

Highly Compensated Employee Definition

Notice 97-45

I. PURPOSE

This notice provides guidance relating to the definition of highly compensated employee (“HCE”) under §414(q) of the Internal Revenue Code (“Code”), as amended by §1431 of the Small Business Job Protection Act of 1996, Pub. L. 104-188 (“SBJPA”). The §414(q) definition of HCE is incorporated by certain provisions of the Code that apply nondiscrimination requirements to various employee benefit plans, entities, or arrangements (“plans”).

Specifically, this notice provides:

- Guidance on making the top-paid group election permitted by §414(q)(1)(B)(ii), under which an employee (other than a 5-percent owner) with compensation in excess of the dollar threshold is an HCE only if the employee is among the highest paid 20 percent of an employer’s workforce.
- A new calendar year data election under which an employer that maintains one or more plans on a fiscal year basis has the option to use calendar year data to simplify the determination of whether an employee is an HCE on account of compensation under §414(q)(1)(B).
- Transition relief from certain requirements of the top-paid group election and the calendar year data election.
- Guidance on plan amendments to reflect the revised definition of HCE, including the application of the remedial amendment period under § 401(b), and certain other matters relating to the determination of HCE status.

II. BACKGROUND

(1) *Section 414(q) prior to SBJPA.* Prior to amendment by SBJPA, § 414(q)(1) generally provided that an employee was an HCE if, at any time during the year or the preceding year, the employee:

(A) was a 5-percent owner,

(B) received more than \$100,000 (for 1996) in annual compensation from the employer,

(C) received more than \$66,000 (for 1996) in annual compensation from the employer and was in the top-paid group of employees during the same year, or

(D) was an officer of the employer who received compensation in excess of \$60,000 (for 1996).

(2) *Guidance under § 414(q) prior to SBJPA.* Under §1.414(q)-1T, A-14(b) of the temporary Income Tax Regulations, employers were allowed to make a calendar year calculation election, under which the preceding year’s calculations relating to HCE determinations were made on the basis of the calendar year ending with or within the current year. Under section 4 of Rev. Proc. 93-42, 1993-2 C.B. 540, as modified by Rev. Proc. 95-34, 1995-2 C.B. 385, an employer was permitted to use a simplified method for determining HCEs. Rev. Proc. 95-34 also provided model plan language for employers to use the simplified method.

(3) *SBJPA amendments to § 414(q).* Section 414(q)(1), as amended by SBJPA, provides that the term “highly compensated employee” means any employee who:

(A) was a 5-percent owner at any time during the year or the preceding year, or

(B) for the preceding year had compensation from the employer in excess of \$80,000 and, if the employer so elects, was in the top-paid group for the preceding year.

The \$80,000 amount is adjusted at the same time and in the same manner as under § 415(d), except that the base period is the calendar quarter ending September 30, 1996.

Pursuant to § 414(q)(3), an employee is in the top-paid group for any year if the employee is in the group consisting of the top 20 percent of the employees of the employer when ranked on the basis of compensation paid to employees during such year. An election pursuant to § 414(q)(1)(B)(ii), under which an employee (who is not a 5-percent owner) who has compensation in excess of \$80,000 is not an HCE if the employee is not a member of the top-paid group, is referred to in this notice as a “top-paid group election.”

The amendments made by § 1431 of SBJPA generally apply to years beginning

after December 31, 1996.

III. EFFECT OF STATUTORY CHANGES ON PRIOR GUIDANCE

(1) *Prior guidance.* Because of the amendments made to § 414(q) by SBJPA, certain portions of § 1.414(q)-1T do not reflect current law. Except as provided in section III(2), the calendar year calculation election under A-14(b) of § 1.414(q)-1T does not apply for years beginning after December 31, 1996. In addition, the guidance provided under section 4 of Rev. Proc. 93-42 and under Rev. Proc. 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.

(2) *Transition relief for 1997.* For any year beginning on or after January 1, 1997 and before January 1, 1998, employers may continue to utilize the calendar year calculation election, taking into account the statutory amendments to § 414(q)(1)(B), and the elimination of § 414(q)(1)(C) and (D), by SBJPA.

IV. PERIODS FOR DETERMINING HCE STATUS

(1) *Determination years and look-back years.* HCE status is determined on the basis of the applicable year (as defined below) of the plan or other entity for which a determination is being made (“determination year”) and the preceding twelve-month period (“look-back year”) in accordance with § 414(q). Thus, under § 414(q), as amended by SBJPA, an employee is an HCE for a determination year if, (a) at any time during the determination year or the look-back year, the employee was a 5-percent owner or (b) for the look-back year, the employee had compensation from the employer in excess of \$80,000 (as adjusted) and, if the employer so elects, was in the top-paid group.

(2) *Applicable year.*

(a) *Retirement plans.* The applicable year for a retirement plan is the plan year. For purposes of this notice, a retirement plan is a plan that is qualified under § 401(a) or 403(a) or described in § 403(b) or 408(k).

(b) *Nonretirement plans.* The applica-

ble year for a nonretirement plan is the plan year, as defined in the written plan document or otherwise identified in the Code and regulations. If a nonretirement plan does not have an identified plan year, then the employer may treat either the calendar year or the employer's fiscal year as the applicable year. For purposes of this notice, a nonretirement plan is any employee benefit arrangement to which the definition of HCE is applicable under a provision of the Code, other than a retirement plan.

V. IMPLEMENTATION OF ELECTIONS

(1) *Top-paid group election.* An employer may make a top-paid group election for a determination year. The effect of the top-paid group election is that an employee (who is not a 5-percent owner at any time during the determination year or the look-back year) with compensation in excess of \$80,000 (as adjusted) for the look-back year is an HCE only if the employee was in the top-paid group for the look-back year. A top-paid group election, once made, applies for all subsequent determination years unless changed by the employer.

(2) *Calendar year data election.*

(a) This notice provides a new calendar year data election which 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 § 414(q)(1)(B). A calendar year data election, once made, applies for all subsequent determination years unless changed by the employer.

(b) A calendar year data election made by an employer does not apply in determining whether the employer's employees are HCEs under § 414(q)(1)(A) 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 employer makes a calendar year data election.

(c) 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.

(3) *No separate notification requirement.* Notification or filing with the Internal Revenue Service of a top-paid group election or 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 this notice.

(4) *Cross-references.* Section VI of this notice provides a consistency requirement that applies if an employer maintains more than one plan. Section VII of this notice describes circumstances under which a top-paid group election or calendar year data election, or changes to such elections, may have to be reflected in plan documents.

VI. CONSISTENCY REQUIREMENT FOR ELECTIONS

(1) *Consistency requirement — in general.* Except as provided in section VI(3) and (4), in order to be effective, a top-paid group election made by an employer must apply consistently to the determination years of all plans of the employer that begin with or within the same calendar year. Similarly, except as provided in section VI(3) and (4), in order to be effective, a calendar year data election made by an employer must 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.

(2) *Interaction of top-paid group election and calendar year data election.* 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 also to make the other election. 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 this notice.

(3) *Multiemployer plans.* Satisfaction of the consistency requirement is determined without regard to any multiemployer plans in which the employer participates.

(4) *Transition relief for years prior to 2000.*

(a) *Transition relief for 1997.* The consistency requirement will not apply to determination years beginning with or within the 1997 calendar year. Thus, an employer may make a top-paid group election or a calendar year data election for a plan for a determination year beginning with or within 1997, without regard to whether the employer makes that election for any other plan.

(b) *Transition relief for 1998 and 1999.* For determination years beginning on or after January 1, 1998, and before January 1, 2000, (i) nonretirement plans are not subject to the consistency requirement, and (ii) satisfaction of the consistency requirement with respect to retirement plans is determined without regard to any plans of the employer that are nonretirement plans.

VII. QUALIFIED RETIREMENT PLAN AMENDMENTS FOR HCE DEFINITION

(1) *Qualified plans that must be amended.* If a retirement plan qualified under § 401(a) or 403(a) contains the definition of HCE under § 414(q), as in effect before SBJPA, the plan must be amended to reflect the definition of HCE under § 414(q), as amended by SBJPA. If an employer makes either a top-paid group or 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 or 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 a top-paid group or calendar year data election.

(2) *Amendment date.* Rev. Proc. 97-41, 1997-33 IRB, provides that qualified retirement plans have a remedial amendment period under § 401(b) so that certain plan amendments for SBJPA are not required to be adopted before the last day of the first plan year beginning on or after January 1, 1999 (with a later date for governmental plans). Pursuant to Rev. Proc. 97-41, a plan provision reflecting the definition of HCE is a disqualifying provision and thus any plan amendments to reflect the definition of HCE in § 414(q), as amended by SBJPA, and to reflect any

choices regarding the top-paid group or calendar year data elections, are not required to be made until the end of this remedial amendment period. However, plans must be operated in accordance with the SBJPA changes to the HCE definition in § 414(q) as of the statutory effective date, and plans required to be amended to reflect those changes must be so amended retroactively effective as of that date. In addition, under Rev. Proc. 97-41, 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), and the first date that the plan operated in accordance with those choices (and any such changes).

VIII. OTHER ISSUES RELATING TO DETERMINATION OF HCE STATUS

(1) *Determining HCE status for 1997.* As noted earlier, the amendments made by § 1431 of the SBJPA generally apply to years beginning after December 31, 1996. However, § 1431(d)(1) provides that, in determining whether an employee is an HCE for years beginning in 1997, the amendments to § 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 with or within the 1997 calendar year, 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 with or within the 1996 calendar year. 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 the guidance in this notice. The SBJPA amendments to § 414(q) are not applicable in determining the employer's HCEs for determination years beginning prior to January 1, 1997.

(2) *Highly compensated former employees.* For purposes of determining status as a highly compensated former employee under § 1.414(q)-1T, A-4, whether an employee was a highly compensated active employee for a determination year that ended on or after the em-

ployee's 55th birthday, or that was a separation year, is based on the rules applicable to determining HCE status as in effect for that determination year.

(3) *Determining 5-percent ownership by attribution of ownership interest to family members.* The definition of 5-percent owner in § 414(q)(2) refers to § 416(i)(1), which in turn refers to the attribution rules of § 318. Under the rules of § 318, an individual is considered to own any stock owned directly or indirectly by the individual's spouse, children, grandchildren or parents. Consequently, an employee who is the spouse, child, parent or grandparent ("family member") of an individual who has a 5-percent interest in the employer at any time during the look-back year or the determination year is treated as an HCE under § 414(q)(1)(A), regardless of the family member's compensation level. These statutory provisions relating to the definition of 5-percent owner under § 414(q)(2) are different from the family aggregation rules under former § 414(q)(6) and are unaffected by the repeal of those rules under § 1431(b)(1) of SBJPA.

IX. EXAMPLES

The following examples illustrate the rules in this notice:

Example 1: (a) Employer A has maintained a defined benefit plan qualified under § 401(a) (Plan M) since 1996 with a plan year beginning April 1 and ending March 31. Employer A has never had a 5-percent owner. For Plan M's determination year beginning April 1, 2000 and ending March 31, 2001, Employer A does not make a calendar year data election or a top-paid group election.

(b) Under § 414(q)(1)(B), Employer A determines HCEs for Plan M's determination year beginning April 1, 2000, based upon the compensation of Employer A's employees in Plan M's look-back year. Thus, the HCEs are those employees who had compensation over \$80,000 (as adjusted) during the period beginning April 1, 1999 and ending March 31, 2000.

Example 2: (a) Assume the same facts as in Example 1, except that Employer A hires a new employee, Employee X, on March 1, 2000 at an annual salary of \$240,000. Employee X is not a 5-percent owner during the determination year beginning April 1, 2000 or the look-back

year beginning April 1, 1999. During the month of March, 2000, Employee X's compensation was \$20,000.

(b) Because Employee X's compensation during Plan M's look-back year beginning April 1, 1999 was less than \$80,000 (as adjusted), Employee X is not an HCE for Plan M's determination year beginning April 1, 2000.

Example 3: (a) Employer B has maintained a qualified defined benefit plan (Plan N) since 1996 that has a calendar plan year. Employer B makes a top-paid group election for Plan N's 1998 determination year, which is the 1998 calendar year. Employer B had 15 employees in the 1997 calendar year and has never had a 5-percent owner. These employees, along with their compensation for the 1997 calendar year, are listed below.

| <i>Employees</i> | <i>1997 Compensation</i> |
|------------------|--------------------------|
| 1 | \$200,000 |
| 2 | 110,000 |
| 3 | 101,000 |
| 4 | 90,000 |
| 5-15 | 50,000 or less |

(b) In determining Employer B's HCEs for the calendar year 1998 under the top-paid group election, Plan N's relevant look-back year is the 1997 calendar year. Employer B must determine whether any employee had compensation above \$80,000, and was in the group consisting of the top 20 percent of the employees of Employer B in the 1997 calendar year, when ranked on the basis of compensation from Employer B during the 1997 calendar year.

(c) Employees 1, 2 and 3 comprise the top 20 percent of Employer B's 15 employees for the 1997 calendar year based on compensation from Employer B during the 1997 calendar year. Although Employee 4 had compensation over \$80,000 in the 1997 calendar year, Employee 4 was not in the top-paid group for the 1997 calendar year and is therefore not an HCE for Plan N's 1998 determination year. This will be the case regardless of whether Employees 1, 2 and 3 continue to be employed in the 1998 calendar year.

Example 4: (a) Employer C has a qualified profit sharing plan (Plan O) with a calendar plan year. Employer C also has a qualified defined benefit plan (Plan P) with a plan year beginning April 1 and ending March 31. Employer C makes the

top-paid group election for Plan O for the calendar year 2000.

(b) Pursuant to the consistency rule requiring that the employer make the same election for all determination years of all plans of the employer that begin with or within the same calendar year, Employer C must also make the top-paid group election for Plan P's determination year beginning April 1, 2000 and ending March 31, 2001.

(c) The look-back year for purposes of determining whether any of Employer C's employees is an HCE under Employer C's top-paid group election for Plan O is the 1999 calendar year and for Plan P is the April 1, 1999 to March 31, 2000 year. The group of Employer C's employees that are HCEs for Plan O's 2000 determination year are those employees who had compensation above \$80,000 (as adjusted) and who were in the top 20 percent of employees based on compensation for the 1999 calendar year, while the group of Employer C's employees that are HCEs for Plan P's determination year beginning April 1, 2000 are those employees who had compensation above \$80,000 (as adjusted) and who were in the top 20 percent of employees based upon compensation for Plan P's look-back year beginning April 1, 1999.

Example 5: (a) Since 1998, Employer D has maintained a qualified cash or deferred arrangement under § 401(k) (Plan Q). Plan Q has a calendar plan year. Employer D has never made a calendar year data election or a top-paid group election for Plan Q and has never had a 5-percent owner. Under § 401(k)(3)(A)(ii), as amended by the SBJPA, unless an employer elects to use current year data for all eligible employees, the actual deferral percentage (ADP) test for the plan year is applied by comparing the ADP for all eligible HCEs for the plan year to the ADP for all other eligible employees (non-HCEs) for the preceding plan year. Employer D has not elected to use current year data for the nonHCEs for the 2000 calendar year.

(b) In conducting the ADP test for the 2000 calendar year, Employer D compares the ADP for the 2000 calendar year for the group of employees who had compensation above \$80,000 (as adjusted) for the 1999 calendar year, and who are eligible under the plan for the 2000 calendar

year, with the ADP for the 1999 calendar year for the group of employees who were nonHCEs for the 1999 calendar year and who were eligible under the plan for the 1999 calendar year. Employer D would have previously determined who the HCEs were for the 1999 calendar year, that is, the employees of Employer D who had compensation above \$80,000 (as adjusted) for the 1998 calendar year. The nonHCEs for the 1999 calendar year are those employees who were employees in the 1999 calendar year and who were not determined to be HCEs for the 1999 calendar year.

Example 6: (a) Employer E has maintained a qualified profit sharing plan (Plan R) since 1996 with an April 1 to March 31 plan year. Employer E has also maintained a defined benefit plan (Plan S) since 1996 with an October 1 to September 30 plan year. Employer E decides to make the calendar year data election for determination years of Plan R and Plan S beginning in the 2000 calendar year. Thus, Employer E makes the election for Plan R's determination year beginning April 1, 2000 and ending March 31, 2001, and Plan S's determination year beginning October 1, 2000 and ending September 30, 2001.

(b) The 2000 calendar year begins within Plan R's look-back year beginning April 1, 1999 and ending March 31, 2000, and Plan S's look-back year beginning October 1, 1999 and ending September 30, 2000 and is treated as Employer E's look-back year for both Plans R and S for purposes of determining Employer E's HCEs on the basis of compensation. Thus, in determining HCE status under § 414(q)(1)(B) Employer E determines whether an employee has compensation for the look-back year in excess of \$80,000 (as adjusted), and if applicable, the composition of the top-paid group, on the basis of compensation for the 2000 calendar year.

Example 7: (a) Assume the same facts as in *Example 6*, except that Employer E also maintains Plan T, a qualified defined benefit plan with a calendar plan year. Employer E fails to make the calendar year data election for Plan T.

(b) Because the consistency requirement for the calendar year data election is applied without regard to calendar year plans, the consistency requirement is sat-

isfied regardless of whether Employer E makes a calendar year data election for Plan T.

Example 8: Assume the same facts as in *Example 6*. For Plan R, in determining whether any of Employer E's employees is an HCE on account of being a 5-percent owner, the employee's ownership in Employer E is examined for Plan R's 2000 and 2001 plan years (April 1, 1999 to March 31, 2000, and April 1, 2000 to March 31, 2001). For Plan S, in determining whether any of Employer E's employees is an HCE on account of being a 5-percent owner, the employee's ownership in Employer E is examined for Plan S's 2000 and 2001 plan years (October 1, 1999 to September 30, 2000, and October 1, 2000 to September 30, 2001). This is because the calendar year data election does not apply in determining whether an employee is a 5-percent owner.

Example 9: (a) Employer F maintains Plan U, a defined benefit plan with a calendar year plan year. Employee Y was employed by Employer F since 1990. Employee Y retired at age 65 from employment with Employer F in 1998. Employee Y was an HCE in 1992 under the rules applicable in 1992 to determine HCE status, but was not an HCE in any other year, including 1998.

(b) Because Employee Y was an HCE for a determination year (1992) ending on or after Employee Y's 55th birthday, Employee Y is a highly compensated former employee for determination years beginning after Employee Y's retirement.

X. PAPERWORK REDUCTION ACT

The collection of information contained in this notice has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1550.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collection of information in this notice is in Section VII. This requirement to amend plan documents is necessary to update plan documents to reflect the amended definition of HCE under § 414(q). This information will be used to

determine which employees are HCEs for purposes of determining contributions, benefits, or the availability of other rights or features under the plan. The collection of information is required to obtain a benefit. The likely respondents are businesses or other for-profit institutions, nonprofit institutions, and small businesses or organizations.

The estimated total annual recordkeeping burden is 65,605 hours.

The estimated annual burden per recordkeeper varies from 10 minutes to 30 minutes, depending on individual circumstances, with an estimated average of 18 minutes. The estimated number of recordkeepers is 218,683.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

XI. COMMENTS

This notice 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. However, any additional requirements would be applied prospectively only. The Treasury and the Service invite comments and suggestions regarding procedural issues and the other matters discussed in this notice.

Comments can be addressed to CC:DOM:CORP:R (Notice 97-45), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 97-45), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may transmit comments electronically via the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

DRAFTING INFORMATION

The principal author of this notice is Ingrid Grinde of the Employee Plans Division. For further information regarding this notice, please contact the Employee Plans Division's taxpayer assistance tele-

phone service at (202) 622-6074 or (202) 622-6075, between the hours of 1:30 p.m. and 3:30 p.m. Eastern Time, Monday through Thursday, or Ms. Grinde at (202) 622-6214, or Patricia McDermott of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations) at (202) 622-6030. These are not toll-free numbers.
