

Coverage Troubleshooting in a Controlled Group



Presenter Information

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Topics

- Testing rules for related employers
- Plan considerations and strategies
- Compensation
- HCE status
- Coverage and Minimum Participation
- ADP/ACP Testing
- Nondiscrimination



Let's start with a fact pattern

- Company X maintains a Safe Harbor nonelective plan
 - Covers all EEs who satisfy the eligibility requirements
 - 4 HCEs and 20 NHCEs
- In 2024, X acquired companies Y and Z
- Y maintains a traditional 401(k) plan
 - Covers all EEs who satisfy the eligibility requirements
 - 1 HCE and 70 NHCEs
- Z maintains a Safe Harbor match plan
 - Covers all EEs who satisfy the eligibility requirements
 - 5 HCEs and 10 NHCEs

Fact Pattern (cont.)

- Do any of the plans have a coverage problem for the 2024 plan year?
 - *No. The coverage transitional rule covers them for the balance of the year.*
- How about for 2025?
 - *No. The coverage transitional rule covers them for the entire year.*
- **2026?**
 - *The controlled group (single employer) will be treated as maintaining three plans and each plan will need to be tested, taking into consideration the employees of the entire controlled group*

Fact pattern (cont.)

Employers	HCE coverage ratio	NHCE coverage ratio	Coverage ratio
X	$4/10 = 40\%$	$20/100 = 30\%$	50%
Y	$1/10 = 10\%$	$70/100 = 70\%$	700%
Z	$5/10 = 50\%$	$10/100 = 10\%$	20%

Fact Pattern (cont.)

- Does each plan pass the ratio percentage test?
 - **Only the Y plan passes the ratio percentage test**
- Can we aggregate the plans for coverage?
 - **No. Each plan has a different testing method (e.g., SH match, SH nonelective and traditional)**
- Can X or Z plans pass the average benefit test (ABT)?
 - **The X plan has a good chance of passing ABT**
 - **X's 50% coverage ratio passes the first step in the ABT**
 - **Z's 20% coverage ratio probably won't satisfy the first step (the safe harbor to unsafe harbor range is 26.75% - 20%)**

Options

1. Merge all of the plans and maintain a single plan, starting in 2026
2. Merge X and Z plans
 - Only works if the merged plans can pass the ABT
3. Amend X and Z plans so that they mirror each other and then aggregate the plans
 - Will need to pass the ABT

What happens if they do nothing?

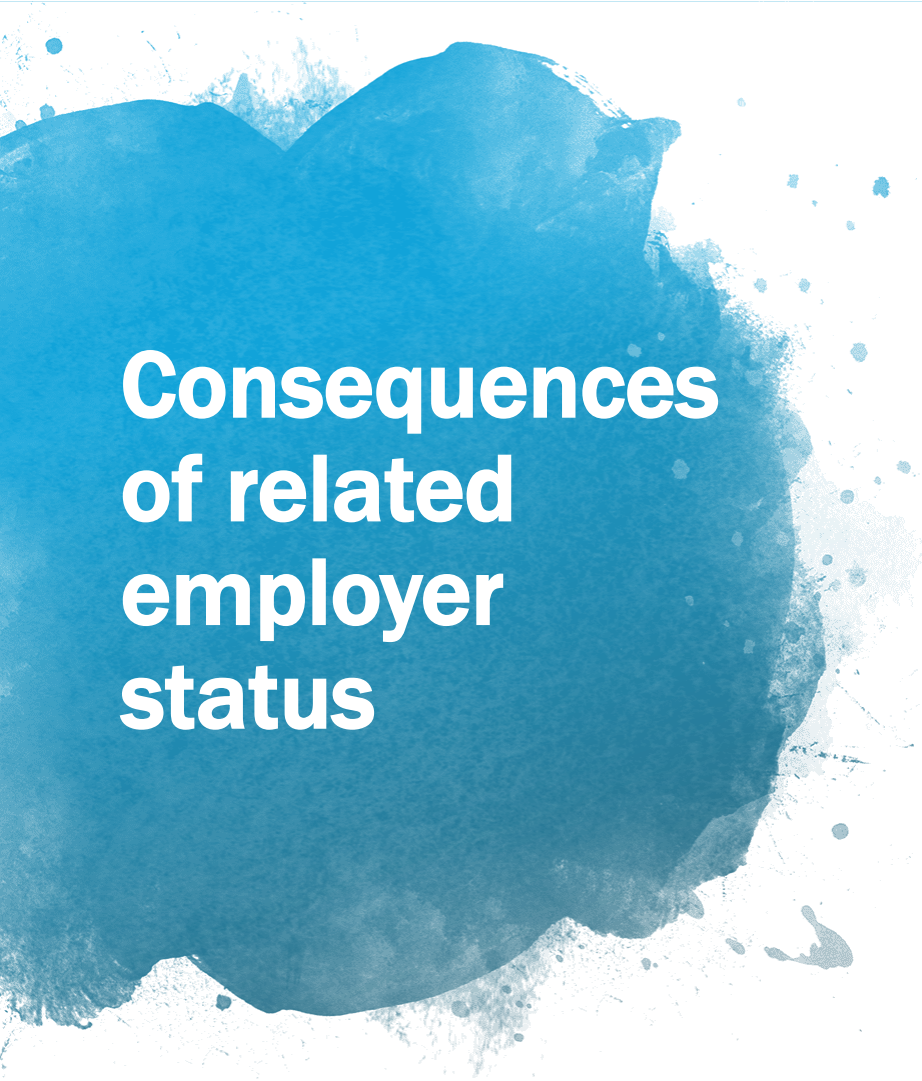
- Consequences:
 - Z's plan fails coverage
 - If the plan is disqualified for coverage failure, HCEs takes into income their entire account balances
 - If only failure, doesn't affect NHCEs

Testing Rules for Related Employers



Related Employers

- **Controlled group**
 - Parent-subsidiary
 - Brother-sister
 - Combined
- **Common control**
 - Special tax-exempt rules
- **Traditional affiliated service groups**
 - A-Org
 - B-Org
- **Management function groups**



Consequences of related employer status

- All employees of all related employers are considered to be employed by a **single employer** for most retirement plan purposes
 - Exclusive benefit rule
 - Crediting service for eligibility, vesting and benefit accrual
 - Coverage
 - Nondiscrimination
 - 415 limits
 - Top-heavy

What does related employer really mean?

- Who are the employees of this employer?
 - Count all employees of any related employer
- Who is the employer of this employee?
 - The employee's employer and any business related to that employer
- Moving from one related employer to another is not a separation/severance
- All related employers count all service with any related employer

Asking the right questions

- The related employer rules don't directly address which employees need to be included in the plan
- Instead, the related employer rules answer these questions:
 - **Who are the employees of this employer?**
 - **Who is the employer of this employee?**
- Easiest way to resolved related employer consequences questions
 - ask yourself:
 - **If this were one corporation with two different offices, what would the Code require?**

Typical related employer question

- Fact pattern:
 - A and B are in a controlled group
 - A sponsors a plan
 - Does the plan need to cover the employees of B?
- The related employer rules don't answer that question
 - Instead, they tell you all employees of A and B are deemed to have a single employer

Related Employer Question (cont.)

- So what's the answer?
 - SEPs, SIMPLEs, standardized plans: plan document (and IRS rules) require the plan to cover all employees of the related employer
 - Other plans: you don't have to cover B employees if you can pass coverage and nondiscrimination (and minimum participation for defined benefit plans)

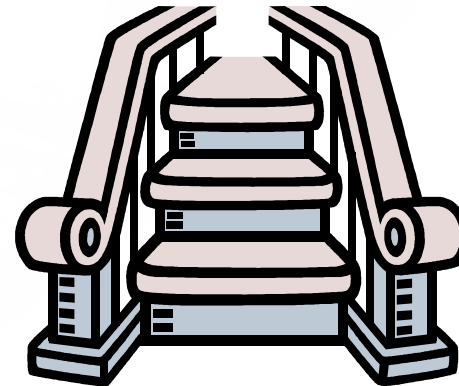
Coverage testing



Coverage – the first step

- The coverage test is the first step in the nondiscrimination analysis
- Understanding coverage is essential for nondiscrimination testing
 - ❑ Coverage principles used in applying the general nondiscrimination test

Note: It is important to distinguish between coverage for coverage purposes and using principles of coverage for purposes of applying the general nondiscrimination test. When using coverage principles in nondiscrimination testing, there are some key differences.



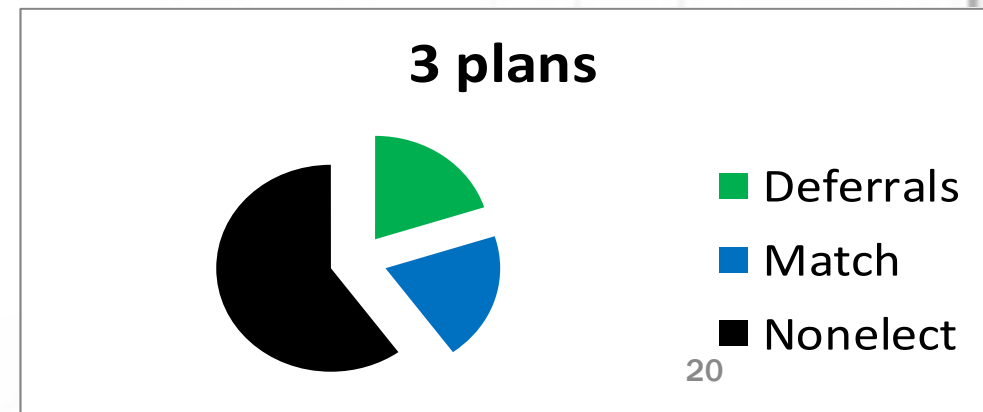
Plans

- For coverage purposes “plan” starts with 414(l) plan — a fund of money to provide retirement benefits to EEs
 - Must separate into separate plans
 - Elective deferrals
 - Matching contributions
 - Nonelective ER contributions
 - ESOP/Non-ESOP
 - Can separate QSLOBS
 - Can split plans with otherwise excludable employee (OEE) rule
 - Can permissively aggregate plans
 - Joins plans for coverage and nondiscrimination

Plans by contribution type

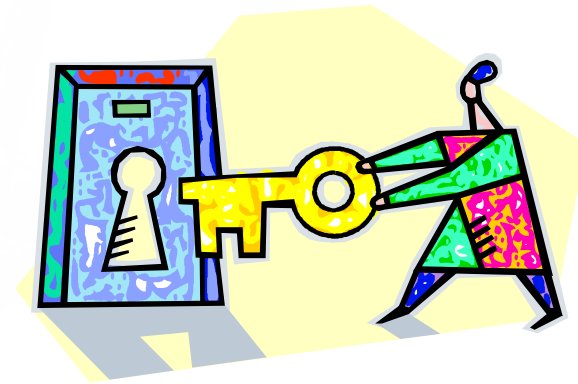
401(k)	401(m)	401(a)(4) (nonelect)
Elective deferrals	Matching contributions	Profit sharing
Roth elective deferrals	After-tax contributions	Top-heavy
	Forfeitures allocated as match	Forfeitures allocated as nonelective
	SH match	SH nonelective
		Minimum gateway
	QMAC used in ADP test	QNEC used in ADP/ACP test

- Must pass ACP with and without QMAC shifted to ADP
- Must pass 401(a)(4) with and without QNEC shifted to ADP or ACP
- Only average benefit percentage test (AB%T) adds all 3 contribution types



Coverage tests

- Plan must satisfy one of two alternative coverage tests:
 - ❑ Ratio percentage test
 - ❑ Average benefit test
- The key to coverage testing is building the fractions correctly
 - ❑ Numerator — nonexcludable EEs who benefit under the plan
 - ❑ Denominator — nonexcludable EEs



Benefiting

- A participant in a plan is benefiting from that plan for a given year as follows:
 - **Elective deferrals:** The participant is eligible to defer
 - **Matching contributions:** The participant satisfies all the allocation conditions to receive a match (whether or not (s)he defers)
 - **Nonelective contributions:** The participant receives any allocation of nonelective contributions

401(k), (m) benefiting examples

	Plan terms	Participant status	Benefit from 401(k)	Benefit from 401(m)
1	Only salaried can defer	Hourly employee	NO	NO
2	All can defer and receive match	Does not defer	YES	YES
3	All can defer; last day needed for match	Defers, but quits before year end	YES	NO
4	All can defer; last day needed for match	Does not defer, but is employed on last day	YES	YES
5	All can defer; last day needed for match	Does not defer, quits mid-year	YES	NO
6	All can defer; 1,000 HOS and last day for match	Defers, but only 900 HOS	YES	NO

Nonexcludable Employees

- Starting proposition: all EEs with an HOS during the plan year are included (*i.e.*, counted in the denominator of the fraction) unless statutorily excluded
 - ❑ excludable means “disregarded in the coverage test”
 - ❑ The plan may exclude EEs who are not “excludable,” but the plan must count them in coverage testing (*i.e.*, the denominator)

Statutory Exclusions

➤ Statutory exclusions:

- ☐ Minimum age and service conditions
- ☐ Union employees
- ☐ Nonresident aliens with no U.S. source income
- ☐ Airline pilots
- ☐ Certain terminated employees:
 - Terminates employment prior to last day of year,
 - With less than 501 HOS, and
 - Who does not benefit because of an allocation condition



Coverage testing

- Denver and Jacksonville maintain separate profit sharing plans
- Denver plan excludes union employees and commissioned employees
- Denver plan provides a 4% contribution
- Jax plan provides a 10% contribution
- Both plans require 1000 HOS and employment on last day to receive allocation
- *Per the charts that follow, which employees are statutorily excludable? Nonexcludable? Benefiting?*
 - ❑ When the problem refers to “participants,” it means an employee who has satisfied the eligibility requirements and entered the plan.

Denver plan

	Excludable	Nonexcludable	Benefiting
10 NHCEs w/ less than 1 YOS	10		
5 NHCE participants who terminated before last day of PY with less than 501 HOS	5		
5 NHCE participants employed last day of PY but who completed less than 1,000 HOS		5	
50 NHCE participants who have completed the allocation conditions		50	50
5 NHCE sales associates who have satisfied the eligibility requirements		5	
12 union employees who have satisfied the eligibility requirements	12		
NHCEs Totals	27	60	50
1 HCE participant who terminated before the last day of PY with more than 501 HOS		1	
2 HCE participants who have completed allocation conditions		2	2
HCEs Totals	0	3	2

Jax plan

	Excludable	Nonexcludable	Benefiting
6 NHCEs w/ less than 1 YOS	6		
4 NHCE participants who terminated before the last day of PY with more than 501 HOS		4	
2 NHCE participants who terminated before the last day of PY with fewer than 501 HOS	2		
1 NHCE participant employed last day of PY but who completed less than 1,000 HOS		1	
35 NHCE participants who completed allocation conditions		35	35
NHCEs Totals	8	40	35
7 HCE participants who completed allocation conditions		7	7
HCEs Totals		7	7

Coverage calculation

- Complete coverage fractions for each plan:

	Denver	Jax	Total
Benefiting NHCES	50	35	85
Benefiting HCEs	2	7	9
Nonexcludable NHCES	60	40	100
Nonexcludable HCEs	3	7	10

	Denver		Jax	
	NHCE	HCE	NHCE	HCE
Benefiting	50	2	35	7
Nonexcludable	100	10	100	10
Ratio	50%	20%	35%	70%
Coverage %	250%		50%	

Average Benefit Test *in Coverage*

1. Nondiscriminatory Classification Test

A. Reasonable, objective criteria

B. Numerical — either:

1) Coverage ratio \geq Safe harbor %, or

2) Both:

a) Coverage ratio \geq Unsafe harbor %, and

b) Plan passes facts and circumstances

2. Average Benefit Percentage Test (AB%T) —

NHCE average benefit %

HCE average benefit %

$\geq 70\%$

- AB%T considers all benefits from all plans ER maintains

Safe and Unsafe Harbors

- NHCE concentration percentage =

includible NHCEs
includible employees

- Round concentration percentage down to nearest whole %

Concentration Percentage	Safe Harbor	Unsafe Harbor
0 - 60%	50.00%	40.00%
66%	45.50%	35.50%
70%	42.50%	32.50%
75%	38.75%	28.75%
80%	35.00%	25.00%
83%	32.75%	22.75%
90%	27.50%	20.00%
99%	20.75%	20.00%

Nondiscriminatory classification test

- *What are the classifications in the X plans? Are the classifications reasonable?*
- *What is the concentration percentage for X? What are the safe and unsafe harbors?*
- *Does the Jax plan (coverage fraction = 50%) satisfy the nondiscriminatory classification test?*

	Denver	Jax	Total
Benefiting NHCES	50	35	85
Benefiting HCEs	2	7	9
Nonexcludable NHCES	60	40	100
Nonexcludable HCEs	3	7	10

Average benefit % test

- *Does the Jax plan pass the AB%T? Could it test on the basis of benefits instead of allocation rates?*

		NHCE	HCE
A	Benefiting EEs in Denver plan	50	2
B	Denver contribution	4%	4%
C	Total Denver benefit (A x B)	200%	8%
D	Benefiting EEs in Jax plan	35	7
E	Jax contribution	10%	10%
F	Total Jax benefit (D x E)	350%	70%
G	Denver + Jax benefit (C + F)	550%	78%
H	Nonexcludable employees	100	10
I	Average benefit (G / H)	5.5%	7.8%
J	Average benefit % (NHCE/HCE)	70.51%	

Coverage Questions and Answers

- If an employer maintains a 401(k) plan with the following plan components: deferral contributions, matching contributions and nonelective contributions (e.g., profit sharing contributions), must the employer apply separate coverage and nondiscrimination tests with respect to each component of the plan?
- Yes. For purposes of the coverage and nondiscrimination tests, the employer must treat the deferral, matching and profit sharing components of the plan as three separate plans (i.e., mandatory disaggregation applies) Treas. Reg. §1.410(b)-7(a) and (c).



**Plan considerations and
strategies**

Alternative
approaches

Joint Plan Sponsorship

- A and B jointly adopt a single plan covering all eligible employees of both A and B
- One plan document
- One Form 5500
- Easy testing
- Recommendation: Each employer contributes for its own employees
 - Could have deductibility issues otherwise

Joint plan sponsorship (cont.)

- Does the plan have to provide the same benefits and features for both employees of both employers?
 - Not necessarily
 - However, plan still has one ADP and ACP test
 - If the plan provides different matching formulas, plan must apply BRF test – current availability (e.g., nondiscriminatory classification test) and effective availability
 - BRF testing would also apply if plan provides different features to the employees of the different employers (e.g., investment options, loans)

One Plan vs. Multiple Plans

One Plan

- Reduces administrative costs
- Simplifies retirement plan administration
- Facilitates movement between employers

Multiple Plans

- Employers have different profit centers
- Employers desire to provide different benefit packages
- Employer don't want employees to be aware of benefits provided to the other employees
- History

One employer carries the load

- A adopts a plan covering the employees of A and B
 - B does not cosponsor the plan
- Issues:
 - Deduction limit just based on A's employees
 - A may have difficulties deducting contributions for B even if it is within the limit
 - As a practical matter, B needs to be involved if you have elective deferrals

Separate plans

- A adopts a plan for its eligible employees
- B adopts a plan for its eligible employees
- Two plans to maintain
- Two SPDs
- Two Forms 5500
- Allows different approaches for the two employers
- Either:
 - Each plan must separately pass coverage and nondiscrimination
 - Permissively aggregate (if possible) the plans to test as a single plan

Permissive aggregation

- Valuable option: can facilitate passing coverage or nondiscrimination
- Requirements:
 - Same plan year end
 - Same testing method
 - Safe harbor contribution method
 - Traditional 401(k)
 - Current or prior year testing



Permissive Aggregation

- Helpful features:
 - Similar benefits, rights, and features
 - Since you'll be testing the plans as a single plan for all elements of 401(a)(4)
 - Very difficult to pull off – generally have some differences (e.g., investment options)
 - If not, must apply BRF testing
 - Different vesting schedules OK
 - Same eligibility requirements
 - Otherwise excludable employee rule can help

Exclude related employer

- A adopts a plan covering its employees (only)
- B doesn't have a plan
- Can work if the plan passes coverage and nondiscrimination





Compensation

Total
Nondiscriminatory
Allocation

415 Compensation

- Compensation for 415 purposes includes all compensation from all related employers
- A and B are related employers
 - Each has a separate plan
- Ben works for both A and B
 - Each pays Jack \$50,000
- Result: Ben has \$100,000 compensation for purposes of
 - 415 limit
 - Top heavy minimum
 - Key employee determination
 - HCE determination
 - Deduction limit
 - 5%/7.5% minimum gateway

Nondiscriminatory (414(s)) compensation

- Plan must use nondiscriminatory definition of compensation for:
 - Coverage testing
 - ADP/ACP testing
 - Safe harbor 401(k) contributions
 - Nondiscrimination testing
- Safe harbor nondiscriminatory definitions include all compensation from all related employers
- Alternative definition: Just count compensation from one of the related employers
 - Must pass compensation ratio test each year

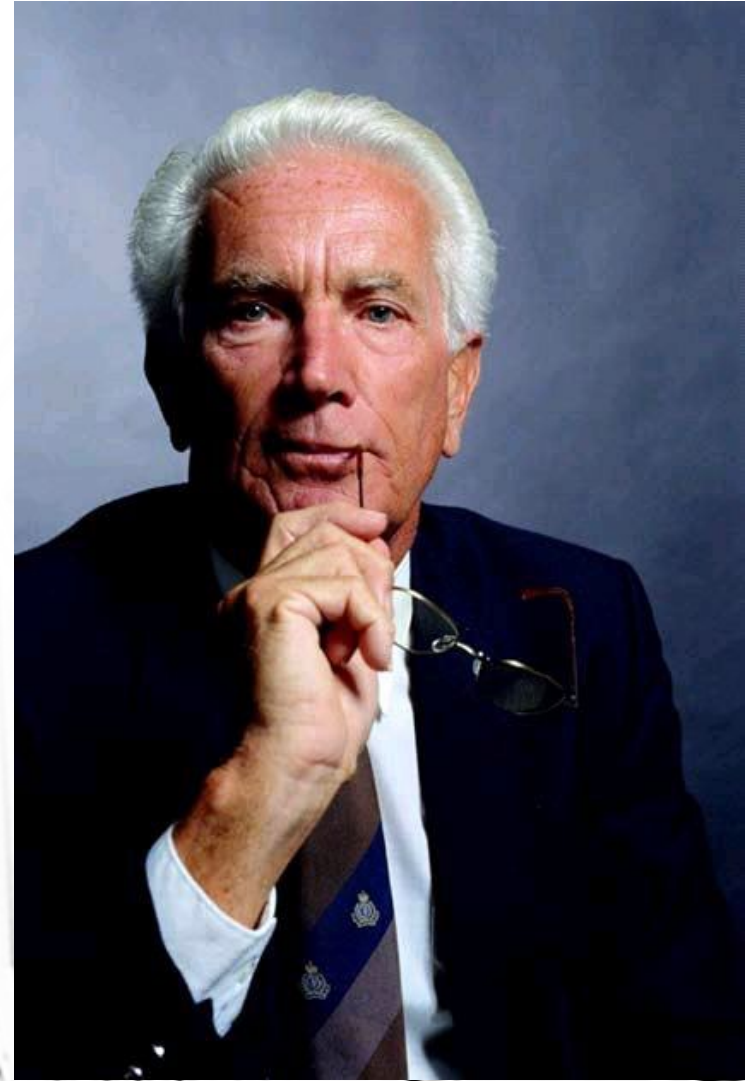
Allocation definitions

- Need not use nondiscriminatory definition for purposes of:
 - Determining deferrals
 - Limitations on matching contributions
 - Although if the definition is discriminatory it could create a discriminatory right or feature
 - If so, must test
 - Allocating employer nonelective contribution

Allocation definitions (cont.)

- So you can consider compensation from only one related employer even if that is discriminatory
 - Example
 - A and B are related employers and jointly sponsor a plan
 - A contributes 10% of compensation allocated to A employees
 - B contributes 5% of compensation allocated to B employees

Highly compensated Employee (HCE) status



5% owner status

- If you are a more than 5% owner of any related employer, you are an HCE of that employer and any related employer
- Example:
 - Corporations A and B are related employers
 - Mary owns 10% of B and 0% of A
 - Mary is an employee of A or B
 - Mary is an HCE of B and an HCE of A

HCE by compensation

- Add all compensation from all related employers to determine an employee's compensation
 - Chris works for A and B and each pays her \$75,000 in 2010
 - A sponsors a plan covering A employees
 - Chris is an HCE for 2020 with 2019 compensation of \$150,000
- Top 20% rule
 - Count all employees from all related employers
 - Count all compensation from all related employers
 - All plans of all related employers must make same choice regarding top 20% rule

**Coverage
and
Minimum
Participation**



Coverage testing with separate plans

	HCE	NHCE
A	4	6
B	6	14
Total	10	20

- A and B are related employers. Each has a 401(k) plan covering its own employees. The nonexcludable employees are shown.

- Does the A plan pass ratio percentage?

$$6/20 \div 4/10 = 30\% / 40\% = 75\%$$

- Does the B plan pass ratio percentage?

$$14/20 \div 6/10 = 70\% / 60\% = 116.67\%$$

Coverage testing with separate plans

	HCE	NHCE
A	4	6
B	6	14
C	2	10
Total	12	30

- C is now part of the group and doesn't have a plan or participate in the A or B plan

- Does the A plan pass ratio percentage?

$$6/30 \div 4/12 = 20\% / 33\% = 60\%$$

- What are A's options?

- Bring in some of C employees
- Pass average benefit test
- Permissively aggregate the A and B plans

$$20/30 \div 10/12 = 67\%/83\% = 80\%$$

Average benefit test for coverage

	Alloc.	HCE	NHCE
A	10%	4	6
B	6%	6	14
C	0%	2	10
Total		12	30

- Nondiscriminatory classification
 - Covering employees of only one employer is reasonable, objective classification
 - A's coverage fraction of 60% exceeds safe harbor % (41.75%)

- Average benefit % test (AB%T)

$$\text{NHCE\%} = (6 \times 10\% + 14 \times 6\%) / 30 = 4.80\%$$

$$\text{HCE\%} = (4 \times 10\% + 6 \times 6\%) / 12 = 6.33\%$$

$$\text{AB\%} = 4.80\% / 6.33\% = 75.83\%$$

Minimum participation under 401(a)(26)

- Only applies to DB plans
- Requires lesser of 50 employees or 40% of nonexcludable employees benefit
- Count all nonexcludable employees of all related employers
- Clinic has 6 NHCEs and is in ASG with 3 doctors (each of which is sole employee of a PC)
- Dr. X wants to set up a defined benefit plan
- The plan must benefit at least 4 employees

Coverage transition rule (410(b)(6)(C))

- Sometimes called the “free pass”
- Applies to ownership transactions:
 - Formation of controlled group/ASG, etc.
 - Change in controlled group/ASG, etc.
 - Asset or stock acquisition
 - Merger
- Plan must be in existence prior to transaction
 - Must satisfy coverage and minimum participation immediately prior to transaction
 - No significant coverage change during transition period

Result of free pass

- If the free pass applies, then plan passes 410(b) and 401(a)(26) throughout coverage transition period
 - Transition period:
 - Begins on date of transaction
 - Ends at earlier of:
 - End of following plan year
 - Change in coverage or benefits

Example

- Corporation X maintains a safe harbor 401(k) plan
 - The plan specifies that only employees of X participate
 - X has 5 HCE, 5 NHCEs; all participate
 - Plan passes 410(b)
 - Calendar year plan
- 3/16/2019, Y company acquires 100% of X stock
 - Controlled group formed 3/16/2019
 - Y has 500 NHCEs, 20HCEs
 - X doesn't amend plan in 2019 or 2020
 - X's plan passes 410(b) for 2019 and 2020

Free pass example: 3 situations

1. X decides to amend plan 1/1/2020 to increase benefits
 - Free pass ends immediately
 - X fails 410(b) immediately for 2020
2. X's plan terms cover all controlled group members
 - Free pass doesn't apply
 - So check the terms before the transaction
3. Z acquires Y on 1/15/2020
 - Coverage transition rule doesn't apply
 - Plan didn't satisfy minimum participation/coverage on date of transaction without regard to the free pass

ADP/ACP testing



ADP and ACP testing

- ADP test considers only employees eligible to defer to the plan
- ACP test considers only employees eligible to receive a match
- A sponsors a 401(k) plan covering to 30 A employees and not the 20 B employees
 - The ADP test only considers the A employees eligible to defer
- One plan means one ADP test

ADP and ACP tests

- A and B jointly sponsor a 401(k) plan
 - A provides a match of 50% of deferrals up to 6% of comp
 - B provides a match of 100% of deferrals up to 4% of comp
 - There is a single ACP test
 - Plan must apply BRF test in addition to ACP test because of the different match rates
 - If the plan were a safe harbor 401(k) plan could the plan have different matching formulas? NO

HCE in multiple plans

- A and B sponsor separate plans
 - A is a safe harbor plan a 3% nonelective contribution
 - B is an ADP-tested plan
- Harry, an HCE, is eligible to defer to both plans
 - But only defers to the A plan
- The B plan counts Harry's deferrals to both plans in the ADP test (ADR = 10%)
- Same applies to ACP

	Comp	Deferral
A	\$100,000	\$15,000
B	\$50,000	\$0
Total	\$150,000	\$15,000

- » Use the comp definition and plan year of the plan being tested
- » This rule is for HCEs only
- » If the B plan fails the ADP test, Harry's excess deferrals returned to him can't exceed his B deferrals

Problem for ACP safe harbor

- ACP safe harbor condition: Rate of match of any HCE at any level of deferrals cannot exceed rate of match of any NHCE at same level of deferrals
 - HCE aggregation rules (adding match from all plans) apply to determine if this limit is satisfied
 - This could easily blow ACP safe harbor
 - Escape hatch:
 - HCE didn't participate in both plans simultaneously (e.g., employee moved from A to B and switched plans at same time)
 - Period used to determine match for each plan limited to period HCE participated in the plan

Can't combine safe harbor/ADP tested

- A and B jointly maintain a 401(k) plan
 - A wants a 3% safe harbor nonelective plan for its employees
 - B wants an ADP-tested plan
- Can't do it in a single document
 - All NHCE participants of the employer (A and B) would have to receive the safe harbor contribution
 - Can't restructure or split a single employer in a single plan for ADP/ACP
 - Exceptions: Otherwise excludable employee rule, union/nonunion, QSLOBs, and ESOP/non-ESOP

Coverage transition and safe harbor termination

- If a safe harbor plan has an event that qualifies for the coverage transition rule, then the employer can terminate the plan midyear
 - Without giving 30 days advance notice
 - Keeping the ADP/ACP safe harbor and top-heavy exemption (if applicable)
 - But has to fund up to date of termination
- The termination must be “in connection with” the merger, acquisition, controlled group change, etc.

Change of testing method

- General rule: If plan is on current year testing (and previously used prior year testing) it can convert to prior year testing only if it has been current-year tested for 5 years
- Exception: If:
 - A merger, acquisition, change in related employers, or other event giving rise to the coverage transition rule of Code §410(b)(6)(C) takes place, and
 - The employer (related employers) maintain both a prior year tested plan and a current year tested plan as a result of the change, then
 - The employer can switch to prior year testing any time within the coverage transition period

Effect of coverage transition rule on ADP/ACP

- Coverage transition rule applies to 401(k) coverage requirement
- No free pass of ADP/ACP
- Warning: Plan coverage change complicates prior year testing
 - Plan establishment or amendment,
 - Plan merger or spinoff,
 - A change in permissive aggregation,
 - A reclassification of a substantial group of employees that has the same effect as a plan amendment, or
 - A combination of the above

Other plans

- SIMPLE IRA and 401(k)
 - Free pass lasts one year longer
- SEPs
 - No free pass!!!
- 403(b)
 - Should be able to use free pass for 410(b) testing
 - Doesn't need free pass for deferrals



Nondiscrimination under 401(a)(4)

Principles for 401(a)(4)

- If the plan is a safe harbor design plan, then it satisfies 401(a)(4), regardless of whether all employees are participants
 - The key is to pass coverage
 - Or have the benefit of the coverage transition rule
- If the plan is not a safe harbor design, and must perform the general nondiscrimination test then:
 - You must take into consideration all nonexcludable employees of all related employers (regardless of whether they benefit from the plan being tested)
 - If you must run the average benefit % test (AB%T) then you must take all plans maintained by any related employer into consideration

Average benefit test in nondiscrimination

	Alloc.	HCE	NHCE
A	10%	4	6
B	6%	6	15
C	0%	0	9
Total		10	30

- A, B and C are related employers
- A and B jointly sponsor a plan for their employees; C employees have no plan
- A contributions go to A employees and B contributions go to B employees
- Plan as a whole passes ratio percentage test for coverage (70%)
- Not a safe harbor plan; general test required for nondiscrimination

Average benefit test in nondiscrimination

	Alloc.	HCE	NHCE
A	10%	4	6
B	6%	6	15
C	0%	0	9
Total		10	30

- Divide employees into rate groups based on allocation rate
- Two rate groups: 10%, 6%
- 10% rate group includes 6/30 NHCEs and 4/10 HCEs
 - Coverage fraction = 50%, passes nondiscriminatory classification test
- 6% rate group includes 21/30 NHCEs and all HCEs
 - Coverage fraction = 70% passes ratio percentage test
- $AB\%T = 5\%/7.6\% = 65.79\%$ **FAIL**₇₄

Alternative approach: restructuring

- No special plan provisions needed
- Allows you to divide plans into component plans, each consisting of the benefits provided to a group of employees
 - You pick who is in what group
- If each component passes coverage and nondiscrimination alone, plan as a whole passes nondiscrimination

Beware of benefits, rights, and features issues

- Particularly a problem if you are permissively aggregating two plans maintained by different related employers
- Need to make sure that all benefits, rights, and features benefit nondiscriminatory classification of employees
 - Coverage fraction should equal safe harbor %
 - No need to perform AB%T

Beware of benefits, rights, and features issues (cont.)

- A plan has in-service distribution (age 59½); B does not
- A plan has different investment options than B plan
- A plan allows participant investment direction; B plan is trustee directed
- A plan has different match rate than B plan
- A plan allows deferral from bonus; B plan does not

Coverage transition rule and 401(a)(4)

- Can use coverage transition rule to pass coverage for component plans if restructuring
- Can't use coverage transition rule to pass general nondiscrimination test
- Uncertain what approach IRS would take:
 - Take into account all employees of newly related employer
 - Perform nondiscrimination testing as though merger/acquisition/change had not occurred
 - Argue that the coverage transition rule somehow applies

Cross-testing related employers

Company A only

Name	Allocation	EBAR
Hilda	20%	3.78%
Nick	5%	2.14%
Nancy	5%	7.27%
Norman	5%	3.22%
Nadia	5%	16.45%

**3.78% rate group covers 50% of NHCEs
(30% midpoint)
AB%T = 192.07%
Plan passes**

A and B together

Name	Allocation	EBAR
Hilda	20%	3.78%
Harry	0%	0%
Nick	5%	2.14%
Nancy	5%	7.27%
Norman	5%	3.22%
Nadia	5%	16.45%
6 other NHCES	0%	0%

**3.78% rate group covers 50% of HCEs and
20% of NHCEs = 40% (27.75% midpoint)
AB%T = 153.66%
Plan passes**

Required and permissive aggregation



Plan Aggregation

- **Coverage:** In applying the coverage tests, each single plan is a separate plan
- **Permissive aggregation:** However, an employer may aggregate two or more plans and test them as a single plan for coverage, provided the aggregated plans also can satisfy the nondiscrimination rules as a single plan
- **Minimum participation:** This permissive aggregation rule is for coverage only and is not available for the minimum *participation* requirement for defined benefit plans

Mandatory Disaggregation

- An employer may not aggregate two or more plans for which the regulations require mandatory disaggregation
- An employer may *not* aggregate:
 - a collectively bargained plan with a non-collectively bargained
 - 401(k) elective deferrals with other portion of the plan
 - ESOP/non-ESOP
- 401(m) matching and after-tax employee contributions w/ other portions of the plan



Disaggregation Rule Exceptions

- The disaggregation rule for ESOPs applies solely to the ratio percentage test and to the nondiscriminatory classification test portion of the average benefit test
- The employer includes contributions under the ESOP portion of a plan, elective deferrals under a 401(k) plan, and employee contributions or matching contributions in determining an employee's **average benefit percentage** for purposes of applying the average benefit test

Exclusion of excludible employees within disaggregated portion

- When applying the coverage tests to a particular portion of the plan, the employer excludes those employees who fail to satisfy the minimum age and service requirements for the portion of the plan being tested



Excludible employees within disaggregated plan

- An employee is eligible to participate in the 401(k) arrangement six months after his/her employment date
- An employee may not participate in the profit sharing portion of the plan until January 1 or July 1 following his/her completion of one year of service
- When determining the excludible employees for the 401(k) portion of the plan, X may exclude only employees with less than six months of service
- When determining the excludible employees for the profit sharing portion of the plan, X may exclude an employee who has not reached the first entry date following his/her completion of one year of service

Disaggregation of 401(k)/(m) plan - example

- X maintains a profit sharing plan that includes contributions under a 401(k) arrangement, employer matching contributions and nondeductible employee contributions subject to 401(m), and employer discretionary contributions
- For purposes of testing the plan under the coverage rules, the plan consists of three separate plans: a 401(k) “plan,” a 401(m) “plan” and a profit sharing plan

Otherwise excludable example

	< 1 YOS	≥ 1 YOS	Total
HCE	0	4	4
Shipping	4	2	6
Other NHCE	1	8	9
Coverage Ratio	Pass	80%	60%

- Profit Sharing plan excludes shipping department but otherwise allows immediate entry
- No HCEs in shipping



Permissive Aggregation Rules

- An employer can aggregate (treat as a single plan) for coverage two plans so long as:
 - The plans have the same plan year
 - The plans pass nondiscrimination on an aggregated basis
 - The plans aren't disaggregated under earlier rules (other than QSLOB)

Permissive aggregation example

	X	Y	XY
NHCEs	2	18	20
HCEs	2	1	3
NHCE Ratio	10%	90%	100%
HCE Ratio	67%	33%	100%
Coverage	15%	270%	100%
Concentration %			90%
Unsafe Harbor			20%

- X and Y are related employers
 - Each corporation has its own calendar year PS plan
 - The X plan fails coverage on its own
- Aggregate X and Y and the X plan passes
- Must test X and Y as a single plan for nondiscrimination

No Double Aggregation

- The employer may not aggregate the same plan with two or more plans to form more than one plan for coverage purposes
- Example, if an employer maintains three plans (A, B and C), and aggregates plans A and B to form a “single” plan for coverage, the employer may not aggregate plan A or plan B to form a *separate* "single" plan with plan C



No aggregation if mandatory disaggregation applies

- An employer may not aggregate plans that are subject to mandatory disaggregation

Average Benefit Percentage Test

- Includes all plans, all employees
- However, the following are still disaggregated:
 - Union and nonunion
 - QSLOBS
 - Employers in multiple employer plan

Plan Aggregation - Nondiscrimination

- The nondiscrimination requirements separately apply to each plan maintained by an employer
- However, under certain circumstances an employer may aggregate two or more plans for purposes of satisfying coverage and nondiscrimination

Nondiscrimination Testing

- For nondiscrimination testing purposes, an employer must aggregate two plans only if the employer has aggregated the plans for the ratio percentage test or for the nondiscriminatory classification test portion of the average benefit test
- If a plan independently satisfies the nondiscriminatory classification test, the plan also may independently satisfy nondiscrimination, even though the employer must aggregate the plan with other plans to perform the average benefit percentage test portion of the average benefit test

401(k) an 401(m) Aggregation

- If the employer designates the plans as a single plan for coverage (other than for purposes of meeting the average benefit test), the employer *must* aggregate the plans for purposes of the ADP and ACP tests
- **Same plan year rule.** For aggregation, the aggregated plans must have the same plan year
- **Inconsistent testing methods.** Aggregated plans must apply a single testing method. Therefore, the employer cannot aggregate plans with inconsistent testing methods (e.g., a plan that applies the ADP test and a plan that applies the ADP safe harbor)

Plan Aggregation and Related Employers

- Code §415 requires an employer to treat all defined contribution plans it maintains (whether or not terminated) as a single defined contribution plan
- Thus, an employer must aggregate all annual additions under each defined contribution plan it maintains during the limitation year in applying the 415 limit
- Similarly, an employer must treat as a single defined benefit plan all defined benefit plans it has ever maintained, whether or not the plan is terminated

Related employer aggregation/single 415 limit

- All members of:
 1. a controlled group of corporations;
 2. a group of trades or businesses under common control
 3. an affiliated service group; and
 4. any other aggregated group of employers
- are a single employer for purposes of applying the 415 limit

415 rule - Parent-subsidary

- In determining whether a parent-subsidary controlled group exists *solely for purposes of applying the 415 limitations*, the Code substitutes a “more than 50%” ownership level for the “at least 80%” ownership level normally required under Code §§414(b) and (c)
- Therefore, it is possible to have a parent-subsidary controlled group for Code §415 purposes and *not* for any other qualification requirements
- The more than 50% test does not apply for brother-sister groups, but it does apply for aggregation of tax-exempt organizations

Mid-year Aggregation

- The effect of two plans becoming aggregated in the middle of a limitation year (such as by the formation of a controlled group) depends on whether the plans are defined benefit plans or defined contribution plans
- Before the final regulations, the plans were considered separate (disaggregated) until the following plan year

Defined Benefit Plans

- For the year in which two defined benefit plans become aggregated, and a participant's total benefit between the two plans exceeds the 415(b) limit
- the aggregation will not cause a 415 violation so long as the employer does not amend either plan to increase benefits during that year
- For future years, the aggregation will not cause a 415 violation so long as the participant's benefit is frozen, until the combined benefit no longer exceeds the limit

Defined Contribution Plans

- For the year in which two defined contribution plans become aggregated, the plans will not violate 415, even though a participant's total annual additions under the two plans exceeds the 415(c) limit,
- So long as there are no annual additions credited to the participant's account for the balance of the year

Top Heavy

- Under the 401(k) and 401(m) rules an employer must disaggregate the 401(k) and 401(m) portions of the plan and treat the portions of the plan as separate plans for coverage and nondiscrimination testing
- Must the employer also treat the 401(k) and 401(m) portions of the plan as “separate plans” for top-heavy testing purposes?
- *No. The disaggregation requirement is only for coverage and nondiscrimination testing and not for the determination of top-heavy status.*

Required Top Heavy Aggregation

- An employer must aggregate each plan in which a **key employee** is a participant and each plan which enables a plan covering a key employee to meet the coverage or nondiscrimination requirements
- The employer only will make one top heavy determination for the appropriate aggregation group
- The related group rules apply for top heavy purposes

Component plans

Restructuring



Principles of restructuring

- Alternative approach to passing nondiscrimination
- Separate 401(a)(4) plan into separate component plans
 - Each plan consists of allocations, accruals, benefits, rights, and features provided to a given set of employees
 - You get to pick which employees are in each set
 - Each participant is in one and only one set
- The plan as a whole passes nondiscrimination if:
 - Each component plan separately passes coverage and
 - Each component plan separately passes nondiscrimination
 - Can use different testing methods for each

Limitations

- Must pass coverage for the plan as a whole
- Can't use component plans for:
 - Uniform points plan
 - ADP test
 - ACP test
 - Top-heavy
 - Gateways
 - DB minimum participation
- If any component plan tested by reference to benefits, plan must provide minimum gateways to all NHCEs benefiting from any component unless an exception applies on the basis of the plan as whole:
 - Broadly available allocation rates,
 - Graduated age/service schedule,
 - Uniform target benefit

Methodology

- The plan must first satisfy coverage without regard to restructuring
- No need for special plan document provisions; this is a testing option
- Divide plan participants into separate component plans
 - On any basis you choose
- If the plan as a whole passes the ABPT (2nd step in Avg Benefit Test), then each component plan does as well

Enjoy the flexibility

- You can do it some years and not others
- You choose how many component plans to test
- You choose who is in what plan
 - Each participant must be in one and only one plan
- Each year you can make a different choice
 - Whether you use restructuring at all
 - How many component plans to test
 - Who is in what plan

Passing coverage in the component plan

- Each component plan must either:
 - **Pass ratio percentage test, or**
 - **Pass average benefit test:**
 - Nondiscriminatory classification
 - Reasonable, objective classification
 - Tough when you're picking and choosing people however you want
 - Average benefit percentage test (for plan as a whole)

Simple example

- Employer has a profit sharing plan for all its employees
- The plan is not a safe harbor nondiscrimination design and the employer must run the general test
 - It would pass
- Or use restructuring
 - Components: Chicago/Denver
 - Chicago coverage = $40\%/25\% = 160\%$
 - Denver coverage = $60\%/75\% = 80\%$
 - Each component is safe harbor

	PS %	HCE	NHCE
Chicago	5%	10	40
Denver	20%	30	60
Total		40	100

NHCE4 is part-time; SH 401(k)

Employee	Compensation	Deferrals	SH 3%	Regular PS	Total	Allocation rate
HCE1	\$275,000	\$18,500	\$8,250	\$28,250	\$36,500	13.27%
HCE2	\$200,000	\$18,500	\$6,000	\$20,545	\$26,545	13.27%
NHCE1	\$90,000	\$7,200	\$2,700	\$9,245	\$11,945	13.27%
NHCE2	\$60,000	\$4,000	\$1,800	\$6,164	\$7,964	13.27%
NHCE3	\$50,000	\$2,500	\$1,500	\$5,136	\$6,636	13.27%
NHCE4	\$30,000	\$0	\$900	\$0	\$900	3.00%
Total	\$705,000	\$50,700	\$21,150	\$69,341	\$90,491	12.84%

- Put NHCE4 alone in a group:
 - No HCEs: This group passes automatically
- The 13.27% group has 75% coverage fraction
 - Passes ratio percentage for safe harbor
 - Safe harbor

Integrated allocation with 3% safe harbor nonelective, component plans

- Safe harbor 401(k) plan with a 3% nonelective contribution
- The profit sharing plan has a two-tier integrated formula
 - Last day of employment condition

Employee	Total Comp	Excess Comp	Combined Comp	3% safe harbor	Integrated Alloc.	Total Alloc.	Alloc. Rate
HCE1	\$275,000	\$146,600	\$421,600	\$8,250	\$23,058	\$31,308	11.38%
HCE2	\$200,000	\$71,600	\$271,600	\$6,000	\$14,854	\$20,854	10.43%
NHCE1	\$90,000	\$0	\$90,000	\$2,700	\$4,922	\$7,622	8.47%
NHCE2	\$60,000	\$0	\$60,000	\$1,800	\$3,281	\$5,081	8.47%
NHCE3	\$50,000	\$0	\$50,000	\$1,500	\$2,735	\$4,235	8.47%
NHCE4	\$30,000	\$0	\$30,000	\$900	\$0	\$900	3.00%
Total	\$705,000	\$576,600	\$1,281,600	\$21,150	\$48,850	\$70,000	9.93%

Example (cont.)

- The safe harbor contribution is totally separate from the integrated allocation
 - Does not count in determining the base contribution percentage
- This is not a uniform allocation plan
 - Different allocation conditions for the safe harbor contribution and the integrated contribution
 - Top-heavy exemption does not apply; no corresponding exemption for safe harbor nonelective contributions

Example (cont.)

- To pass nondiscrimination, separate the plan into two component plans
- The first component consists solely of NHCE4. Since no HCEs are in that component, it passes coverage and nondiscrimination automatically.
- The second component consists of the other 5 participants.
 - Covers 75% of the NHCEs and therefore satisfies the ratio percentage test
 - Uniform permitted disparity design and therefore satisfies a nondiscrimination safe harbor
- Since both components separately pass coverage and nondiscrimination, the plan as a whole is nondiscriminatory

THANK YOU

The text 'THANK YOU' is written in a bold, dark blue, sans-serif font. Below the text is a thick, blue, stylized wave or swoosh that starts under 'THANK' and extends under 'YOU', ending in a small curl.