

IRS Provides Additional Guidance on the Definition of Highly Compensated Employee

WHO'S AFFECTED This information applies to sponsors of qualified pension, profit sharing and stock bonus plans. It also applies to sponsors of tax sheltered annuity plans.

BACKGROUND AND SUMMARY The Small Business Job Protection Act of 1996 (SBJPA) changed and simplified the definition of highly compensated employee (HCE). However, these changes raised several questions. For example, could a plan sponsor change a plan's HCE definition from one year to the next to take advantage of permitted optional provisions? Was the old law "calendar year election" still allowed?

The IRS has now provided additional guidance regarding the new HCE definition, including answers to these questions. This guidance includes information on the top-paid group election, a "new" calendar year election, consistency requirements, and transition relief from certain provisions.

ACTION AND NEXT STEPS The new HCE definition is generally effective for plan years beginning in 1997. Some transition rules provide for later effective dates. In general, qualified plans must be amended to reflect the new HCE rules by the last day of the 1999 plan year. The amendment deadline for governmental plans is generally the last day of the 2000 plan year. Tax sheltered annuity plans that incorporate these terms in their plan documents must be amended by the last day of the 1999 plan year. However, plan sponsors must operate their plans in accordance with these changes beginning with the 1997 plan year.

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IRS Provides Additional Guidance on the Definition of Highly Compensated Employee

The Small Business Job Protection Act of 1996 (SBJPA) changed the definition of highly compensated employee (HCE) for plan years beginning after December 31, 1996. The new definition of HCE is any employee who:

- Is a 5% owner at any time during the current year or preceding year, or
- For the preceding year, received more than \$80,000 (as indexed) of compensation from the employer and, if the employer so elects, was in the top-paid group (top 20% of employees when ranked by compensation) of employees.

As simple as this definition is, it raised several questions especially with respect to the use of prior law options permitted by IRS regulations. For example, an employer previously was allowed to make a "calendar year election." This allowed an employer to use data from the calendar year ending with or within the current year to make the required look-back year determinations. For plans with calendar plan years, this meant the look-back year would be the same as the determination year and greatly simplified data collection. However, this seemed to contradict the intent of the new law.

IRS Notice 97-45 answers this and many of the other questions that had been raised regarding the application of old law regulations to the new definition of HCE.

Determination Year and Look-Back Year

What "years" does an employer look at to determine if someone is an HCE? To determine HCE status, an employer must look at the plan year for which the determination is being made (the "determination year") and the preceding twelve-month period (the "look-back year").

Thus, an employee is an HCE if at any time during the current plan year or look-back year, he or she is a 5% owner; or, in the look-back year received more than \$80,000 (as indexed) compensation from the employer, and if the employer so elects, was in the top-paid group.

Note that while a determination year may be shorter than 12 months (for example, when the plan year is changed and a short plan year results), the look-back year is always 12 months long. This means that the \$80,000 compensation measurement will never be prorated.

Top-Paid Group Election

The "top-paid group" is the top 20% most highly paid employees of the employer. To use the top-paid group limitation, the sponsor of a plan that contains a specific HCE definition must amend the plan to show that the top-paid group election has been made. The employer may change this election from year to year but must amend the plan document to reflect any such change. The top-paid group election must be applied consistently to the determination years of all plans sponsored by the employer (determined on a controlled group basis) beginning with or within the same calendar year.

For example, ABC Company sponsors Plan A and Plan B. Plan A has a calendar plan year. Plan B's plan year begins on July 1. For the 1999 plan year, Plan A makes the top-paid group election. Plan B must also use the top-paid group election for the plan year beginning July 1, 1999.

Old Law Simplified Testing Methods

The old law "calendar year election" does not apply for plan years beginning after December 31, 1996. All other prior simplified testing methods are eliminated for plan years after 1996. This includes the simplified definition of HCE for employers with significant business activities in two or more separate geographical areas and the snapshot day testing option.

New "Calendar Year Election"

The IRS is providing a new "calendar year election." If elected, the employer's look-back year would be the calendar year beginning with or within the standard look-back year. However, this election does not apply for determining who is an HCE on account of being 5% owners. The look-back year for determining 5% owners is always the twelve-month period preceding the current plan year. In addition, if the plan has a calendar plan year, the look-back year must always be the preceding twelve-month calendar year period. Thus, the calendar year election is not available to plans with calendar plan year.

To make the calendar year election, the sponsor of a plan that contains a specific HCE definition must amend the plan document. As with the top-paid group election, this election may be changed from year to year with plan amendments. It must also be applied consistently to all plans sponsored by the controlled group employer, other than plans with calendar plan years.

Consistency Requirements

The top-paid group and calendar year election consistency requirements mentioned above do not apply to plan years beginning between January 1, 1997 and December 31, 1997. Therefore, an employer may make a top-paid election for one of its plans for 1997 but not for its other plans. Likewise, an employer may make a calendar year election for some but not all of the plans it sponsors.

It is important to note that the top-paid group and calendar year elections are always independent of each other. Therefore, an employer that makes one of these elections is not required to make the other election.

In addition, if an employer participates in a multiemployer plan, that plan is disregarded when determining if the employer's other plans meet the consistency requirement.

Plan Amendments Required

Plan sponsors must amend qualified retirement plans for these changes by the last day of the 1999 plan year. However, plans must operate in accordance with these provisions beginning with the 1997 plan year. Plans that must be amended must do so retroactively. Retroactive amendments must reflect the elections made for each plan year, including the top-paid group election and the calendar year election, and include the first date that the plan operated under each election.

Therefore, plan sponsors must carefully document any elections made and later incorporate them in the final SBJPA plan amendments.

Note, however, that if a plan did not contain a specific pre-SBJPA definition of HCE, it does not have to be amended either to contain the new definition or to reflect these special elections.

Highly Compensated Former Employees

An employee who is determined to be a highly compensated employee on or after his 55th birthday continues to be considered a highly compensated employee even after he terminates employment. This determination is based on the HCE definition that is (or was) in effect for that year.

Family Attribution Rules

Although the family aggregation rules were repealed by SBJPA, family attribution rules affecting the treatment of stock owned directly or indirectly by an individual's spouse, children, grandchildren or parent have not changed. Any individual who is a spouse, child, grandparent or parent of someone who is a 5% owner (or who together with that individual would own more than 5% of a company's stock) is treated as a 5% owner. Therefore, such individuals would each be considered HCEs for the applicable plan year or look-back year.



COMPLIANCE CLIPS

IRS Issues Guidance Relating to Plan Amendments for Recent Legislation

The Small Business Job Protection Act of 1996 (SBJPA) did not provide a plan amendment deadline. It simply said that a plan sponsor would not have to amend its plan to reflect new SBJPA rules before the first day of the 1998 plan year (first day of the 2000 plan year for a governmental plan).

Recent IRS guidance provides that, in general, an employer must amend its qualified plan to comply with the provisions of SBJPA, the Uruguay Round Agreements Act of 1994 (GATT) and the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA) by the last day of the plan's 1999 plan year.

The sponsor of a governmental plan must amend that plan to reflect SBJPA, GATT and USERRA rules by the later of (1) the first day of the plan's 2000 plan year, or (2) the last day of the first plan year beginning on or after the "1999 legislative date." The "1999 legislative date" is the 90th day after the opening of the first legislative session beginning after January 1, 1999, of the governing body with authority to amend the plan, if that body does not meet continuously.

Until these dates, plan sponsors must operate their plans in compliance with the provisions of these laws and any related guidance that is issued by the IRS, Department of Labor or other governmental authorities.

"SBJPA" amendments must contain appropriate retroactive effective dates and must reflect any legislatively-required plan design changes made by the plan sponsor. For example, a plan sponsor must amend the plan each time it changes either the top-paid group or calendar year election for defining Highly Compensated Employees. The SBJPA amendment would have to document each change made to these elections between 1997 and 1999.

If a plan is required to operate in compliance with a provision of any of these laws before the amendment deadline, the subsequent amendment must reflect the way the plan was actually operated. For example, SBJPA eliminated the compensation limit family aggregation rules for plan years beginning after 1996. Initially, the IRS raised concerns about operating plans in a manner that ignored these rules which, while no longer required were still permissible and were stated in plan documents. They felt that in some cases elimination of the family aggregation rules might impermissibly cut back some employees' benefits. The IRS has now officially stated that operational compliance with the removal of the family aggregation rules is permissible and will not violate anticutback rules, as long as the eventual plan amendment eliminating this provision is retroactive to the 1997 plan year.

If a plan terminates after the effective date of SBJPA, GATT or USERRA changes, but before the date those plan amendments are required, the plan sponsor must make the appropriate amendments in conjunction with the plan termination. These amendments may be adopted after the actual date of plan termination if they are made while the IRS is reviewing the plan to issue a final determination letter.

Pension Analyst by Prudential Retirement

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