrual method
3. the flat benefit method
4. the alternative flat benefit method
5. the insurance contract method
6. the cash balance plan method
7. the floor-offset plan method

These safe harbors are described in detail in the Treasury Regulations.[[27]](#footnote-27)

**Q. 4.19: What is the general nondiscrimination test and when is it applicable?**

The general nondiscrimination test can be used to satisfy the nondiscrimination in amount requirement if none of the safe harbor approaches is satisfied. Generally this test establishes *rate groups* for each HCE and all other employees with equal or higher rates. These rate groups must pass the same Code Section 410(b) test that is used to test for nondiscriminatory coverage (see Q. 4.03):[[28]](#footnote-28)

1. the ratio percentage test or
2. the average benefits test.

**Practice Point:** This test must be passed each year based on the participants in that year. If there is a major change in the profile of the employees because of turnover, the makeup of the individual groups changes and the test may fail. In that case, the plan contribution allocation has to be amended to satisfy the test.

**Q. 4.20: What is a rate group?**

A rate group is a subset of the plan participants to be used for nondiscrimination testing and consists of an HCE and all other participants (both HCE and NHCE) that have an allocation rate (for defined contribution plans) or an accrual rate (for defined benefit plans) equal to or greater than the HCE’s rate. Each HCE is placed in a separate rate group, while all other HCEs and NHCEs are placed in one or more rate groups, depending on their allocation or accrual rate.[[29]](#footnote-29)

**Q. 4.21: How is the ratio percentage test applied to a defined contribution plan for the nondiscrimination in amount test?**

The following example demonstrates the formation of rate groups and the subsequent nondiscrimination test.

**Example 6.** In Table 4-2, HCE 1, NHCE 1, and NHCE 4 receive an allocation of 20 percent of compensation, while all other participants receive an allocation of 10.39 percent of compensation. This variable allocation rate may be based on job description, specific departments within the business, geographical location for businesses with multiple locations, or any other valid business guideline. All forfeitures are allocated based on total compensation.

|  |
| --- |
| Table 4-2. Variable Allocation Rate |
|  | ***Salary*** | ***Employer Contribution*** | ***Forfeitures*** | ***Total*** | ***Allocation Percent*** |
| HCE #1 | $255,000 | $45,731 | $ 5,269 | $51,000 | 20.00% |
| HCE #2 |  $115,000 |  $ 9,200 |  $ 2,749 | $11,949 | 10.39% |
| **S TOTAL** | **$370,000** | **$54,931** | **$ 8,018** | **$62,949** |  |
|  |  |  |  |  |  |
| NHCE #1 | $ 25,000 | $ 4,401 | $ 599 | $ 5,000 | 20.00% |
| NHCE #2 | $ 35,000 | $ 2,800 | $ 838 | $ 3,638 | 10.39% |
| NHCE #3 | $ 28,000 | $ 2,240 | $ 671 | $ 2,911 | 10.39% |
| NHCE #4 | $ 18,000 | $ 3,169 | $ 431 | $ 3,600 | 20.00% |
| NHCE #5 |  $ 50,000 |  $ 4,000 |  $ 1,197 | $ 5,197 | 10.39% |
| **S TOTAL** | **$156,000** | **$16,610** | **$ 3,736** | **$20,346** |  |
|  |  |  |  |  |  |
| **TOTAL** | **$526,000** | **$71,541** | **$11,754** | **$83,295** |  |

Table 4-2 has two HCEs, which means one rate group for each HCE must be tested. The basis for this approach is that if each rate group were a separate plan, it would be tested under the coverage test of Code Section 410(b), as discussed previously in this chapter. If different benefit structures (contribution rates) can be provided in two plans without being discriminatory, those same two contribution rates should be nondiscriminatory if provided in one plan.

The first rate group comprises HCE 1, NHCE 1, and NHCE 4, remembering that each rate group is based on one HCE and all participants, including other HCEs, that have an equal or higher allocation rate. In this rate group, HCE 1 has an allocation rate of 20 percent. The only other participants who have allocation rates equal to or higher than that are NHCE 1 and NHCE 4.

The next step is to test the rate group as if it were a separate plan covering only those three employees. The ratio percentage test in Code Section 410(b) provides that the percentage of NHCEs covered must be at least 70 percent of the percentage of HCEs covered. The same guidelines apply in this test. Because only HCE 1 is in the first rate group, the rate group covers 50 percent of the HCEs (one out of two). With two NHCEs included in the first rate group, 40 percent of the NHCEs are covered (two out of five). Dividing the NHCE percentage (40 percent) by the HCE percentage (50 percent) the result is 80 percent and the test for the first rate group is passed (the ratio must be at least 70 percent).

The second rate group (one for each HCE) includes all employees because the allocation rate for HCE 2 is 10.39 percent, and all other participants, including HCE 1, have an allocation rate equal to or higher than HCE 2’s allocation rate of 10.39 percent. The plan includes 100 percent of the HCEs and 100 percent of the NHCEs. When the NHCE percentage is divided by the HCE percentage, the result is 100 percent. Again, the test is passed for the second rate group.

With only two HCEs to consider, this is a simplified application of the general test; however, the same test works for a plan with five or ten HCEs and thirty, forty, or fifty NHCEs. The approach is the same but the process is much longer and more time-consuming. This approach can be used when a plan allocates different percentages based on profit centers, geographical locations, or other business or employee groups.

**Q. 4.22: Is Social Security integration allowed for purposes of the general nondiscrimination test?**

Yes. The regulations allow for permitted disparity, i.e., Social Security integration. If a plan is integrated with Social Security, the value of the contribution to Social Security may be taken into consideration in calculating the allocation percentage.[[30]](#footnote-30)

**Q. 4.23: How is the average benefits test applied to a defined contribution plan for the nondiscrimination in amount test?**

A rate group that fails the ratio percentage test can be tested using the average benefits test, which has two parts (similar to the nondiscrimination coverage test of Q. 4.05): the nondiscriminatory classification test and the average benefits ratio test.[[31]](#footnote-31)

1. The nondiscriminatory classification test
	1. The coverage ratio of the rate group must be at least at the midpoint between the safe harbor percentage and the unsafe harbor percentage from the table in Appendix 4-1.
	2. Note that the nondiscrimination in amount test applies the table in Appendix 4-1 somewhat differently than for the nondiscrimination coverage test (see Q. 4.05).
2. The average benefits ratio test.
	1. The average accrual or allocation rates of the NHCEs must be equal to at least 70 percent of the average accrual or allocation rates of the HCEs.
	2. This test is the same as for the nondiscrimination coverage test, except that rate groups are used for the nondiscrimination in amount test.

**Q. 4.24: What is a new comparability plan?**

A comparability plan is another option available for defined contribution plans (except a 401(k), an employee stock option plan (ESOP), or employee voluntary contributions) to satisfy the nondiscriminatory in amount requirement. This approach projects contributions with interest to retirement age and then converts that accumulated sum to accrual rates (annuity payments). It then uses the accrual rates in place of allocation rates following the rules for the general nondiscrimination test above to compare rate groups.[[32]](#footnote-32)

**Q. 4.25: How are accrual rates in a comparability plan test determined?**

Accrual rates (annuity payments) can be determined via an annual accrual method or an accrued-to-date method:[[33]](#footnote-33)

1. Annual accrual method.
	1. Determine the amount of the allocation taken into account, including employer contributions and forfeitures only.
	2. Convert the allocation to future annuity payments (the accrual rate) at the testing age (usually age 65).
	3. Divide the annuity payment by plan year compensation (as limited) to determine the accrual rate.
	4. Adjust the accrual rate for Social Security integration (optional).
	5. Determine whether each rate group satisfies the ratio percentage test.
2. Accrued to date method.
	1. The accrued-to-date method takes into consideration prior benefits that have been accumulated as a result of prior years’ employer contributions, forfeitures, and investment earnings.

**Q. 4.26: How is the comparability plan approach applied for purposes of the ratio percentage test using the annual accrual method?**

The following example demonstrates the application of the comparability plan approach for the ratio percentage test using the annual accrual method.

**Example 7.** Table 4-3 (see also Table 4-4) shows how a comparability plan uses permitted disparity to pass the nondiscrimination rules. This type of plan is often referred to as a class allocation plan, i.e., in which a different rate of contribution is allocated to different classes of employees. The classes must have a business basis, e.g., job description, geographical location, or business division. Table 4-3 has two classes: (1) HCEs with a contribution of 25 percent up to the dollar limit of $51,000 and (2) all other employees with a contribution of 6.60 percent (rounded).

|  |
| --- |
| Table 4-3. Comparability Plan without Permitted Disparity (Class Allocation Plan) |
|  | ***Salary*** | ***Age*** | ***Employer Contribution*** | ***Forfeitures*** | ***Future Value*** | ***Accrual\**** | ***Accrual Rate*** |
| HCE #1 | $255,000 | 60 | $51,000 |  | $73,217 | $6,388 | 2.505% |
| HCE #2 | $115,000 | 55 |  $28,750 |   | $59,255 | $5,170 | 4.496% |
| **S TOTAL** | **$370,000** |  | **$79,750** | **$ -** |  |  |  |
|  |  |  |  |  |  |  |  |
| NHCE #1 | $ 25,000 | 50 | $ 1,025 | $ 625 | $ 4,882 | $ 426 | 1.704% |
| NHCE #2 | $ 35,000 | 38 | $ 1,435 | $ 875 | $16,279 | $1,421 | 4.059% |
| NHCE #3 | $ 28,000 | 29 | $ 1,148 | $ 700 | $24,969 | $2,179 | 7.782% |
| NHCE #4 | $ 18,000 | 25 | $ 738 | $ 450 | $21,437 | $1,871 | 10.392% |
| NHCE #5 | $ 50,000 | 48 |  $ 2,050 |  $1,250 | $11,284 | $ 985 | 1.969% |
| **S TOTAL** | **$156,000** |  | **$ 6,396** | **$3,900** |  |  |  |
|  |  |  |  |  |  |  |  |
| **TOTAL** | **$526,000** |  | **$86,146** | **$3,900** |  |  |  |
| \* Based on IAM83 mortality at 7.5 percent pre-retirement interest. |

This plan maximizes the contribution for the two HCEs within the nondiscrimination testing limits. In keeping with the procedure for testing, the third party administrator (TPA) now creates and tests the rate groups, based on each HCE’s accrual rate (accrual divided by salary) and all employees, including other HCEs, with equal or higher accrual rates, as if each rate group were a separate plan required to pass the coverage rules of Code Section 410(b).

The first rate group consists of HCE 2, NHCE 3, and NHCE 4. The second rate group consists of HCE 2, HCE 1, NHCE 2, NHCE 3, and NHCE 4. The breakdown of the rate groups are illustrated below.

|  |
| --- |
| Table 4-4. Ratio Percentage Test |
| ***First Rate Group:*** | ***Second Rate Group:*** |
| HCE 2 |  4.496% | HCE 2 | 4.496% |
|  |  | HCE 1 | 2.505% |
|  |  |  |  |
|  |  | NHCE 2 | 4.059% |
| NHCE 3 |  7.782% | NHCE 3 | 7.782% |
| NHCE 4 | 10.392% | NHCE 4 | 10.392% |

One out of two HCEs is in the first rate group, which represents 50 percent of the HCEs. Two out of five NHCEs are in the same rate group, representing 40 percent of the NHCEs.

40% / 50% = 80%

The result is more than 70 percent; thus, the test is passed for the first rate group. The second rate group includes both HCEs so 100 percent of the HCEs are included. Three of the NHCEs are included, or 60 percent.

60% / 100% = 60%

The second rate group does not pass.

Although rate group 2 would pass the average benefit test discussed later in this chapter, for illustration purposes the rate group is treated as failing nondiscrimination testing; the plan, as is, would not be qualified. But this is not the end of the line. As in the case of plans integrated with Social Security (permitted disparity), the plan can take credit for Social Security benefits in nondiscrimination testing. Table 4-5 shows the results.

|  |
| --- |
| Table 4-5. Comparability Plan with Permitted Disparity (Class Allocation Plan) |
|  | ***Salary*** | ***Age*** | ***Employer Contribution*** | ***Forfeitures*** | ***Future Value*** | ***Accrual\**** | ***Accrual Rate*** | ***Accrual W Perm Disp*** |
| HCE #1 | $255,000 | 60 | $51,000 |  | $73,217 | $ 6,388 | 2.505% | 2.632% |
| HCE #2 | $115,000 | 45 |  $28,750 |   | $59,255 | $ 5,170 | 4.496% | 4.868% |
| **S TOTAL** | **$370,000** |  | **$79,750** | **$ -**  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |
| NHCE #1 | $ 25,000 | 50 | $ 1,025 | $ 625 | $ 4,882 | $ 426 | 1.704% | 2.404% |
| NHCE #2 | $ 35,000 | 38 | $ 1,435 | $ 875 | $16,279 | $ 1,421 | 4.059% | 4.709% |
| NHCE #3 | $ 28,000 | 29 | $ 1,148 | $ 700 | $24,969 | $ 2,179 | 7.782% | 8.432% |
| NHCE #4 | $ 18,000 | 25 | $ 738 | $ 450 | $21,437 | $ 1,871 | 10.392% | 11.042% |
| NHCE #5 | $ 50,000 | 48 |  $ 2,050 |  $1,250 | $11,284 | $ 985 | 1.969% | 2.669% |
| **S TOTAL** | **$156,000** |  | **$ 6,396** | **$3,900** |  |  |  |  |
|  |  |  |  |  |  |  |  |  |
| **TOTAL** | **$526,000** |  | **$86,146** | **$3,900** |  |  |  |  |
| \* Based on IAM83 mortality at 7.5 percent pre-retirement interest. |

The first rate group consists of HCE 2, NHCE 3, and NHCE 4. The second rate group consists of HCE 2, HCE 1, NHCE 2, NHCE 3, NHCE 4, and NHCE 5. The breakdown of the rate groups is illustrated in Table 4-6.

|  |
| --- |
| Table 4-6. Ratio Percentage Test |
| ***First Rate Group:*** | ***Second Rate Group:*** |
| HCE 2 | 4.868% | HCE 2 | 4.868% |
|  |  | HCE 1 | 2.640% |
|  |  |  |  |
|  |  | NHCE 2 | 4.709% |
| NHCE 3 |  7.782% | NHCE 3 | 8.432% |
| NHCE 4 | 10.392% | NHCE 4 | 11.042% |
|  |  | NHCE 5 | 2.669% |

Using the same approach as in Table 4-4, one out of two HCEs are in the first rate group, which represents 50 percent of the HCEs. Two out of five NHCEs are in the same rate group representing 40 percent of the NHCEs.

40% / 50% = 80%

Because the result is more than 70 percent, the test is passed for the first rate group. The second rate group includes both HCEs so 100 percent of the HCEs are included. Four of the NHCEs are included or 80 percent.

80% / 100% = 80%

The second rate group passes.

The use of comparability in defined contribution plans is sensitive to the age of the HCEs. In Tables 4-3 through 4-6, the HCEs are fifty-five and sixty, giving the plan a great deal of leverage because the NHCEs are much younger. Table 4-7 shows the effect of a younger HCE.

|  |
| --- |
| Table 4-7. Comparability Plan with Younger HCE |
|  | ***Salary*** | ***Age*** | ***Employer Contribution*** | ***Forfeitures*** | ***Future Value*** | ***Accrual*** | ***Accrual Rate*** | ***Accrual W Perm Disp*** |
| HCE #1 | $255,000 | 60 | $51,000 |  | $ 73,217 | $ 6,388 | 2.505% | 2.632% |
| HCE #2 | $115,000 | 45 |  $28,750 |  | $122,126 | $10,657 | 9.267% | 9.639% |
| **S TOTAL** | **$370,000** |  | **$79,750** | **$ - \_** |  |  |  |  |
|  |  |  |  |  |  |  |  |  |
| NHCE #1 | $ 25,000 | 50 | $ 1,025 | $ 625 | $ 4,882 | $ 426 | 1.704% | 2.404% |
| NHCE #2 | $ 35,000 | 38 | $ 1,435 | $ 875 | $16,279 | $ 1,421 | 4.059% | 4.709% |
| NHCE #3 | $ 28,000 | 29 | $ 1,148 | $ 700 | $24,969 | $ 2,179 | 7.782% | 8.432% |
| NHCE #4 | $ 18,000 | 25 | $ 738 | $ 450 | $21,437 | $ 1,871 | 10.392% | 11.042% |
| NHCE #5 | $ 50,000 | 48 |  $ 2,050 |  $1,250 | $11,284 | $ 985 | 1.969% | 2.669% |
| **S TOTAL** | **$156,000** |  | **$ 6,396** | **$3,900** |  |  |  |  |
|  |  |  |  |  |  |  |  |  |
| **TOTAL** | **$526,000** |  | **$86,146** | **$3,900** |  |  |  |  |

In Table 4-7, the two HCEs are age sixty and forty-five. The results would be more favorable to the HCEs by using permitted disparity.

The first rate group consists of HCE 2 and NHCE 4. The second rate group consists of HCE 2, HCE 1, NHCE 2, NHCE 3, NHCE 4, and NHCE 5.

|  |
| --- |
| Table 4-8. Ratio Percentage Test |
| ***First Rate Group:*** | ***Second Rate Group:*** |
| HCE 2 | 9.639% | HCE 2 | 9.639% |
|  |  | HCE 1 | 2.640% |
|  |  | NHCE 2 | 4.709% |
|  |  | NHCE 3 | 8.432% |
| NHCE 4 | 11.042% | NHCE 4 | 11.042% |
|  |  | NHCE 5 | 2.669% |

Again, as in the prior two examples, one out of two HCEs is in the first rate group, which represents 50 percent of the HCEs. One out of five NHCEs is in the same rate group, representing 20 percent of the NHCEs.

20% / 50% = 40%

Because the result is less than 70 percent, the test is not passed for the first rate group. The second rate group includes both HCEs so 100 percent of the HCEs are included. Four of the NHCEs are included or 80 percent.

80% / 100% = 80%

The second rate group passes. Because the first rate group does not pass, the overall test is not passed.

**Q. 4.27: How is the comparability plan approach applied for purposes of the average benefits test using the annual accrual method?**

The following example demonstrates the application of the comparability plan approach for the average benefits test using the annual accrual method.

**Example 8.** Because rate group 1 in Table 4-8 (see Q. 4.26) fails the ratio percentage coverage test, the plan fails nondiscrimination testing. Fortunately, there is one more option in the comparability plan approach. Rate groups that do not pass the ratio percentage test can then be tested under the average benefits test. This test has two parts to it: the nondiscriminatory classification test and the average benefit ratio test.

Under the classification test, the coverage ratio of the rate group must be at least at the midpoint between the safe harbor percentage and the unsafe harbor percentage (see Appendix 4-1). Under the average benefit ratio test, the average accrual or allocation rates of the NHCEs must be equal to at least 70 percent of the average accrual or allocation rates of the HCEs. These rules as applied to rate group 1 as described in Table 4-8 are as follows:

1. *Determine the concentration percentage.* Divide the total number of NHCEs by the total number of employees (five divided by seven); the percentage equals 71.4 percent.
2. Determine the midpoint from Appendix 4-1. If the midpoint percentage is less than or equal to the coverage percentage (ratio percentage) in the failed rate group, the first part of the average benefit test is passed. Because the coverage percentage in the failed rate group 1 is 40 percent ((1 NHCE / 5 NHCEs) / (1 HCE / 2 HCEs)), this part of the test is passed.

|  |  |
| --- | --- |
| **Safe harbor percentage** | 41.75% |
| **Midpoint percentage** | 36.75% |
| **Unsafe harbor percentage** | 31.75% |

1. *Compare the average accrual or allocation rate of the NHCEs to that of the HCEs.* If the ratio of the NHCE average to the HCE average is equal to or more than 70 percent, the second part of the average benefits test is passed.

|  |  |
| --- | --- |
| **NHCEs** | (2.404 + 4.709 + 8.432 + 11.042 + 2.669) ÷ 5 NHCEs = 5.851% |
| **HCEs** | (2.640 + 9.639) ÷ 2 HCEs = 6.140% |
| **Ratio** | NHCE % ÷ HCE % |
|  | 5.851% ÷ 6.140% = 95.29% |

The average benefit test is passed and the plan qualifies. This is certainly a lot of work for a seven-person plan, but as a result of the extra work, the two HCEs have been allocated a total contribution of $79,750 at a cost for the employees of $6,396. Even if the administrative cost to maintain this plan were $2,000 annually—which is on the high end of the likely fees—the result is highly favorable. Although the approach is similar and the basis for testing is the same, the initial steps for the accrued-to-date method are somewhat different.

**Q. 4.28: How is the comparability plan approach applied for purposes of the average benefits test using the accrued-to-date method?**

The following example demonstrates the application of the comparability plan approach for the average benefits test using the accrued-to-date method.

**Example 9.** The accrued-to-date method takes into consideration prior benefits that have been accumulated as a result of prior years’ employer contributions, forfeitures, and investment earnings. The original data from Table 4-7 (see Q. 4.26) is used, but the account balance is substituted for the employer contributions. The account balance is divided by years of service, and the result (column 6) is projected to the future value and the subsequent accrual. The rate groups, including permitted disparity, are illustrated in Table 4-10. The first rate group consists of HCE 2, NHCE 1, and NHCE 4. The second rate group consists of HCE 2, HCE 1, NHCE 1, NHCE 2, NHCE 3, and NHCE 4.

|  |
| --- |
| Table 4-9. Accrued-to-Date Method of Nondiscrimination Testing |
|  | **1** | **2** | **3** | **4** | **5** |
|  | ***Salary*** | ***Age*** | ***Employer Contributions*** | ***Current Account Balance*** | ***Service*** |
|  |  |  |  |  |  |
| HCE #1 | $255,000 | 60 | $51,000 | $1,301,100 | 15 |
| HCE #2 |  $115,000 | 55 |  $28,750 | $ 431,250 | 10 |
| **S TOTAL** | **$370,000** |  | **$79,750** |  |  |
|  |  |  |  |  |  |
| NHCE #1 | $ 25,000 | 50 | $ 1,025 | $ 82,000 | 12 |
| NHCE #2 | $ 35,000 | 38 | $ 1,435 | $ 22,000 | 6 |
| NHCE #3 | $ 28,000 | 29 | $ 1,148 | $ 3,000 | 2 |
| NHCE #4 | $ 18,000 | 25 | $ 738 | $ 11,000 | 6 |
| NHCE #5 |  $ 50,000 | 48 |  $ 2,050 | $ 9,000 | 5 |
| **S TOTAL** | **$156,000** |  | **$ 6,396** |  |  |
|  |  |  |  |  |  |
| **TOTAL** | **$526,000** |  | **$86,146** |  |  |
|  |  |  |  |  |  |
|  | **6** | **7** | **8** | **9** | **10** |
|  | ***Column 4 Divided By Column 5*** | ***Future value*** | ***Accrual*** | ***Accrual Rate*** | ***Accrual With Social Security*** |
|  |  |  |  |  |  |
| HCE #1 | $86,740 | $124,526 | $ 10,865 | 4.261% | 4.388% |
| HCE #2 | $43,125 | $ 88,882 |  $ 7,755 | 6.744% | 7.116% |
|  |  |  |  |  |  |
| NHCE #1 | $ 6,833 | $ 20,219 | $ 1,764 | 7.057% | 7.757% |
| NHCE #2 | $ 3,667 | $ 25,840 | $ 2,255 | 6.442% | 7.092% |
| NHCE #3 | $ 1,500 | $ 20,267 | $ 1,769 | 6.316% | 6.966% |
| NHCE #4 | $ 1,833 | $ 33,081 | $ 2,887 | 16.037% | 16.687% |
| NHCE #5 | $ 1,800 | $ 6,155 | $ 537 | 1.074% | 1.774% |

|  |
| --- |
| Table 4-10. Ratio Percentage Test |
| ***First Rate Group:*** | ***Second Rate Group:*** |
| HCE 2 | 7.116% | HCE 2 | 7.116% |
|  |  | HCE 1 | 4.674% |
| NHCE 1 | 7.757% | NHCE 2 | 7.757% |
| NHCE 4 | 16.687% | NHCE 3 | 7.092% |
|  |  | NHCE 4 | 6.966% |
|  |  | NHCE 5 | 16.687% |

Following the same approach as in the prior two examples, one out of two HCEs is in the first rate group that represents 50 percent of the HCEs. Two out of five NHCEs are in the same rate group representing 40 percent of the NHCEs.

40% / 50% = 80%

Because the result is more than 70 percent the test is passed for the first rate group. The second rate group includes both HCEs so 100 percent of the HCEs are included. Four of the NHCEs are included or 80 percent.

80% / 100% = 80%

The second rate group passes. Because the second rate group passes, the overall test is passed.

**Q. 4.29: What are the issues with using the new comparability approach?**

The comparability approach to designing defined contribution plans results in plans that are highly favorable to HCEs. Therefore, the IRS published proposed regulations changing the nondiscrimination rules for comparability plans. For a defined contribution plan to satisfy the nondiscrimination rules using comparability, the plan must also satisfy these proposed regulations.[[34]](#footnote-34)

The proposed regulations offer two approaches:

1. Two “gateways,” or safe harbor rules, that automatically satisfy nondiscrimination:
	1. Each eligible NHCE receives an allocation of at least 5 percent of compensation.
	2. Even if the allocation rate for any NHCE is less than 5 percent, the nondiscrimination test is still passed if the minimum allocation rate for any NHCE is at least one-third of the highest allocation rate for any HCE.
2. If the plan offers “broadly available” allocation rates, nondiscrimination testing may still be satisfied by either of the following two mathematical tests:
	1. *Mathematical Test 1.* Each HCE allocation rate must be available to a group of employees that satisfies Code Section 410(b), i.e., the ratio percentage (70 percent) test.
	2. *Mathematical Test 2.* The allocation rates increase as an employee ages or accumulates additional service, and that increase is a “smooth increase.” An increase is smooth if all three of the following requirements are satisfied:
		1. The rate for each group, i.e., based on age or service, exceeds the rate for the next lower band by not more than five percentage points.
		2. Rate bands must cover the same range of age and service. There is no restriction on the highest band, and there is no restriction on the lowest band of age if its highest limit does not exceed twenty-five.
		3. The rate for any band is not more than twice the rate for the next lower band, and for each rate, the ratio of that rate to the next lower rate is never greater than the ratio of the next lower rate to the second next lower rate.

**Example 4-10.** The following chart demonstrates Mathematical Test 1.

|  |  |  |
| --- | --- | --- |
|  | ***Rate Group 1*** | ***Rate Group 2*** |
| HCE 1 | 10% |  |  |
| HCE 2 | 15% | HCE 2 | HCE 1 |
|  |  | NHCE 1 | NHCE 4 |
| NHCE 1 | 15% | NHCE 2 | NHCE 5 |
| NHCE 2 | 15% |  |  |
| NHCE 3 | 5% | HCE coverage 50% (1/2) | HCE coverage 50% (1/2) |
| NHCE 4 | 10% | NHCE coverage 40% (2/5) | NHCE coverage 40% (2/5) |
| NHCE 5 | 10% | Coverage test 80% (40/50) | Coverage test 80% (40/50) |
|  | PASS | PASS |

**Example 4-11.** This example demonstrates Mathematical Test 2.

Age: 25 and under; 26 through 35; 36 through 45; 46 and over

Service: 10 and under; 11 through 20; 21 and over

In the example the lowest age band ends at twenty-five, so the lowest band does not have to cover the same range as the other bands, i.e., ten years (e.g., eleven through twenty), and as indicated in item 2, there is no restriction on the highest band. The service bands cover the same range, i.e., ten years, and again there is no restriction on the highest band.

**Example 4-12.** The following is an example of a smooth rate series mentioned in Mathematical Test 2.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| 5% | 10% | 15% | 20% | 25% |

Here the difference in rate is not more than 5 percent between any two rates. Each rate is no more than two times the next lowest rate:

* 10% / 5% = 2.00
* 15% / 10% = 1.50
* 20% / 15% = 1.33
* 25% / 20% = 1.25

Item 3 is satisfied:

* (25 / 20)  (20 / 15)  (15 / 10)  (10 / 5)
* 1.25  1.33  1.50  2.00

An example of a rate series that is not smooth would be:

* 3% 5% 6% 10%

Although this series satisfies the first two requirements, i.e., no rate is more than 5 percent higher than the previous lower rate, and no rate is more than twice the previous lower rate, it does not satisfy item 3 above.

* (10 / 6)  (6 / 5)  (5 / 3)
* 1.66 1.20 1.66

This series would satisfy the requirement if the first two rates, i.e., 10 percent and 6 percent, were changed so that their ratio would be equal to or less than 1.20.

**Example 4-13.** Table 4-11 is based on a comparability profit sharing plan that passes the nondiscrimination test. If the plan were amended to a safe harbor 401(k) plan (see Chapter 6) the results would be different because employee deferrals do not count in determining allocation rates.

|  |
| --- |
| Table 4-11. Percentage Allocation |
|  | ***Salary*** | ***Age*** | ***Employer Contribution*** | ***Forfeitures*** | ***Total Allocation*** | ***Percent Allocation*** |
| HCE #1 | $255,000 | 60 | $ 51,000 |  | $51,000 | 20.00% |
| HCE #2 | $115,000 | 55 | $ 28,750 |   | $28,750 | 25.00% |
|  |  |  |  |  |  |  |
| NHCE #1 | $ 25,000 | 50 |  $ 1,025 | $ 625 | $ 1,650 | 6.60% |
| NHCE #2 | $ 35,000 | 38 |  $ 1,435 | $ 875 | $ 2,310 | 6.60% |
| NHCE #3 | $ 28,000 | 29 |  $ 1,148 | $ 700 | $ 1,848 | 6.60% |
| NHCE #4 | $ 18,000 | 25 |  $ 738 | $ 450 | $ 1,188 | 6.60% |
| NHCE #5 | $ 50,000 | 48 |  $ 2,050 |  $ 1,250 | $ 3,300 | 6.60% |

**Example 4-14.** Table 4-12 is based on a safe harbor 401(k) plan. In this case, the allocation to the NHCEs is reduced from 6.60 percent to 3.67 percent, satisfying the rule that the NHCEs’ minimum allocation rate must be at least one-third of the highest HCE allocation rate but not more than 5 percent. The only disadvantage of this approach is that the first 3 percent contributed for the NHCEs must be 100 percent vested in a safe harbor 401(k) plan. If employee turnover is high, excluding the 401(k) option may be less costly, considering that the cost for the NHCEs would be reduced by forfeitures in the profit sharing plan. Remember that the new regulations must be satisfied *in addition* to the nondiscrimination testing illustrated earlier in this chapter. Clearly, comparability defined contribution plans are not gone—only more closely regulated.

|  |
| --- |
| Table 4-12. Safe Harbor 401(k) Plan |
|  | ***Salary*** | ***Age*** | ***Employer Contribution*** | ***Employee Deferrals*** | ***Forfeitures*** | ***Total ER Allocation*** | ***Percent Allocation*** |
| HCE #1 | $255,000 | 60 | $28,000 | $23,000 |  | $ 28,000 | 10.980% |
| HCE #2 | $115,000 | 55 | $ 3,450 | $23,000 |   | $ 3,450 | 3.000% |
|  |  |  |  |  |  |  |  |
| NHCE #1 | $ 25,000 | 50 | $ 293 |  | $ 625 | $ 918 | 3.673% |
| NHCE #2 | $ 35,000 | 38 | $ 411 |  | $ 875 | $ 1,286 | 3.673% |
| NHCE #3 | $ 28,000 | 29 | $ 329 |  | $ 700 | $ 1,029 | 3.673% |
| NHCE #4 | $ 18,000 | 25 | $ 211 |  | $ 450 | $ 661 | 3.673% |
| NHCE #5 | $ 50,000 | 48 |  $ 587 |  |  $1,250 | $ 1,837 | 3.673% |

**Q. 4.30: Is compensation for nondiscrimination testing purposes subject to the same compensation limit for qualified plan benefits?**

Yes. The plan must apply the Code Section 401(a)(17) compensation limit for nondiscrimination testing purposes.[[35]](#footnote-35)

**Q. 4.31: What is included in compensation for nondiscrimination testing purposes?**

For testing purposes, compensation is defined in Code Section 414(s), which refers to Code Section 415(c)(3) and includes:[[36]](#footnote-36)

1. Wages, salaries, fees for professional services, and other amounts received for personal services actually rendered in the course of employment with the employer maintaining the plan to the extent that the amount is includable in gross income;
2. In the case of an employee who is an employee within the meaning of Code Section 401(c)(1) and the regulations thereunder (self-employed person or owner employee), the employee’s earned income as defined in Code Section 401(c)(2);
3. Amounts received through an accident or health insurance plan (Code Section 104(a)(3), Code Section 105(a)), and amounts paid to HCEs under a discriminatory self-insured medical reimbursement plan, to the extent these amounts are included in the gross income of the employee;
4. Amounts paid or reimbursed by the employer for moving expenses if it is reasonable to expect that those amounts will not be deductible by the employee under Code Section 217;
5. The value of nonqualified stock options granted to an employee by the employer to the extent included in the employee’s gross income in the year granted; and
6. The amount includable in the employee’s gross income if property is transferred to the employee by the employer in exchange for the performance of services in accordance with Code Section 83(b).

All other forms of compensation are excluded for purposes of the Code Section 415(c)(3) definition. As an alternative to the preceding six-item list, there are two safe harbor definitions of compensation for purposes of Code Section 415(c)(3):[[37]](#footnote-37)

1. Income tax withholding wages, as defined in Code Section 3401(a) for purposes of federal income tax withholding
2. Form W-2 box 5 wages, as long as the instructions for the amount reported in box 10 remain the same as for 1990 and 1991 tax years

**Practice Point:** Although multiple definitions of compensation are permitted, plans should use a uniform definition. The rules and regulations governing qualified plans are complex enough without adding unnecessary complexity. In addition, the administration cost would be increased with the use of multiple definitions of compensation because of the additional recordkeeping required.

**Q. 4.32: Is it possible for a plan amendment, plan termination or grant of past service to violate the nondiscrimination rules?**

Yes. Any plan amendment, plan termination, or grant of past service must be nondiscriminatory on its face and in operation.[[38]](#footnote-38)

Plan amendments include the establishing of a plan, termination of a plan, and any changes that affect benefits or allocations under the plan. Whether a plan satisfies this requirement is a facts-and-circumstances determination. The issues to be considered are the relative number of HCEs and NHCEs affected by the amendment, the relative benefits for the HCEs and NHCEs before and after the amendment, the relative service of the HCEs and the NHCEs, the length of time the plan has been in effect, and the turnover of the employees before the effective date of the plan.

The same issue must be addressed with respect to past service.[[39]](#footnote-39) A plan that provides past service credits having the effect of discriminating in favor of HCEs does not satisfy nondiscrimination rule 2. Credit for past service would include benefits earned based on service before the effective date of the plan, increases in benefits to reflect service before the effective date of an amendment, and higher benefits because of prior service with another employer. Any plan that limits past service credits to five years is deemed to satisfy this requirement. If a plan provides for past service credits in excess of five years, it does not automatically fail to satisfy nondiscrimination requirements unless the facts and circumstances support that conclusion.

Appendix 4-1

Safe and Unsafe Harbor Used for Nondiscrimination Testing

|  |  |  |
| --- | --- | --- |
| **Nonhighly compensated employee concentration percentage** | **Safe harbor percentage** | **Unsafe harbor percentage** |
| 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 |

1. IRC Sec. 401(a)(4), Sec. 414(q)(1). [↑](#footnote-ref-1)
2. Treas. Reg. § 1.401(a)(4)-11(g)(1). [↑](#footnote-ref-2)
3. IRC Sec. 410(b); Treas. Reg. § 1.410(b)-2. [↑](#footnote-ref-3)
4. IRC Sec. 410(b)(1); Treas. Reg. § 1.410(b)-2(b)(2). [↑](#footnote-ref-4)
5. Treas. Reg. § 1.410(b)-4. [↑](#footnote-ref-5)
6. Treas. Reg. § 1.410(b)-5. [↑](#footnote-ref-6)
7. IRC Sec. 410(b)(2); Treas. Reg. § 1.410(b)-2(b)(3). [↑](#footnote-ref-7)
8. Treas. Reg. § 1.414(r)-1(b)(2)(iv); Treas. Reg. § 1.414(r)-5. [↑](#footnote-ref-8)
9. Treas. Reg. § 1.414(r)-1(b)(2)(ii). [↑](#footnote-ref-9)
10. Treas. Reg. § 1.414(r)-3(a). [↑](#footnote-ref-10)
11. IRC Sec. 401(a)(26); Treas. Reg. § 1.401(a)(26)-2; Treas. Reg. § 1.410(b)-3. [↑](#footnote-ref-11)
12. Treas. Reg. § 1.401(a)(26)-6(b). [↑](#footnote-ref-12)
13. Treas. Reg. §§ 1.401(b)-3(a)(1); 1.401(b)-3(a)(2)(i); 1.401(b)-3(a)(2)(iv); Rev. Proc. 93-42, 1993-2 C.B. 540. [↑](#footnote-ref-13)
14. For floor offset plans, see Chapter 11. [↑](#footnote-ref-14)
15. For target benefit plans, see Chapter 11. [↑](#footnote-ref-15)
16. IRC Sec. 401(a)(26). [↑](#footnote-ref-16)
17. Treas. Reg. § 1.401(a)(4)-4. [↑](#footnote-ref-17)
18. Treas. Reg. § 1.401(a)(4)-4(b). [↑](#footnote-ref-18)
19. Treas. Reg. § 1.401(a)(4)-4(c). [↑](#footnote-ref-19)
20. Treas. Reg. § 1.401(a)(4)-4(e)(3)(iii). [↑](#footnote-ref-20)
21. Treas. Reg. § 1.401(a)(4)-11(g). [↑](#footnote-ref-21)
22. Treas. Reg. § 1.401(a)(4)-4(e)(1). [↑](#footnote-ref-22)
23. IRC Sec. 411(a)(9); Treas. Reg. § 1.411(d)-4(d); Treas. Reg. §§ 1.401(a)(4)-12; 1.411(a)-7(c)(4)(ii) [↑](#footnote-ref-23)
24. For defined contribution plans, Treas. Reg. § 1.401(a)(4)-2; for defined benefit plans, Treas. Reg. § 1.401(a)(4)-3. [↑](#footnote-ref-24)
25. Treas. Reg. § 1.401(a)(4)-1(b)(2)(ii)(B). [↑](#footnote-ref-25)
26. Treas. Reg. § 1.401(a)(4)-2(b). [↑](#footnote-ref-26)
27. Treas. Reg. § 1.401(a)(4)-3(b). [↑](#footnote-ref-27)
28. For defined contribution plans, Treas. Reg. § 1.401(a)(4)-2(c); for defined benefit plans, Treas. Reg. § 1.401(a)(4)-3(c). [↑](#footnote-ref-28)
29. For defined contribution plans, Treas. Reg. § 1.401(a)(4)-2(c)(1); for defined benefit plans, Treas. Reg. § 1.401(a)(4)-3(c)(1). [↑](#footnote-ref-29)
30. Treas. Reg. § 1.401(a)(4)-2(c)(2)(iv). [↑](#footnote-ref-30)
31. For defined contribution plans, Treas. Reg. § 1.401(a)(4)-2(c); for defined benefit plans, Treas. Reg. § 1.401(a)(4)-3(c). [↑](#footnote-ref-31)
32. Treas. Reg. § 1.401(a)(4)-8. [↑](#footnote-ref-32)
33. Treas. Reg. § 1.401(a)(4)-8(b)(2). [↑](#footnote-ref-33)
34. Prop. Treas. Reg. § 1.401(a)(4)-8(b). [↑](#footnote-ref-34)
35. Treas. Reg. § 1.415-2(d)(2). [↑](#footnote-ref-35)
36. IRC Sec. 414(s); Treas. Reg. § 1.415-2(d)(2). [↑](#footnote-ref-36)
37. Treas. Reg. § 1.415-2(d)(11)(ii). [↑](#footnote-ref-37)
38. Treas. Reg. § 1.401(a)(4)-5(a). [↑](#footnote-ref-38)
39. Treas. Reg. § 1.401(a)(4)-11(d)(3). [↑](#footnote-ref-39)