As the Education Director of NIPA, Kim Martin is responsible for the leadership and strategic management of the association’s educational programs. Kim is also a case manager at Pension Plan Professionals, Inc., providing administration and consulting services to clients.
What We Will Cover

- Mandatory Disaggregation
- Permissive Disaggregation
- Otherwise Excludable Employees
- Consequences of Using Disaggregation

How Disaggregation Works

Plan A

- Plan A1
  - Perform Coverage Test
- Plan A2
  - Perform Coverage Test
Mandatory Disaggregation

- Parts of a plan are required to be tested separately from other parts
- Plans subject to mandatory disaggregation:
  - 401(k) arrangement
  - 401(m) arrangement
  - ESOPs
  - Union plans
  - Multiple employer plans
  - QSOBs (elective)

401(k) and 401(m) Arrangements

- Under mandatory disaggregation, a 401(k) plan may be treated as three separate plans:
  - 401(k) plan
    - Salary deferrals, even if shifted to the ACP test
  - 401(m) plan
    - After-tax employee contributions
    - Regular matching contributions
    - QMACs, even if in the ADP test
    - Safe harbor matching contributions
  - Non-elective (“401(a)”) portion of plan
    - “Profit sharing” contributions
    - QNECs, regardless of ADP/ACP testing
    - Safe harbor non-elective contributions
Mandatory Disaggregation of a 401(k) Plan

401(k) Plan
- 401(k) portion
  - Perform coverage test on deferrals
- 401(m) portion
  - Perform coverage test on match
- 401(a) portion
  - Perform coverage test on profit sharing

Other Plans Subject to Mandatory Disaggregation

Employee Stock Ownership Plan
- ESOP portion
- Non-ESOP portion

Union Plan
- Union 1 portion
- Union 2 portion, etc.
- Non-union portion

Multiple Employer Plan
- Employer 1 portion
- Employer 2 portion
- Employer 3 portion, etc.
Each separate “plan” must comply with coverage.

<table>
<thead>
<tr>
<th>Identify HCEs</th>
<th>Determine testing group</th>
<th>Determine benefiting group</th>
<th>Perform coverage test</th>
</tr>
</thead>
</table>

Determine the Testing Group

- Separately determined for each “plan”
- Excludable employees
  - Have not met the plan’s age and service requirements
  - Certain terminated employees
  - Union employees
  - Nonresident aliens
- Example: A 401(k) plan’s eligibility requirements are 6 months for salary deferrals and matching contributions, but a year of service and age 21 for profit sharing contributions. Employees who haven’t had a year of service or attained age 21 are excludable under the profit sharing portion of the plan, while employees who haven’t been employed six months are excludable under the 401(k) plan and under the 401(m) plan.
Determine the Testing Group

- **Excludable terminated employees**
  - Terminated plan participant
  - Credited with less than 501 hours of service
  - Doesn’t receive allocation due to failure to satisfy the plan’s minimum service and/or last day allocation requirements

- **Special 401(k)/401(m) rules**
  - 401(k) – terminated employee exclusion doesn’t apply
    - Example: Jill is a participant who terminates with 400 hours of service; she is *not* excludable from the 401(k) portion of the plan.
  - 401(m) – terminated employee exclusion applies if arrangement contains only a match with allocation conditions
    - Example: If the plan allocates a match to active participants, Jill is excludable from the 401(m) portion of the plan.
  - Annual testing period required

Determine the Benefiting Group

- **Separately determined for each “plan”**
- **401(k) plan**
  - Benefiting = eligible to defer, even if do not
- **401(m) Plan**
  - Benefiting =
    - Eligible to receive a match if had deferred, or
    - Eligible to make an after-tax employee contribution, even if do not
  - Impact of allocation conditions
    - Example: Assume instead that Jill terminates with 700 hours. The plan matches salary deferrals of participants employed on the last day of the plan year. Is Jill treated as benefiting? What if there are no allocation conditions to receive the match?
    - Benefiting with monthly/quarterly allocation requirements
Perform the Coverage Test

Disaggregate plan into component parts

Identify HCEs

Determine testing group for each part

Determine benefiting group for each part

Perform ratio percentage test for each part

If fail test

Perform average benefit test for each failed part

Mandatory Disaggregation: Ratio Percentage Test Example

• Sunshine 401(k) Plan includes salary deferrals, matching contributions and profit sharing contributions.
  • 6 months eligibility for salary deferrals and matching contributions
  • Year of service and age 21 for profit sharing contributions
  • Last day requirement for matching and profit sharing contribution
  • Union employees are excluded

• Census:

<table>
<thead>
<tr>
<th></th>
<th>HCE</th>
<th>NHCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Employees</td>
<td>10</td>
<td>190</td>
</tr>
<tr>
<td>Employed &lt; 6 mo</td>
<td>0</td>
<td>15</td>
</tr>
<tr>
<td>Employed 6-11 mo</td>
<td>0</td>
<td>15</td>
</tr>
<tr>
<td>Under age 21</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Union Employees</td>
<td>0</td>
<td>35</td>
</tr>
<tr>
<td>Term &lt; 501 hours</td>
<td>0</td>
<td>20</td>
</tr>
<tr>
<td>Term ≥ 501 hours</td>
<td>0</td>
<td>25 (≥ age 21/YOS) 15 (6-11 mo srvc)</td>
</tr>
<tr>
<td></td>
<td>“401(k)”</td>
<td>“401(m)”</td>
</tr>
<tr>
<td>------------------------</td>
<td>-----------</td>
<td>-----------</td>
</tr>
<tr>
<td>Total</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Excludable</td>
<td>50</td>
<td>70</td>
</tr>
<tr>
<td>Testing Group</td>
<td></td>
<td></td>
</tr>
<tr>
<td>HCE</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>NHCE</td>
<td>140</td>
<td>120</td>
</tr>
<tr>
<td>Benefiting Group</td>
<td></td>
<td></td>
</tr>
<tr>
<td>HCE</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>NHCE</td>
<td>140</td>
<td>80</td>
</tr>
<tr>
<td>Group Ratio</td>
<td></td>
<td></td>
</tr>
<tr>
<td>HCE</td>
<td>100%</td>
<td>10/10 = 100%</td>
</tr>
<tr>
<td>NHCE</td>
<td>100%</td>
<td>80/120 = 66.67%</td>
</tr>
<tr>
<td>Plans’ Ratio %</td>
<td>100%</td>
<td>66.67%</td>
</tr>
</tbody>
</table>

**Mandatory Disaggregation: Average Benefit Test**

- **Nondiscriminatory classification test**
  - Performed separately for each disaggregated plan
  - Must satisfy either a safe harbor or facts and circumstances test
- **Average benefit percentage test**
  - Examines the benefits received by participants under the plan.
  - Exception to mandatory disaggregation rules
    - Contributions from 401(k) plans, 401(m) plans and ESOPs are used to calculate a participant’s benefit percentage.
Mandatory Disaggregation: Ratio Percentage/Nondiscriminatory Classification

Mandatory Disaggregation: Average Benefit Percentage Test

Combined benefit used to calculate a participant’s ABP
Mandatory Disaggregation: Average Benefit Test Example

- Sunshine 401(k) Plan
  - The 401(m) portion failed the ratio percentage test.

<table>
<thead>
<tr>
<th>Benefit Group</th>
<th>NHCE</th>
<th>HCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Testing Group</td>
<td>120</td>
<td>10</td>
</tr>
<tr>
<td>Group Ratio</td>
<td>66.67%</td>
<td>100%</td>
</tr>
<tr>
<td>Plan’s Ratio %</td>
<td>66.67%</td>
<td></td>
</tr>
</tbody>
</table>

- Nondiscriminatory classification test
  - NHCE concentration % = 120 NHCEs/130 Total = 92%
  - Safe harbor % (table look-up) = 26%
  - 401(m) plan’s ratio % of 66.67% ≥ SH 26% → pass safe harbor

Average benefit percentage test

<table>
<thead>
<tr>
<th>HCEs</th>
<th>Comp</th>
<th>Deferral</th>
<th>Match</th>
<th>Profit Sharing</th>
<th>Benefit %</th>
</tr>
</thead>
<tbody>
<tr>
<td>HCE 9</td>
<td>$150,000</td>
<td>$0</td>
<td>$0</td>
<td>$7,500</td>
<td>5.00%</td>
</tr>
<tr>
<td>HCE 10</td>
<td>$125,000</td>
<td>$10,000</td>
<td>$1,875</td>
<td>$6,250</td>
<td>14.50%</td>
</tr>
</tbody>
</table>

HCE average benefit % = 120% total HCE benefit % / 10 HCEs = 12%

(Assumes benefit % for HCEs 1-8 included in the 120% total HCE benefit %)
Mandatory Disaggregation:
Average Benefit Test Example

**Average benefit percentage test**

**NHCEs**

<table>
<thead>
<tr>
<th></th>
<th>Comp</th>
<th>Deferral</th>
<th>Match</th>
<th>Profit Sharing</th>
<th>Benefit %</th>
</tr>
</thead>
<tbody>
<tr>
<td>NHCE 119</td>
<td>↓ $20,000</td>
<td>↓ $700</td>
<td>↓ $300</td>
<td>↓ $1,000</td>
<td>10.00%</td>
</tr>
<tr>
<td>NHCE 120</td>
<td>$15,000</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>0.00%</td>
</tr>
</tbody>
</table>

NHCE average benefit % = 720% total NHCEs benefit % / 120 NHCEs = 6%

(Assumes benefit % for NHCEs 1-118 included in the 720% total NHCE benefit %)

---

Mandatory Disaggregation:
Average Benefit Test Example

**Average benefit percentage test**

**HCEs**

<table>
<thead>
<tr>
<th></th>
<th>Comp</th>
<th>Deferral</th>
<th>Match</th>
<th>Profit Sharing</th>
<th>Benefit %</th>
</tr>
</thead>
<tbody>
<tr>
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<td>↓ $0</td>
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<td>$10,000</td>
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<td>$6,250</td>
<td>14.50%</td>
</tr>
</tbody>
</table>

HCE average benefit % = 120% total HCE benefit % / 10 HCEs = 12%

<table>
<thead>
<tr>
<th></th>
<th>Comp</th>
<th>Deferral</th>
<th>Match</th>
<th>Profit Sharing</th>
<th>Benefit %</th>
</tr>
</thead>
<tbody>
<tr>
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<td>↓ $20,000</td>
<td>↓ $700</td>
<td>↓ $300</td>
<td>↓ $1,000</td>
<td>10.00%</td>
</tr>
<tr>
<td>NHCE 120</td>
<td>$15,000</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>0.00%</td>
</tr>
</tbody>
</table>

NHCE average benefit % = 720% total NHCEs benefit % / 120 NHCEs = 6%

Average benefit % = 6% / 12% = 50% → fail ABP test
Do Not Aggregate When You Must Disaggregate!

• An employer may elect to aggregate plans in order to satisfy coverage.
• Permissive aggregation is not available to plans subject to mandatory disaggregation.
  • An ESOP cannot be aggregated with a non-ESOP.
  • A 401(k) plan cannot be aggregated with a 401(m) plan.
  • A union plan cannot be aggregated with a non-union plan.
• However, the same disaggregated type may be aggregated.

Permissive Disaggregation

• An optional type of disaggregation is available to plans that allow employees to become participants sooner than the statutory one year of service/age 21 eligibility requirements.
• Such plans may be treated as comprising separate plans for coverage testing:
  • Not available with a 2-year eligibility requirement.
For Each Disaggregated “Plan”

1. Identify HCEs
2. Determine testing group
3. Determine benefiting group
4. Perform coverage test

Permissive Disaggregation

• Testing Group
  • Otherwise excludable employee “plan”
    • Excludable employees = statutory employees and employees who haven’t attained the plan’s lower age/service requirements
  • Statutory employee “plan”
    • Excludable employees = employees who haven’t attained age 21 or one year of service
Permissive Disaggregation

• Coverage Testing
  • Each disaggregated portion must pass either the ratio percentage test or the average benefit test.
  • Average benefit percentage test
    • Disaggregation of otherwise excludable employees and statutory employees is not ignored.

<table>
<thead>
<tr>
<th>Statutory Employee Coverage Test</th>
<th>Plan</th>
<th>Otherwise Excludable Coverage Test</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Permissive Disaggregation: Ratio Percentage Test Example

• Beach Bum Profit Sharing Plan has the following requirements:
  • Eligibility = 3 months/age 18
  • Allocation conditions = 1,000 hours/last day

• Census:

<table>
<thead>
<tr>
<th></th>
<th>HCE</th>
<th>NHCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Employees</td>
<td>5</td>
<td>24</td>
</tr>
<tr>
<td>Employed &lt; 3 mo</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Employed 3-11 mo</td>
<td>0</td>
<td>8</td>
</tr>
<tr>
<td>Age 18-20</td>
<td>0</td>
<td>6</td>
</tr>
<tr>
<td>Under age 18</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Term &lt; 501 hours</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>&lt; 1,000 hours</td>
<td>1</td>
<td>2 (statutory)</td>
</tr>
<tr>
<td></td>
<td>0</td>
<td>8 (otherwise excl)</td>
</tr>
</tbody>
</table>
### Permissive Disaggregation Under a Mandatorily Disaggregated Plan

- Each separate plan that is mandatorily disaggregated does not need to elect otherwise excludable testing.
  - Example: An employer can elect permissive aggregation for the 401(k) and 401(m) portions, but not for the non-elective portion.

<table>
<thead>
<tr>
<th>PSP (all employees)</th>
<th>“Statutory Employees”</th>
<th>“Otherwise Excl Employees”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>29</td>
<td>29</td>
</tr>
<tr>
<td>Excludable</td>
<td>3</td>
<td>17</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Testing Group</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>HCE</td>
<td>5</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>NHCE</td>
<td>21</td>
<td>7</td>
<td>14</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Benefiting Group</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>HCE</td>
<td>4</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>NHCE</td>
<td>11</td>
<td>5</td>
<td>6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Group Ratio</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>HCE</td>
<td>4/5 = 80%</td>
<td>4/5 = 80%</td>
<td>only benefits</td>
</tr>
<tr>
<td>NHCE</td>
<td>11/21 = 52.38%</td>
<td>5/7 = 71.43%</td>
<td>NHCEs →</td>
</tr>
</tbody>
</table>

**Plans’ Ratio %**
- 65.48%
- 89.29%

Automatic pass!
Permissive Disaggregation
Under a Mandatorily Disaggregated Plan

- Example: In the Sunshine 401(k) Plan, employees are eligible to defer and receive a match after 6 months of employment. However, last day employment is required for the match. The 401(k) portion can test statutory and otherwise excludable employees together, while the disaggregated 401(m) portion can test otherwise excludable employees separately.

<table>
<thead>
<tr>
<th></th>
<th>“401(m)”</th>
<th>“Statutory”</th>
<th>“Otherwise Excl”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>200</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Excludable</td>
<td>70</td>
<td>105</td>
<td>165</td>
</tr>
<tr>
<td>Testing Group</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>HCE</td>
<td>10</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>NHCE</td>
<td>120</td>
<td>85</td>
<td>35</td>
</tr>
<tr>
<td>Benefiting Group</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>HCE</td>
<td>10</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>NHCE</td>
<td>80</td>
<td>60</td>
<td>20</td>
</tr>
<tr>
<td>Group Ratio</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>HCE</td>
<td>10/10 = 100%</td>
<td>10/10 = 100%</td>
<td>only benefits</td>
</tr>
<tr>
<td>NHCE</td>
<td>80/120 = 66.67%</td>
<td>60/85 = 70.59%</td>
<td>NHCEs →</td>
</tr>
<tr>
<td>Plans’ Ratio %</td>
<td>66.67%</td>
<td>70.59%</td>
<td>automatic pass!</td>
</tr>
</tbody>
</table>
Permissive Disaggregation

• Optional
  • It’s an elective disaggregation rule, not mandatory.

• Operational
  • Written election isn’t required.
  • Decision made on a year-by-year basis.

Benefits of Permissive Disaggregation

• Improved test results
  • May enable plan to satisfy coverage
    • Beach Bum Profit Sharing Plan
    • Sunshine 401(k) Plan – 401(m) portion

• Increased flexibility in plan design
  • Eligibility provisions
    • Early eligibility
  • Allocation conditions
    • Hours/last day
Consequences of Disaggregation

- Relationship of the IRC § 410(b) minimum coverage rules to the nondiscrimination rules of IRC § 401(a)(4)
  - Requirements designed to work together
  - Nondiscrimination rules use the definition of "plan" used for coverage
    - After application of disaggregation

Mandatory Disaggregation

- Separate “plans” for coverage testing → separate “plans” for nondiscrimination testing
  - 401(k) arrangement
  - 401(m) arrangement
  - ESOPs
  - Union plans
  - Multiple employer plans
  - QSOBs
- Nondiscrimination includes ADP/ACP testing
Mandatory Disaggregation of a 401(k) Plan

401(k) Plan

401(k) portion
Perform coverage test & ADP test on deferrals

401(m) portion
Perform coverage test & ACP test on match

401(a) portion
Perform coverage test & 401(a)(4) test on profit sharing

Permissive Disaggregation

- Separate “plans” for coverage testing → separate “plans” for nondiscrimination testing
  - Otherwise excludable employees
  - Statutory employees
- Nondiscrimination includes ADP/ACP testing
  - Otherwise excludable employee disaggregation
  - Early participation rule
    - Does not apply to coverage testing
    - May not be used in a safe harbor 401(k) plan
Early Participation: Single ADP Test

- **401(k) Portion**
  - Statutory Employees
  - Coverage Test
  - ADP Test (Statutory + HCE Otherwise Excl)
  - Coverage Test

(Applies similarly to 401(m) portion and ACP test.)

Disaggregation: Separate ADP Tests

- **401(k) Portion**
  - Statutory Employees
  - Coverage Test
  - ADP Test
  - Coverage Test
  - ADP Test

(Applies similarly to 401(m) portion and ACP test.)
Permissive Disaggregation: Safe Harbor 401(k) Plans

401(k) Portion

Statutory Employees – Safe Harbor Plan

Coverage Test

Otherwise Excludable Employees Plan

Coverage Test

ADP Test

Permissive Disaggregation: Satisfying Testing

- Example: Safe harbor 401(k) plan has 3 month eligibility for deferrals and a year of service/age 21 for safe harbor basic matching contribution.

<table>
<thead>
<tr>
<th></th>
<th>YOS?</th>
<th>Compensation</th>
<th>Deferral</th>
<th>Basic Match</th>
</tr>
</thead>
<tbody>
<tr>
<td>HCE 1</td>
<td>Yes</td>
<td>$200,000</td>
<td>$15,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>NHCE 1</td>
<td>Yes</td>
<td>$50,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>NHCE 2</td>
<td>No</td>
<td>$30,000</td>
<td>$1,200</td>
<td>$0</td>
</tr>
<tr>
<td>NHCE 3</td>
<td>No</td>
<td>$20,000</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>

- Plan #1 = HCE 1 and NHCE 1
- Plan #2 = NHCE 2 and NHCE 3
Top Heavy Plans

- Permissive disaggregation only applies to coverage and nondiscrimination.
  - Does not apply to top heavy
    - Can't divide into two plans for top-heavy purposes
    - Top heavy minimums required for all active non-key employees
- Safe harbor 401(k) plan
  - Impact of permissive disaggregation on top-heavy exemption
    - Exemption must be satisfied by whole plan
    - Permissive disaggregation invalidates exemption

Top-Heavy Exemption and Otherwise Excludable Employees

<table>
<thead>
<tr>
<th>YOS?</th>
<th>Compensation</th>
<th>Deferral</th>
<th>Basic Match</th>
</tr>
</thead>
<tbody>
<tr>
<td>Key 1</td>
<td>Yes</td>
<td>$200,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Non-Key 1</td>
<td>Yes</td>
<td>$50,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Non-Key 2</td>
<td>No</td>
<td>$30,000</td>
<td>$1,200</td>
</tr>
<tr>
<td>Non-Key 3</td>
<td>No</td>
<td>$20,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

- The safe harbor 401(k) plan has a 3 month eligibility for deferrals and a year of service eligibility for the safe harbor. Assume all non-keys are NHCEs.
- Since the safe harbor is not provided to all eligible NHCEs, the top-heavy exemption is not available and the plan is subject to the top-heavy rules.
- The employer would need to contribute an additional $2,000 to satisfy the required top-heavy minimum contributions:
  - Non-Key 1 = $500
  - Non-Key 2 = $900
  - Non-Key 3 = $600
Prior Year ADP/ACP Testing Method

- Which year’s data is used?

<table>
<thead>
<tr>
<th></th>
<th>HCE Current Year</th>
<th>NHCE Current Year</th>
<th>NHCE Prior Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coverage</td>
<td>✅</td>
<td>✅</td>
<td></td>
</tr>
<tr>
<td>ADP/ACP</td>
<td>✅</td>
<td></td>
<td>✅</td>
</tr>
</tbody>
</table>

- Further broken down by statutory employees and otherwise excludable employees if permissive disaggregation elected

Data Used: Prior Year ADP/ACP Testing Method

401(k) Portion - Otherwise Excludable Plan

Coverage Test

ADP Test

Current Year HCEs
Current Year NHCEs
Current Year ADP of HCEs
Prior Year ADP of NHCEs
Data Used:
Prior Year ADP/ACP Testing Method

- 401(k) Portion – Statutory Employees Plan
- ADP Test
- Coverage Test
- Prior Year ADP of NHCEs
- Current Year ADP of HCEs
- Current Year NHCEs
- Current Year HCEs

Impact of electing permissive disaggregation
- Year-to-year election could trigger a plan coverage change
- Special weighted–average calculation of prior year NHCE %

2013
• Disaggregation

2014
• None

2015
• Disaggregation