MassMutual's Regulatory Advisory Services

HIGHLY COMPENSATED EMPLOYEES

Plans Impacted - This white paper applies to qualified retirement plans, including defined contribution plans intending to satisfy section 401(a) of the Internal Revenue Code (*e.g.,* 401(k) profit sharing plan), defined benefit plans and ERISA 403(b) [1] plans. This is a high level overview of a complex topic; as a result, many rules are not described or, if mentioned, not described in detail.

INTRODUCTION

A qualified plan must not discriminate in favor of Highly Compensated Employees (HCEs). Under the plan, contributions or benefits to be provided must not discriminate in favor of HCEs. Most qualified plans satisfy this requirement by "passing" various nondiscrimination tests (*e.g.*, minimum coverage, ADP/ACP tests) so proper identification of an employer's HCEs is one of the most crucial factors to yielding accurate and reliable nondiscrimination testing results.

An HCE for 2016 is an individual who meets either of the following tests:

1, Owned more than 5% of the interest in the business at any time during the current year or preceding year (the five-percent owner test); or

2. For the preceding year, received compensation that is more than $120,000 (if the preceding year is 2015 or 2016) (the compensation test).

If the plan has made the top paid group election, an individual who is not in the top 20% of employees when ranked by compensation for the preceding year (top paid group) is not considered to be an HCE. A plan sponsor makes this top paid group election in one of two ways: administratively (if the plan document does not include an HCE definition); or, by plan amendment (if the document includes an HCE definition.

[1] 403(b) plans of non-qualified church controlled organizations that are not subject to ERISA are subject to the nondiscrimination testing requirements on the employer contributions.

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RS4153 216 C:40231-00, Expiration date: 9/2018

Any individual who does not satisfy one of these two tests is considered a non-highly compensated employee (NHCE).

The dollar limit noted above will change over the years as it is indexed/tied to inflation.

Ownership

Treasury Regulation § 1.414(q)-1T, A-8 provides specific rules for determining who is a 5% owner when it states that:

"An employee is a 5-percent owner of the employer for a particular year if, at any time during such year, such employee is a 5-percent owner as defined in § 416(i)(B)(i) and § 1.416-1 1.416–1 A T–17&18. Thus, if the employer is a corporation, a 5-percent owner is any employee who owns (or is considered as owning within the meaning of section 318) more than 5 percent of the value of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 5-percent owner is any employee who owns more than 5 percent of the capital or profits interest in the employer. The rules of subsections (b), (c), and (m) of section 414 do not apply for purposes of determining who is a 5-percent owner. Thus, for example, an individual who is a 5-percent owner of a subsidiary corporation that is part of a controlled group of corporations within the meaning of section 414(b) is treated as a 5-percent owner for purposes of these rules. "

To add to the complexity in determining HCEs, family attribution must be applied. The spouse, children, grandchildren and parents of each 5% owner are also treated as 5% owners. There is no attribution if the 5% owner and his/her spouse are legally separated or divorced.

Because of the importance of accurate HCE (and NHCE) classifications, we recommend that you work closely with your tax advisor to understand who must be considered a 5% owner.

Compensation

For purposes of HCE determination, compensation is reviewed during the look back year rather than the individual's compensation for the current plan year. Current year compensation has no bearing on the HCE determination.

The look back year is typically the 12-month period preceding the current plan year. Most plans have calendar plan years so the preceding 12-month period is a calendar year. However, if the plan has a fiscal year plan (*e.g.*, July 1 through June 30) the sponsor has the option of using calendar year data to simplify the HCE determination. The sponsor would need to adopt a calendar year election as a plan provision, if the plan document includes an HCE definition. Our pre-approved plan document includes an HCE definition as well as a calendar year election option provision. Some plans (usually individually designed plans) may not define HCE. A sponsor of a non-calendar year plan either amends its plan document or documents the decision "outside" of the plan, as applicable. Please refer to your specific plan document.

Top 20% Limitation (a/k/a Top Paid Group)

As we mentioned above, a plan may limit the number of individuals who are identified as HCE by making a "top

paid group" election. The top-paid group of employees for the year is that group of employees who are in the top 20 percent of all employees of the employer ranked on the basis of compensation. This election limits the number of employees who are recognized as HCE to those who:

- are in the top 20% of employees group for the look back year, and
- have compensation in excess of the required dollar amount (*e.g.*, $120,000 for 2015 look back years).

The following employees may be excluded when applying the top 20% limitation: employees who have not completed at least six months of service, employees who normally work less than 17 ½ hours per week, employees who normally work during less than six months a year, and employees who were under age 21. Union employees may also be disregarded but only if 90% or more of employees are covered by collective bargaining agreements and the plan doesn't benefit any of the union employees (*i.e.*, they may neither make nor receive plan contributions). The plan can provide for a shorter period of service or lower age to apply these exclusions.

The top 20% limitation can be helpful in producing more favorable testing results when HCEs who fall below the top 20% ranking in compensation and are contributing, are able to be moved to a non-HCE classification.

It is important to note that all 5% owners and family members based on family attribution are added as HCEs after the top 20% limitation is completed.

The top paid group election must be applied consistently to the determination years of all plans of the employer beginning with or within the same calendar year. And, if the employer is a member of a controlled group of corporations or an affiliated service group, this rule then applies to all plans of all the members of the controlled group of corporations or affiliated service group.

More information about the impact of controlled group and affiliated service group rules

When making HCE determinations, all employees employed by members of an affiliated service group, a controlled group of corporations, a group of trades or businesses under common control or other entities defined in IRC section 414(o) are treated as employed by a single employer. The employers in the group do not separately determine their HCEs.

If the employer is a member of a controlled group or affiliated service group, the top paid group election must be applied consistently to all employers in the group and to all plans of all the controlled group members. Before the top-paid group is identified an employer needs to determine: (1) if the company is a member of a controlled group of corporations or an affiliated service group; (2) if so, what qualified retirement plans (if any) the other companies have; and (3) the identification of HCEs and non-HCEs for each controlled group or affiliated service group.

The determination of whether an employer is part of a group to which this rule applies is involved. A correct determination is critical in order to achieve accurate testing results.

Final thoughts

Compensation - The plan document will define what is considered compensation for purposes of HCE determination. There are specific Internal Revenue Code requirements, found under Section 415, concerning what must be included as compensation.

New Employees - A new employee won't be an HCE during his/her first year of employment unless the new employee is a 5% owner or is subject to the family attribution rules briefly discussed earlier.

New Employer - For the first year of existence, an employer will have no HCEs on the basis of compensation. The only HCEs will be those who are 5% owners and those employees who are subject to family attribution rules.

Plan Amendment - So long as a plan doesn't base the allocation of employer contributions on HCE status (*e.g.*, cross tested plans), a plan can, generally, be amended mid-year to change the definition of HCE to add or remove the top paid group limitation. The amendment must be signed no later than the last day of the plan year in which it is to take effect.

MassMutual Regulatory Advisory Services

If you have questions about the information in this white paper or wondering what your "next steps" might be with respect to Highly Compensated Employees, please contact your MassMutual representative.

This document is for informational purposes only and should not be construed as legal and/or tax advice. Please consult with your own legal counsel and other experienced advisors regarding the application of the matters described herein to your specific circumstances.