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2014 NIPA ANNUAL FORUM & EXPO

NATIONAL INSTITUTE *of* PENSION ADMINISTRATORS

410(b) Disaggregation – Tips and Pitfalls

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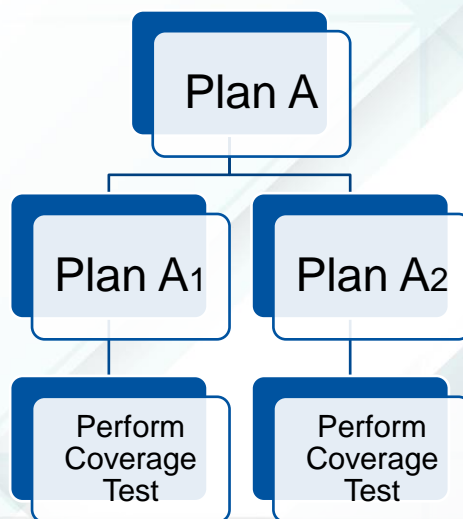
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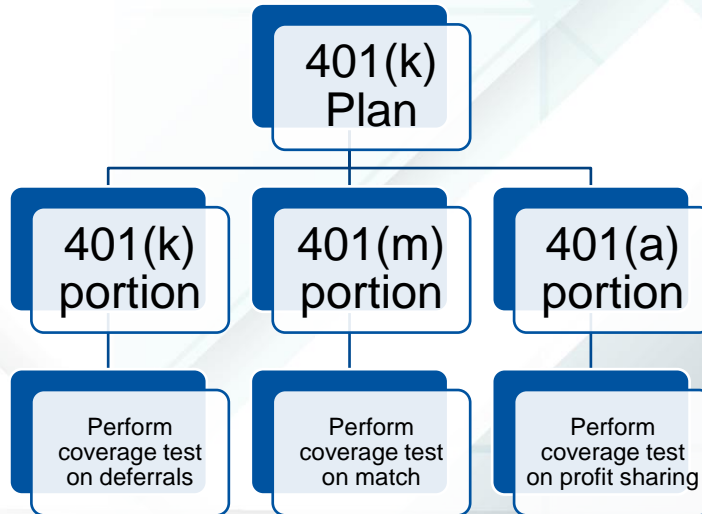
2014 NIPA ANNUAL FORUM & EXPO

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

- 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



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.

Identify
HCEs

Determine
testing
group

Determine
benefiting
group

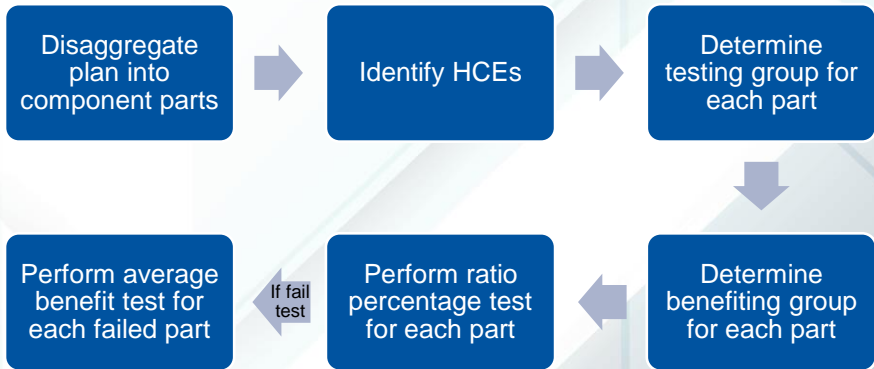
Perform
coverage
test

- 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.

- 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

- 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



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:

	HCE	NHCE
Total Employees	10	190
Employed < 6 mo	0	15
Employed 6-11 mo	0	15
Under age 21	0	5
Union Employees	0	35
Term < 501 hours	0	20
Term ≥ 501 hours	0	25 (≥ age 21/YOS) 15 (6-11 mo srv)

	"401(k)"	"401(m)"	"PS"
Total	200	200	200
Excludable	50	70	105
Testing Group			
HCE	10	10	10
NHCE	140	120	85
Benefiting Group			
HCE	10	10	10
NHCE	140	80	60
Group Ratio			
HCE	100%	10/10 = 100%	10/10 = 100%
NHCE	100%	80/120 = 66.67%	60/85 = 70.59%
Plans' Ratio %	100%	66.67%	70.59%

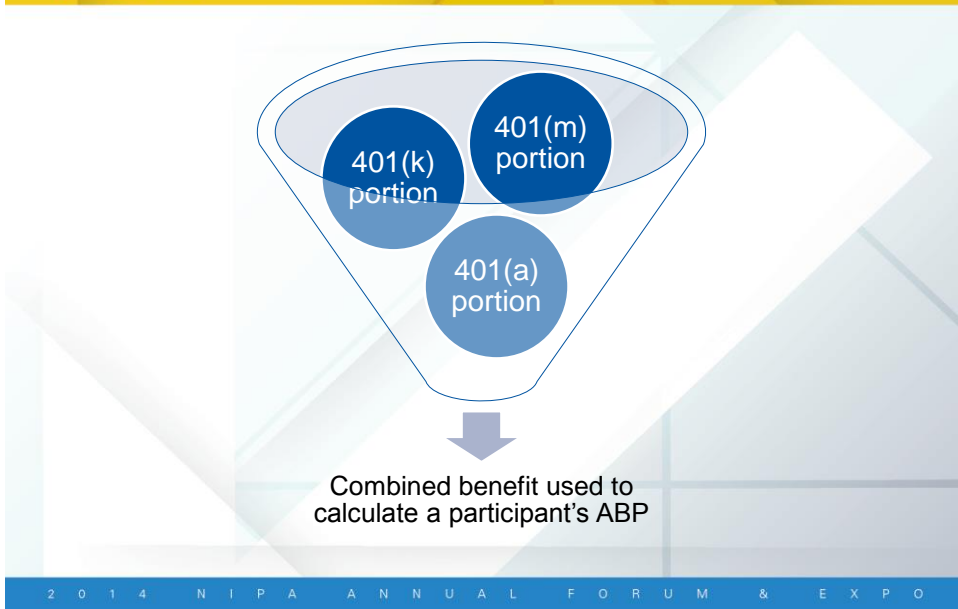
Mandatory Disaggregation: Average Benefit Test

- 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





Mandatory Disaggregation: Average Benefit Test Example

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

	NHCE	HCE
Benefiting Group	80	10
Testing Group	120	10
Group Ratio	66.67%	100%
Plan's Ratio %	66.67%	

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



Mandatory Disaggregation: Average Benefit Test Example

Average benefit percentage test HCEs

	Comp	Deferral	Match	Profit Sharing	Benefit %
↓ HCE 9	↓ \$150,000	↓ \$0	↓ \$0	↓ \$7,500	↓ 5.00%
HCE 10	\$125,000	\$10,000	\$1,875	\$6,250	14.50%
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

	Comp	Deferral	Match	Profit Sharing	Benefit %
NHCE 119	\$20,000	\$700	\$300	\$1,000	10.00%
NHCE 120	\$15,000	\$0	\$0	\$0	0.00%
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

	Comp	Deferral	Match	Profit Sharing	Benefit %
HCE 9	\$150,000	\$0	\$0	\$7,500	5.00%
HCE 10	\$125,000	\$10,000	\$1,875	\$6,250	14.50%
HCE average benefit % = 120% total HCE benefit % / 10 HCEs = 12%					
NHCE 119	\$20,000	\$700	\$300	\$1,000	10.00%
NHCE 120	\$15,000	\$0	\$0	\$0	0.00%
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.

Identify HCEs

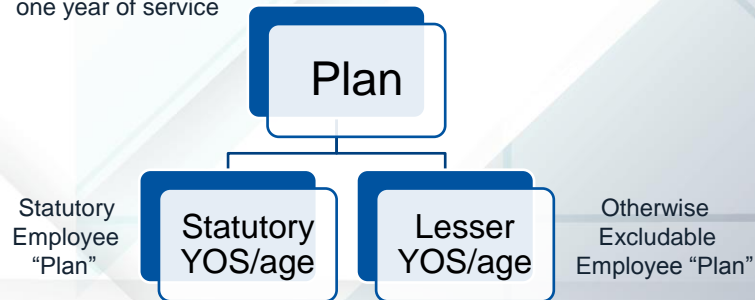
Determine testing group

Determine benefiting group

Perform coverage test

- 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



- 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.



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

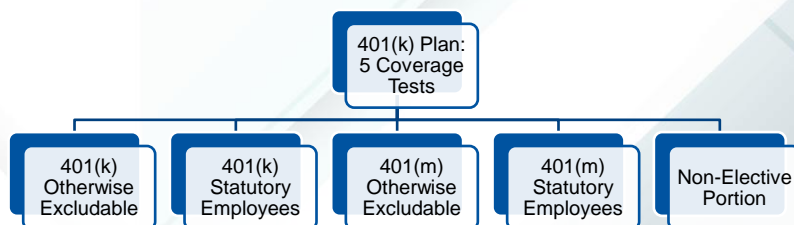
• Census:

	HCE	NHCE
Total Employees	5	24
Employed < 3 mo	0	1
Employed 3-11 mo	0	8
Age 18-20	0	6
Under age 18	0	0
Term < 501 hours	0	2
< 1,000 hours	1 0	2 (statutory) 8 (otherwise excl)

	PSP (all employees)	“Statutory Employees”	“Otherwise Excl Employees”
Total	29	29	29
Excludable	3	17	15
Testing Group			
HCE	5	5	0
NHCE	21	7	14
Benefiting Group			
HCE	4	4	0
NHCE	11	5	6
Group Ratio			
HCE	4/5 = 80%	4/5 = 80%	only benefits
NHCE	11/21 = 52.38%	5/7 = 71.43%	NHCEs →
Plans’ Ratio %	65.48%	➔ 89.29%	automatic pass!

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.





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.

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Permissive Disaggregation: Sunshine 401(k) Plan Example

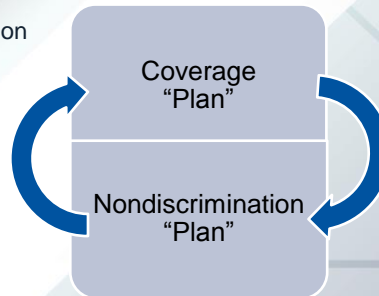
	"401(m)"	"Statutory"	"Otherwise Excl"
Total	200	200	200
Excludable	70	105	165
Testing Group			
HCE	10	10	0
NHCE	120	85	35
Benefiting Group			
HCE	10	10	0
NHCE	80	60	20
Group Ratio			
HCE	10/10 = 100%	10/10 = 100%	only benefits
NHCE	80/120 = 66.67%	60/85 = 70.59%	NHCEs →
Plans' Ratio %	66.67%	70.59%	automatic pass!

2 0 1 4 N I P A A N N U A L F O R U M & E X P O

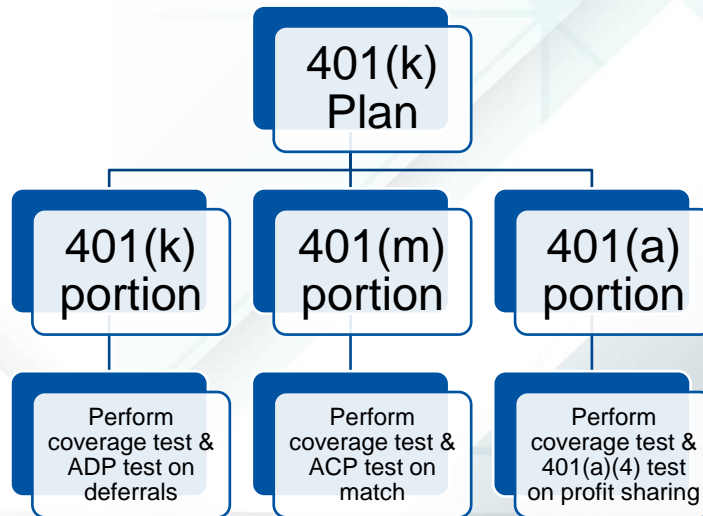
- **Optional**
 - It's an elective disaggregation rule, not mandatory.
- **Operational**
 - Written election isn't required.
 - Decision made on a year-by-year basis.

- **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

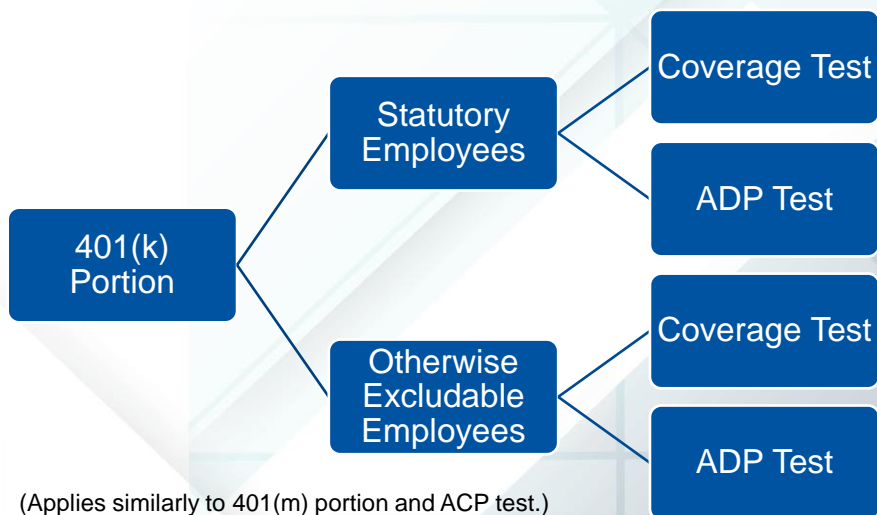
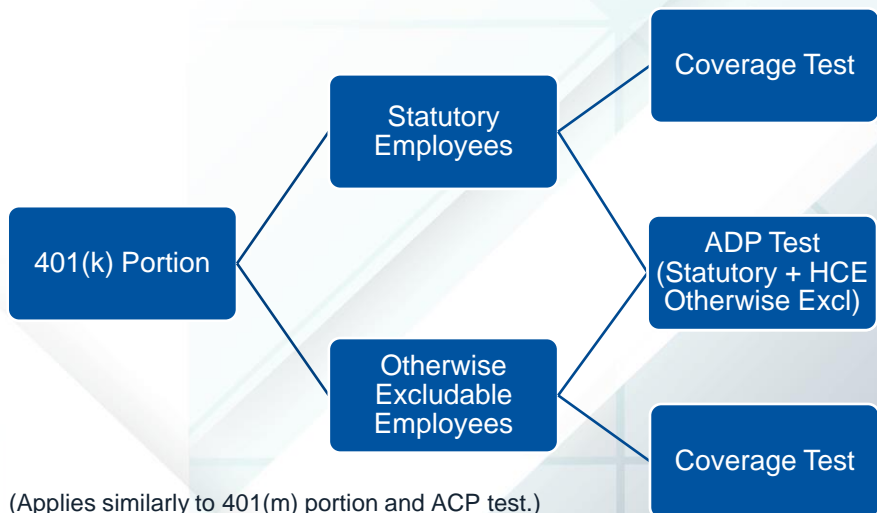
- Relationship of the IRC § 410(b) minimum coverage rules to the nondiscrimination rules of IRC § 401(a)(4)
 - Requirements designed to work together
 - Nondiscrimination rules use the definition of “plan” used for coverage
 - After application of disaggregation



- 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



- 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





- 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.

	YOS?	Compensation	Deferral	Basic Match
HCE 1	Yes	\$200,000	\$15,000	\$8,000
NHCE 1	Yes	\$50,000	\$1,000	\$1,000
NHCE 2	No	\$30,000	\$1,200	\$0
NHCE 3	No	\$20,000	\$0	\$0

- Plan #1 = HCE 1 and NHCE 1
- Plan #2 = NHCE 2 and NHCE 3

- 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

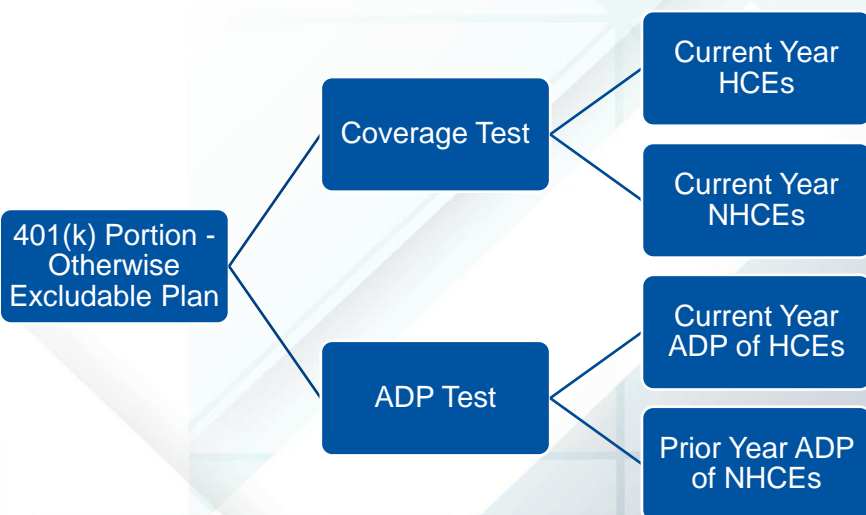
	YOS?	Compensation	Deferral	Basic Match
Key 1	Yes	\$200,000	\$15,000	\$8,000
Non-Key 1	Yes	\$50,000	\$1,000	\$1,000
Non-Key 2	No	\$30,000	\$1,200	\$0
Non-Key 3	No	\$20,000	\$0	\$0

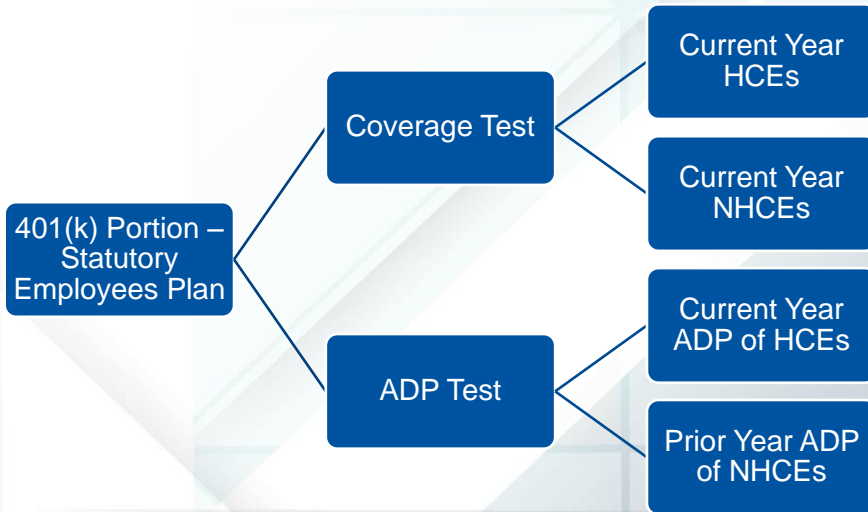
- The safe harbor 401(k) plan has a 3 month eligibility for deferrals and a year of service eligibility for the safe harbor. Assume all non-keys are NHCEs.
- Since the safe harbor is not provided to all eligible NHCEs, the top-heavy exemption is not available and the plan is subject to the top-heavy 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

- Which year's data is used?

	HCE Current Year	NHCE Current Year	NHCE Prior Year
Coverage	✓	✓	
ADP/ACP	✓		✓

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





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

