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Using the Nondiscriminatory Classification Test In Designing Qualified Plans

By BRUCE GIVNER

The author describes how the Section 410(b)(1)(B) test may be used by tax planners in designing pension plans of minimal cost to shareholder-employees in terms of covering other employees.

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It is all too true that most clients think of pension plans as tax shelters and not as vehicles for providing retirement income. Accordingly, it is the pension planner's job to design a plan that will save the shareholder-employee the most in taxes at a minimal cost in terms of covering the other employees.

IRC Standards for Coverage

The standard for covering the other employees is found in Internal Revenue Code Section 410 (suitably entitled "Minimum Participation Standards"), subsection (b) (entitled "Eligibility"). In order to receive a favorable determination letter from the Internal Revenue Service with respect to the plan's tax-qualified status, the plan must overcome either the numerical test of Section 410(b)(1)(A) or the nondiscriminatory classification test of Section 410(b)(1)(B). Since the numerical test is unambiguous—a safe harbor for meeting the coverage requirements—most plans are designed and submitted to the IRS based on coverage of seventy percent or more of all employees (excluding employees who have not met the plan's minimum age and service requirements, if any).

However, the nondiscriminatory classification test can be a powerful tool in the pension planner's attempt to keep down the cost of covering the nonshareholder-employees. That test

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is as follows: The plan shall not be qualified under Section 401(a) unless it benefits such employees as qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of employees who are officers, shareholders, or highly compensated. Internal Revenue Code Section 410(b)(1)(B).

The regulations promulgated with respect to the classification test simply add that for purposes of the test all active employees (including employees who do not satisfy the minimum age or service requirements of the plan) are to be taken into account. Treas. Reg. Section 1.410(b)-(1)(b)(2).

IRS's Blueprint Plan in Rev. Rul. 70-200

In Revenue Ruling 70-200, however, the IRS set forth a blueprint that can be followed in meeting the nondiscriminatory classification test. There a profit-sharing plan covered only the 40 salaried employees, not the 110 hourly employees. Twenty-two of the 40 covered employees were persons in whose favor discrimination was prohibited. (Reflecting the language of old Section 401(a)(3)(B), the persons in whose favor discrimination was prohibited were officers, shareholders, supervisors and highly compensated employees. Section 410(b)(1)(B), a successor to that prior section, has dropped the category of supervisors but retains the other three categories.) In analyzing the plan in that ruling, the IRS created the following chart:

Group	Compensation range	Total employees	Excluded employees	Participants	Participants who are officers, shareholders, or supervisors
1	$25,001 to $30,000	4	0	4	4
2	$20,001 to $25,000	0	0	0	0
3	$15,001 to $20,000	25	18	7	7
4	$12,501 to $15,000	45	37	8	8
5	$10,001 to $12,500	50	38	12	3
6	$ 7,501 to $10,000	14	11	3	0
7	$ 5,001 to $ 7,500	9	4	5	0
8	$ 2,500 to $ 5,000	3	2	1	0
	Total	150	110	40	22

Based on that chart the IRS concluded that the profit-sharing plan met the nondiscriminatory classification test. The reasoning was as follows: the compensation of all but 4 of the 40 participants was substantially the same as that of the excluded hourly paid employees; the plan covered employees in all compensation ranges; and those in the middle and lower brackets were covered in more than nominal numbers.

Application of Rev. Rul. 70-200

The application of this blueprint to a law firm may prove easy to understand. In a law firm there are essentially three categories of employees: (1) the partners (this language of partnership lingers on even though the law firm is actually a corporation, and people otherwise referred to as partners are probably the shareholders), (2) the associates, and (3) the nonprofessional staff.

The partners are concerned to give themselves the maximum benefits with the minimum cost in terms of covering the other employees. The greatest cost is in covering the associates. Accordingly, the law firm may be quite happy with a plan if it covers only the partners and the nonprofessional staff, while eliminating the otherwise costly associates.

In this actual case the pension plan required that an employee be in one of the following job categories in order to be eligible: a member of the board of directors; a secretary of a member of the board of directors; a messenger; a word processor; or a receptionist. The following chart was submitted to the IRS as part of the application for a favorable determination letter:

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Group	Compensation range	Total employees	Excluded employees	Partici- pants	Participants who are not officers or shareholders
1	$90,000 and above	4	0	3	0
2	$41,000 to $89,999	7	6	1	0
3	$23,400 to $40,999	6	6	0	0
4	$14,900 to $23,399	8	6	2	2
5	$13,000 to $14,899	7	4	3	3
6	$12,000 to $12,999	7	7	0	0
7	$ 9,000 to $11,999	6	2	4	4
8	$ 0 to $ 8,999	7	3	4	4
	Totals	52	34	17	13

Although the percentage of employees covered by the plan was higher (32.7%) than the percentage covered in Revenue Ruling 70-200 (26.7%), the result is nonetheless attractive. First, note that there are two compensation ranges (Groups 3 and 6) in which no employees were participating. Contrast that with the revenue ruling, in which there were participants in each compensation range in which there were employees (7 out of 7). Second, note that the compensation ranges themselves are not simply $2500 and $5000 ranges as was the case in the revenue ruling. Instead, it is apparent that the ranges were purposely compressed and enlarged to present the best possible picture to the reviewing agent. Third, note that the waiver of participation by one of the partners in Group 1 helped make the chart more palatable to the reviewing agent. Finally, note that the associates—all of whom fell within Groups 3 and 4—were fully excluded from the plan. This was achieved by making Group 4 stretch from the highest paid secretaries, who were covered by the plan, up through the lowest paid associates.

General Considerations

This plan should not be dismissed as an isolated example. This pattern has been repeated time and again with great success. Of course, sometimes amendments must be made to the plan after submission to the IRS and prior to issuance of a favorable determination letter in order to placate a particular reviewing agent. However, that inconvenience is a small price to pay for the result achieved.

Also, it is important to monitor the actual participation in the plan from year to year. Favorable determination letters issued by the IRS only cover plans as drafted. However, in the case of a plan submitted with such a compensation range chart, the determination letter should also cover the plan in every year in which the coverage remains as it was indicated by the chart. The best way to ensure that the tax benefits are not lost is to examine the plan at least one month prior to the end of the plan year. At that point it will be possible to determine whether it will be necessary to broaden the coverage of the plan by, for example, including the bookkeepers. ●

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