NATIONAL RETIREMENT SERVICES, INC.

WHO ARE "HIGHLY COMPENSATED EMPLOYEES" (and Why Do We Care?)

One of the key underlying concepts of retirement plan tax law is that all tax qualified employee retirement plans must not "discriminate in favor of highly compensated employees." Internal Revenue Code section 414(q) makes it clear that "Highly Compensated Employees" (referred to as "HCEs" in this article) is a defined term used in testing for the absence of prohibited discrimination with respect to benefits and plan coverage. For these purposes, employees represented by a union and nonresident aliens are excluded from consideration, but individuals who meet the legal definition of a Leased Employee (discussed in our April 2012 Newsletter, available on our website) are included. Federal regulations prescribe various ways to determine whether a retirement plan engages in prohibited discrimination in favor of HCEs and a separate Code section 410(b) provides rules concerning disproportionate retirement plan coverage of HCEs. If a tax qualified retirement plan discriminates in favor of HCEs, steps must be taken to correct the discrimination or face the prospect of the plan losing its tax favored status, with the possibility of severe financial and tax consequences.

Basic Definition of a Highly Compensated Employee

Code section 414(q) defines a HCE as an employee who is either a "5% owner" **or** whose prior plan year's compensation from the employer exceeded a specific dollar amount.

A **5% owner** is defined as an employee who owned *more than* 5% of the business sponsoring the plan in either the plan year being tested for nondiscrimination or in the immediately preceding plan year, referred to as the "*look back year*." For this purpose, ownership is determined on the basis of voting power or on the basis of value. For example, if Ned owns 100 of the 1,000 shares of voting common stock, he controls 10% of decision making power and is deemed a "5% owner." If Sally owns no common stock, but owns 20 of the 100 outstanding shares of preferred non-voting stock, Sally is deemed to be a 5% owner if the preferred shares are valued at $1,000 per share and the common stock is valued at $50 per share. This is because Sally's holdings are worth $1,000 x 20 = $20,000, which is more than 13% of the combined $150,000 value of both common and preferred stock.

Family attribution must also be considered when determining a 5% owner. An individual is treated as owning any interest that is owned by a spouse, children, grandchildren, or parents but not siblings or grandparents. Thus if Joe owns 3% of the company while his spouse owns 4%, Joe is considered to be a 5% owner because he is considered to own his 3% share and his wife's 4% share to make a 7% (i.e. a greater than 5%) owner.

An employee who earned *more than* $120,000 in 2015 is deemed to be a HCE in 2016 due to the **compensation dollar limit**. The $120,000 dollar limit is subject to adjustment for cost of living increases, but the $120,000 limit remains in effect for 2016. This means that any employee who earns above $120,000 this year will be a HCE in 2017. Compensation is defined as including bonuses, overtime, commissions, and salary deferrals for 401(k) or cafeteria plan benefits. This definition is independent from the Plan's definition of "Compensation."

Businesses that have more than 20% of their work force earning above the compensation limit are permitted to elect to limit the number of HCEs to 20%. This is typically accomplished by a plan document provision or plan amendment. When elected, only those employees who both earn above the dollar limit and are in the top 20% of employees when ranked by compensation are deemed to be HCEs. Employees who are 5% owners remain as HCEs regardless of their compensation.

Some Strategies are Available under the HCE Rules

Application of the HCE rules results in every employee (other than union and nonresident aliens) being classified as either a HCE or a Non-HCE ("NHCE"). A non-owner employee is a NHCE whether he earns $120,000 or $20,000. Furthermore, an employee who owns exactly 5.0% of the employer is not a 5% owner, while an employee owning 5.01% is a 5% owner. Tax law does not prevent an employer from increasing or decreasing compensation or ownership in order to achieve a desired designation for an employee or a group of employees. For example, if Mary, a non-owner employee who typically defers the maximum dollar amount to her 401(k) plan is paid exactly $120,000 in 2016, she will be a NHCE in 2017 and will help to pass the 2017 401(k) plan non-discrimination test. If Mary is paid $120,001, she will be a HCE and will make the test more difficult to pass.

New employees, other than 5% owners, are treated as NHCEs in the year of hire regardless of their first year compensation because they earned zero in the look back year. Those hired later in the plan year may be classified as NHCE for both their first and second plan years of employment. For example, an employee hired on November 1, 2015 who earns $240,000 annually is treated as a NHCE in both 2015 and 2016 for a calendar year plan since 2014 earnings were zero and 2015 earnings were $40,000. Note that compensation is not annualized for purposes of determining an employee's status as either a HCE or NHCE. New *employers* who promptly adopt retirement plans have no HCEs in the first year other than 5% owners. In addition, if the business was started later in the plan year, it is likely that the only HCEs in the second year will be 5% owners.

Some employers who employ many highly paid non-owner employees design their retirement plan so that HCEs only include the top paid 20% of the workforce. This often results in most or all non-owners being classified as NHCE. For example, if a law firm employer wishes to include associate attorneys in a firm-wide 401(k) plan, the top 20% election generally makes it easier for the plan to pass salary deferral non-discrimination tests due to the likelihood of NHCE associate attorneys making large salary deferrals. On the other hand, if the employer prefers to exclude associates from the Firm's retirement plan covering partners and non-attorney staff members, the top 20% election should not be used. This is because most associates will be categorized as HCEs and their exclusion makes it easier for the retirement plan to meet coverage and non-discrimination requirements.

While determination of HCE status and the associated non-discrimination and minimum coverage tests are complex, employers who sponsor retirement plans are well advised to have a basic grasp of the rules, including the above possible strategies.

PPA RESTATEMENTS: LAST CALL

Anyone who reads our newsletters on a regular basis is aware that all IRS pre-approved defined contribution plan documents must be restated by the end of April. Articles on the subject have appeared last year and in every newsletter issued in 2016 and are all available on our website. NRS hopes to complete all required restatements for its clients by mid-April as the IRS deadline is April 30, 2016. Defined contribution plans that use pre-approved documents and fail to restate by the end of April must file under an IRS correction program in order to avoid sanctions. Our February 2016 newsletter discusses this process in detail. *Employers who have not taken steps to restate their pre-approved defined contribution plan are dangerously close to missing the April 30 deadline.*

REMINDERS FOR APRIL

April 15 – Minimum funding requirements for defined benefit, money purchase, and target benefit pension plan years ended 7/31/15 must be met by April 15 in order to avoid excise taxes. An electronic transfer must be completed or a check mailed by this date.

April 18 – Forms 5500 Series/8955-SSA – Forms that are on extension are due for the Plan Year ending 6/30/15.

April 18 – Retirement plan employer contributions are due in order to be **deducted** on employer tax returns due to be filed April 18, 2016.

April 30 – Defined contribution plans that use IRS pre-approved documents must restate those documents no later than April 30.

May 2 – Form 5500 Series/8955-SSA – Forms are due for the Plan Year ending 9/30/15 that are not on extension.

For more information or to request a proposal, please visit our website at www.NRServices.com, or for sales support, please contact:

PACIFIC & MOUNTAIN TIME

Nate DeLong
Sales Representative
T| (800) 350-2172 x 260
E| nate.delong@NRServices.com

Suzan Hall
Sales Representative
T| (800) 350-2172 x 224
E| suzan.hall@NRServices.com

CENTRAL & EASTERN TIME

Jim Houpt
Executive Vice President
T| (800) 627-1610 x 507
E| jim.houpt@NRServices.com

Amber Waddell
Sales Representative
T| (800) 627-1610 x 501
E| amber.waddell@NRServices.com