Identifying Highly Compensated Employees

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An earlier article [JPB 1(4): 68-75] described the definition of "highly compensated employee" enacted by TRA '86, as interpreted by the 1988 IRS regulations. This article describes the revised definition under the Small Business Job Protection Act of 1996 (SBJPA).

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Since 1942, the Internal Revenue Code (Code) has provided that qualified plans may not discriminate in favor of highly compensated employees (HCEs); however, before enactment of the Tax Reform Act of 1986 (TRA 86), there was no statutory or regulatory definition of the term highly compensated employee.

Under pre-TRA 86 law, the term was relative rather than absolute: The HCEs were those employees who were relatively highly paid by comparison with the other employees of that employer. TRA 86 added a new Section 414(q) to the Code, which provided an objective definition. This definition was amplified by temporary regulations issued by IRS in February 1988 (TD 8173), as amended in February 1991 (TD 8334). All references to "Q & A –" in this article are references to Temporary Regulations Section 1.414(q)-1T.

Unfortunately, the procedure for identifying HCEs was so complex that the intended purpose of enacting the new objective definition—certainty as to who was, and who was not, an HCE—remained largely unfulfilled.

Section 1431 of SBJPA has now modified and simplified the statutory definition. In August 1997, IRS issued Notice 97-45, 1997-33 IRB 7, which provides guidance on the new definition. The notice includes nine examples illustrating how the rules will operate in practice. Treasury and the IRS invited comments and suggestions regarding procedural issues and the other matters discussed in the notice.

APPLICABILITY OF THE SECTION 414(q) DEFINITION

The Section 414(q) definition is applicable for purposes of the statutory pension provisions that incorporate it by reference [Q & A 1(a)], notably the general nondiscrimination rule, [IRC § 401(a)(4)] actual deferral percentage and actual contribution percentage testing, [IRC §§ 401(k)(3) and 401(m)(2)] and the minimum coverage rules. [IRC § 410(b)] The definition is also incorporated by various employee benefit provisions, such as Code Sections 117(d) (qualified tuition reduction), 129 (dependent care assistance), 132 (no additional cost services and employee discounts), and 274(j) (employee achievement awards). By contrast, Code Sections 79 (group term life insurance), 105(h) (self-insured medical reimbursement), 125 (cafeteria plans), 127 (educational assistance), and 137 (adoption assistance) use a different definition of the group in whose favor discrimination is prohibited, and those benefits are unaffected by the change. Also, the definition of "key employee" [IRC § 416(i)] has not changed.

The definition is not applicable to qualified plan provisions that do not incorporate it, such as the Section 415 limitations on contributions and benefits, with the exception of Code Sections 415(c)(3)(C) and 415(c)(6) (special rules for permanent and total disability and employee stock ownership plans). [Q & A 1(b)(2)]

The definition is not applicable with respect to any provision of Title I of ERISA, unless it is explicitly incorporated by reference (e.g., ERISA Section 408(b)(1)(B)). [Q & A 1(d)] The Department of Labor has made it clear that, in applying the ERISA exclusions (Sections 201(2), 301(a)(3), and 401(a)(1)) for top hat plans (i.e., nonqualified plans that cover a select group of management or highly compensated employees), the Section 414(q) definition does not apply.

EMPLOYER ELECTIONS

Employers are allowed to make a number of important elections, which generally must be applied consistently to all plans of the employer. The elections must normally be provided for in the plan document.

The following elections are available:

1. An election to include as employees any leased employees covered by a safe-harbor plan. [Q & A 7(b)(4)]
2. An election to modify any of the exclusions allowable in determining the size of the top-paid group, or to exclude collectively bargained employees in testing plans that only cover non-union employees. [Q & A 9(b)(2)]
3. If the plan benefits former employees, an elective special rule for employees who separated from service before January 1, 1987. [Q & A 4(d)]
4. An election to limit the non-5 percent owners who are treated as HCEs to those individuals who both (a) received more than $80,000 (indexed) in compensation from the employer during the preceding year and (b) were members of the top-paid group for the preceding year. [IRC § 414(q)(1)]
5. A new calendar year data election under Notice 97-45.

Prior to enactment of SBJPA, Code Section 414(q)(12) provided a simplified method of determining HCEs for employers that maintained significant business activities, and had employees, in at least two significantly separate geographic areas. SBJPA repealed Code Section 414(q)(12), so this election is no longer available.

Because of the SBJPA changes to Code Section 414(q), the calendar year election under Q & A 14(b), is generally not available for years beginning after 1996. For any plan year beginning in 1997, an employer may continue to use the election, taking into account the SBJPA changes to Code Section 414(q)(1)(B) and the elimination of Code Sections 414(q)(1)(C) and (D). [Notice 97-45, Section III] In addition, the simplified method under Revenue Procedures 93-42 and 95-34 does not apply for years beginning after December 31, 1996. "The Service intends to publish guidance in the future that will make appropriate modifications to these items of guidance." [Notice 97-45, Section III]

THE PROCESS

To identify its HCEs, the employer must determine the following:

1. The relevant testing period(s);
2. The entities that constitute the employer;
3. The employees taken into account;
4. Each employee's compensation;
5. The size of the top-paid group;
6. The highly compensated active employees for the look-back year;
7. The highly compensated active employees for the determination year;
8. Persons who are highly compensated because of attribution of stock ownership;
9. Highly compensated former employees (if necessary); and
10. All HCEs for the plan year being tested.

Under the regulations, it may be necessary for the employer to compile a separate list of HCEs for each plan; however, the employer may generally compile two lists: (1) all qualified plans that have the same plan year, and (2) all welfare plans that have the same plan year. If the employer does not have any leased employees during the previous testing period, then a single list can be compiled for all plans (qualified plans and welfare plans) with the same plan year.

TESTING PERIODS

Unlike the separate-line-of-business regulations, which provide a uniform calendar-year testing period regardless of the plan year, the regulations generally do not permit employers to utilize a uniform testing period with respect to all of their plans. The general rule is that the employer must analyze data for two separate periods, the determination year and the look-back year.

The Determination Year and the Look-Back Year

For a qualified plan, 403(a) plan, 403(b) plan, or SEP, the determination year is generally the plan year being tested. The look-back year is normally the preceding plan year. The look-back year is never less than a 12-month period. [Q & A 14(a)] If the employer has two or more retirement plans with different plan years, this will result in different testing periods for each plan. (See Example 4 in Notice 97-45.)

For a nonretirement plan to which the definition is relevant, the applicable year is determined under Section IV(2)(b) of Notice 97-45.

The Old Calendar-Year Election

Because of the SBJPA changes to Code Section 414(q), the calendar year election under Q & A 14(b), is generally not available for years beginning after 1996; however, for any plan year beginning in 1997, an employer may continue to use the election, taking into account the SBJPA changes to Code Section 414(q)(1)(B) and the elimination of Code Sections 414(q)(1)(C) and (D). [Notice 97-45, Section III]

The New Calendar Year Election

Section V of Notice 97-45 provides a new calendar year data election that an employer may make for a determination year. The effect of the calendar year data election is that the calendar year beginning with or within the look-back year is treated as the employer's look-back year for purposes of determining whether an employee is an HCE on account of the employee's compensation for a look-back year under Code Section 414(q)(1)(B). A calendar year data election, once made, applies for all subsequent determination years unless changed by the employer.

A calendar year data election made by an employer does not apply in determining whether the employer's employees are HCEs on account of being 5-percent owners. Accordingly, if an employee is a 5-percent owner in either the look-back year or the determination year, then the employee is an HCE, without regard to whether the employee's employer makes a calendar year data election.

If a plan has a calendar year as its determination year, then the immediately preceding calendar year is the look-back year for the plan. This is the case whether or not a calendar year data election is made. Thus, a calendar year data election would have no effect on the HCE determination for a calendar year plan.

Notification or filing with the IRS of a calendar year data election is not required in order for the election to be valid; however, under certain circumstances, plan amendments may be required to reflect the election. See Section VII of Notice 97-45.

Change of Plan Year

Q & A 14(c) provides special rules that apply if the plan year is changed.

THE EMPLOYER

The employer includes the employer or employers sponsoring the plan, and all entities aggregated with the plan sponsor under the controlled group and affiliated service group rules. [IRC §§ 414(b), (c), (m), and (o); Q & A 6(a)] Unlike the regulations under Code Sections 410(b) and 414(r), the regulations here do not contain any special rules for entities that become part of the employer, or cease to be part of the employer, during the testing period.

The Section 414(r) separate line of business rules are not applicable in determining the group of HCEs. [Q & A 6(c)] Once the group of HCEs has been identified on a employer-wide basis, the applicable compliance requirements (such as the employee coverage rules of Code Section 410(b)) can, however, be tested on a separate line of business basis, to the extent permitted by Code Section 414(r) and the regulations.

THE EMPLOYEES

Under Q & A 7, the term "employee" generally includes any individual (other than a nonresident alien described in Section 414(q)(8)) who performs services for the employer and is either:

1. A common law employee (including a statutory employee under Code Sections 3121(d)(3) and 7701(a)(20));
2. A self-employed individual described in Code Section 401(c)(1); or
3. A leased employee who is treated as an em-

ployee pursuant to Code Section 414(n)(2) or 414(o)(2). Unless the employer elects otherwise, a leased employee who is covered by a safe-harbor plan described in Code Section 414(n)(5) and is not otherwise covered under a qualified plan of the employer is excluded from the term "employee," but only in testing qualified plans.

HIGHLY COMPENSATED ACTIVE EMPLOYEES

A highly compensated active employee is any employee who both performs services for the employer during the determination year and is described in any one or more of the following groups: [Q & A 3(a)]

1. *5-percent owner.* The employee was a 5 percent owner at any time during the look-back year.
2. *5-percent owner.* The employee is or was a 5 percent owner at any time during the current year.
3. *Compensation above $80,000.* The employee received compensation from the employer in excess of $80,000 (indexed) during the look-back year. The employer may elect to treat as HCEs only those employees who both received more than $80,000 and were in the top-paid group of employees for the look-back year. See Code Section 414(q)(1) and Examples 1-3 in Section IX of Notice 97-45.

A top-paid group election, once made, applies for all subsequent determination years unless changed by the employer. Notification or filing with the IRS of a top-paid group election is not required in order for the election to be valid. Under certain circumstances, plan amendments may be required to reflect the election. See Section VII of Notice 97-45.

If it is necessary to round calculations or break a tie among two or more employees, the employer may adopt any rounding or tie-breaking rules as long as the rules are reasonable, nondiscriminatory, and uniformly and consistently applied. [Q & A 3(b)]

The applicable dollar amount for a non-calendar determination year or look-back year is the dollar amount for the calendar year in which that year begins. [Q & A 3(c)(2)]

CONSISTENCY REQUIREMENT FOR ELECTIONS

A top-paid group election made by an employer must generally apply consistently to the determination years of all plans of the employer that begin with or within the same calendar year. Similarly, in order to be effective, a calendar year data election made by an employer must generally apply consistently to the determination years of all plans of the employer, other than a plan with a calendar year determination year, that begin within the same calendar year. [Notice 97-45, Section VI]

The top-paid group election and the calendar year data election are independent of each other. Thus, an employer making one of the elections is not required to make the other election as well; however, if both elections are made, the look-back year in determining the top-paid group must be the calendar year beginning with or within the look-back year, in accordance with Section V of Notice 97-45.

Satisfaction of the consistency requirement is determined without regard to any multiemployer plans to which the employer contributes.

The consistency requirement does not apply to determination years beginning in 1997. Thus, an employer may make a top-paid group election or a calendar year data election for a plan for a determination year beginning in 1997, without regard to whether the employer makes that election for any other plan.

For determination years beginning in 1998 and 1999, (1) nonretirement plans are not subject to the consistency requirement, and (2) satisfaction of the consistency requirement with respect to retirement plans is determined without regard to any plans of the employer that are nonretirement plans.

Notice 97-45 does not address all of the procedural requirements that may be necessary to implement the top-paid group election or the calendar year data election for future years. Any additional requirements would be applied prospectively only.

FIVE-PERCENT OWNERS

Under Q & A 8, a person is a 5-percent owner if, at any time during the year, the employee is a 5-percent owner as defined in Code Section 416(i)(1)(B)(i) and Treasury Regulations Section 1.416-1, T-17 & 18. If the employer is a corporation, a 5-percent owner is any person who owns (or is considered as owning within Code Section 318) either more than 5 percent of the value of the outstanding stock or stock possessing more than 5 percent of the total voting power. If the employer is not a corporation, a 5-percent owner is any person who owns (or is considered as owning under rules similar to the rules of Code

Section 318) more than 5 percent of the capital or profits interest in the employer.

Under Code Section 318, an individual is treated as owning stock owned, directly or indirectly, by any of the following:

1. His or her spouse, unless they are legally separated;
2. His or her children, grandchildren, or parents;
3. A partnership, estate, trust, or corporation in which he or she has an interest; or
4. A person from whom he or she has an option to buy the stock.

There is no attribution between siblings.

Example 1. A owns 3 percent of the stock of a corporation. His three children (B, C, and D) own 3 percent, 1 percent, and 1 percent, respectively, of the stock. A and B are each treated as owning more than 5 percent of the stock, and so each of them is a 5-percent owner. C and D are each treated as owning 4 percent of the stock, and so neither of them is a 5-percent owner.

The stock ownership attribution rules of Code Section 318 are significantly different from the attribution rules under Code Section 1563, which are applied in determining whether a group of corporations is a controlled group of corporations under Code Section 414(b).

The employer aggregation rules of Code Section 414(b), (c), and (m) do not apply in determining who is a 5-percent owner. Thus, an individual who is a 5-percent owner of any entity that is part of the group of entities that constitute the employer is treated as a 5-percent owner with respect to all such entities.

COMPENSATION

Under Code Section 414(q)(4) and Q & A 13, for plan years beginning in 1997, compensation means compensation as defined in Code Section 415(c)(3), plus elective deferrals or salary reduction contributions under a 401(k) plan, cafeteria plan, 403(b) plan, or SARSEP. Elective deferrals under a Section 457 plan, or pick-up contributions described in Code Section 414(h)(2), are not included. For plan years beginning after 1997, the Section 415(c)(3) definition has itself been amended to include these amounts. Accordingly, for plan years beginning after 1997, compensation means compensation as defined in Code Section 415(c)(3).

THE TOP-PAID GROUP

An employee is in the top-paid group of employees for any year if the employee is in the group consisting of the top 20 percent of employees, when ranked on the basis of compensation paid during that year. [IRC § 414(q)(3)] Under Q & A 9, there is a two-step procedure (discussed in the following subsection) for identifying the top-paid group. Employees who perform no services for the employer during the year are not included in either step. Note again that, if it is necessary to round calculations or break a tie among two or more employees, the employer may adopt any rounding or tie-breaking rules, as long as the rules are reasonable, nondiscriminatory, and uniformly and consistently applied.

Step 1: Determine Number of Employees in Top-Paid Group

The number of employees in the top-paid group is equal to 20 percent of the active employees of the employer for the year. In determining this number, the following employees may be disregarded:

1. Those with less than six months of service by the end of the year
2. Those who normally work less than 17½ hours per week
3. Those who normally work during six or fewer months in any year
4. Those who are under age 21 at the end of the year

The employer may elect to substitute a shorter period of service, smaller number of hours or months, or a lower age, or not to apply any exclusions. [IRC § 414(q)(5); Q & A 9(b)]

Collectively Bargained Employees. Collectively bargained employees are generally included; however, if at least 90 percent of the employees are covered by collective bargaining agreements, and the plan being tested covers only employees who are not covered by such an agreement, then the employees covered by the collective bargaining agreements are not counted in determining the number of employees in the top-paid group in testing that plan. [IRC § 414(q)(5)(E); Q & A 9(b)(1)(iii)] Even if these requirements are satisfied, the employer may elect not to exclude union employees.

Step 2: Identify Members of Top-Paid Group
With the exception of collectively bargained employees, the preceding exclusions are not applicable in identifying the employees in the top-paid group. Thus, for example, an employee who normally works less than 17½ hours per week, and is excluded in determining the number of employees in the top-paid group, may nevertheless be a member of the top-paid group. [Q & A 9(c)]

A person who is highly compensated because he or she is a 5-percent owner may also be a member of the top-paid group. If so, the individual is counted under both categories. Thus, for example, a 5-percent owner may use up one top-paid group slot. [Q & A 3(d)]

> **Example 2.** The employer had 250 employees in the prior year, 80 of whom earned over the $80,000 indexed threshold and 50 of whom had not completed six months of service by the end of the year. Eight of these 50 employees earned more than the $80,000 indexed threshold and were among the 40 highest paid employees.
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> The 50 new employees can all be excluded in determining the number of employees in the top-paid group, which thus includes only 40 employees (20 percent of (250 minus 50)). The eight highly paid new employees will effectively push eight other employees out of the top-paid group, even if the new employees received no benefits in the preceding year.

OFFICERS

Before the enactment of SBJPA, an individual could be an HCE by virtue of being an officer of the employer. Under a special rule, the highest paid officer was treated as an HCE, regardless of how low his or her compensation actually was, and regardless of whether the officer was already an HCE under another provision (for instance, as a 5-percent owner). [Q & A 10(c)]

SBJPA repealed (1) the officer category of HCEs and (2) the highest paid officer rule. Accordingly, under current law, it is irrelevant whether an individual is an officer.

HIGHLY COMPENSATED FORMER EMPLOYEES

If a plan does not benefit former employees, it is not necessary to identify highly compensated former employees. Accordingly, highly compensated former employees generally need not be identified for a defined contribution plan, as the 25 percent of compensation limitation under Code Section 415(c) will prevent them from receiving a current benefit. The only exception is a 403(b) plan participant who has made the special election under Code Section 415(c)(4)(B), as a contribution may be made for such a participant even if he or she has no compensation.

Highly compensated former employees must be identified for a defined benefit plan only if they receive a current benefit, such as an ad hoc cost of living increase.

A person who performs no services for the employer during a determination year (e.g., because of a leave of absence) is treated as a former employee. [Q & A 4(b)] A highly compensated former employee is generally any former employee who had a separation year prior to the determination year and was a highly compensated active employee, either for the separation year or for any determination year ending on or after the employee's 55th birthday. [IRC § 414(q)(6); Q & A 4(a)]

In determining whether the former employee was an HCE during any such prior year, one uses the HCE definition that was in effect for that year, not the current definition. [Notice 97-45, Section VIII(2)]

An employee will be deemed to have a separation year if, prior to age 55, he or she receives compensation less than 50 percent of his or her average annual compensation for the high three consecutive calendar years (or the period of service with the employer, if less). Such an employee may also be treated as having a deemed resumption of employment under Q & A 5(b). The employer may elect a special rule for employees who separated from service before January 1, 1987. [Q & A 4(d)]

In applying Code Section 414(q) to active employees, former employees are not included in the top-paid group. Former employees are not counted as employees in determining the number of employees in the top-paid group. [Q & A 4(e)(2)]

FAMILY MEMBERS

Prior to SBJPA, Code Section 414(q) contained a special rule for any employee who was a member of the family of either a 5-percent owner or one of the 10 HCEs paid the greatest compensation during the year. In that case, the HCE and all of his or her family members were aggregated and treated as a single

HCE. [IRC § 414(q)(6); Q & A 11, 12]

SBJPA repealed the family aggregation rule; however, a family member of a 5-percent owner may be treated as a 5-percent owner by attribution, even if he or she does not actually have any ownership interest in the employer. (See Example 1.) In this situation, current law treats each family member as a separate HCE, unlike the family aggregation rule, which previously treated them as a single HCE.

The repeal of family aggregation is not always advantageous to HCEs who wish to maximize their benefits. For instance, as the family members will now be separate HCEs rather than a single HCE, the HCE with the largest benefit may have a higher equivalent benefit accrual rate (EBAR), thus making it more difficult (or more expensive) to satisfy the general test for a cross tested plan.

CHURCH PLANS

A nonelecting church plan is only required to comply with pre-ERISA coverage and nondiscrimination rules. In applying those rules, no employee will be an officer, supervisor, or highly compensated employee unless he or she is an HCE as defined in Section 414(q)(1). [IRC § 414(q)(9), added by SBJPA Section 1462(a), effective for years beginning after 1996]

TAX-EXEMPT AND GOVERNMENTAL EMPLOYERS

The repeal of the highest paid officer rule, together with the simplified HCE definition and the availability of 401(k) plans, is particularly significant for small tax-exempt employers. Under the prior rules, the executive director was almost always an HCE, regardless of how low his or her compensation was. Tax-exempts do not have 5-percent owners; many have no one earning more than $80,000. Such an organization will, under the new rules, have no HCEs, and need not worry about nondiscrimination testing.

Under Section 1505 of the Taxpayer Relief Act of 1997, governmental plans are exempted from the nondiscrimination and participation rules, for taxable years beginning on or after the date of enactment, August 5, 1997. Such plans are treated as satisfying the requirements for years beginning before that date.

EFFECTIVE DATE

Code Section 414(q) and the regulations were generally effective for plan years beginning after 1986. The changes made by SBJPA are effective for plan years beginning after 1996, except that in determining whether an employee is an HCE for a plan year beginning in 1997, the changes are to be treated as having been in effect for plan years beginning in 1996.

If a plan uses prior year data in performing the 1997 actual deferral percentage and actual contribution percentage tests, the SBJPA Blue Book (p. 151) clarifies that "the data for 1996 is used, even though the definition of highly compensated employee (and therefore nonhighly compensated employee) was different in 1996 than it is in 1997. The data for the 1996 year is not recalculated using the new definition of highly compensated employee."

DETERMINING HCE STATUS FOR 1997

The amendments made by SBJPA generally apply to years beginning after December 31, 1996; however, Section 1431(d)(1) of SBJPA provides that, in determining whether an employee is an HCE for years beginning in 1997, the amendments to Code Section 414(q) are treated as having been in effect for years beginning in 1996. Accordingly, in determining whether an employee is an HCE for the determination year beginning in 1997, an employer must consider whether the employee was a 5-percent owner or had compensation in excess of $80,000 for the look-back year that began in 1996.

An employer also may make the calendar year data election and/or the top-paid group election with respect to determination years beginning with or within the 1997 calendar year, in accordance with Notice 97-45. The SBJPA amendments to Section 414(q) are not applicable in determining the employer's HCEs for determination years beginning prior to 1997. [Notice 97-45, Section VIII(1)]

SIMPLIFIED IDENTIFICATION METHODS

The simplified methods of identifying HCEs, under former Code Section 414(q)(12) and Revenue Procedure 93-42, as modified, are no longer available. Notice 97-45 does not mention the simplified elective method for 403(b) plans under Notice 89-23, so it is not clear whether this method is still available.

QUALIFIED PLAN AMENDMENTS

If a retirement plan qualified under Code Section 401(a) or 403(a) contains the definition of HCE under Code Section 414(q), as in effect before SBJPA, the plan must be amended to reflect the definition as amended by SBJPA. [Notice 97-45, Section VII]

If an employer makes either a top-paid group election or a calendar year data election for a determination year, a plan that contains the definition of HCE must reflect the election. If the employer changes either a top-paid group election or a calendar year data election, the plan must be amended to reflect the change; however, a plan is not required to add a definition of HCE merely to reflect an election.

Any plan amendments to reflect the new definition of HCE, and to reflect any choices regarding the top-paid group election or calendar year data election, are not required to be made until the end of the SBJPA remedial amendment period; however, plans must be operated in accordance with the SBJPA changes as of the statutory effective date, and plans must be amended retroactively effective as of that date. In addition, any retroactive amendments must reflect the choices made in the operation of the plan for each determination year, including choices made with respect to the top-paid group election and the calendar year data election (and any changes to those elections).

CONCLUSION

The determination of which plan participants are HCEs is fundamental to determining whether a plan is in compliance with the complex coverage and nondiscrimination rules under the Code and regulations. Even with the significant simplifications enacted by SBJPA, this process is still unnecessarily complex. An honest mistake in interpreting or applying the rules could result in plan disqualification, penalties under the CAP Program, or expensive correction under the VCR Program. To replace the pre-TRA 86 facts-and-circumstances test with a bright line test is helpful only if the bright line test is clear, which the HCE rules are not.

In the Taxpayer Relief Act of 1997, Congress granted governmental plans a complete exemption from the nondiscrimination rules. The next step should be significant further simplification of the rules for non-governmental plans.