COMMENTS CONCERNING THE IDENTIFICATION OF HIGHLY COMPENSATED EMPLOYEES UNDER INTERNAL REVENUE CODE SECTION 414(q) FOLLOWING A MERGER OR OTHER ACQUISITION

The following views are those of the individual members of the Section of Taxation of the American Bar Association who prepared them and do not represent the positions of the American Bar Association or of the Section of Taxation.

The comments were prepared by individual members of the Committee on Employee Benefits of the Section of Taxation. Principal responsibility was exercised by Thomas R. Hoecker and James B. Morse, Jr. Substantial contributions were made by Pamela Baker, Thomas Graves, Leonard Hirsh, Susan Hoffman and Fritz Richter. The comments were reviewed by Diane J. Fuchs, Chair of the Committee, T. David Cowart of the Section’s Committee on Government Submissions and by Stuart M. Lewis, Council Director.

Although members of the Section of Taxation who participated in the preparation of these comments necessarily have clients affected by federal taxation, including the federal tax rules applicable to the subject area addressed by these comments, no such member (or the firm of such member) has been engaged by a client with respect to the specific subject matter of these comments.

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Executive Summary

In Notice 2000-3, the Internal Revenue Service (the “Service”) and the Department of the Treasury (the “Treasury”) requested comment on, among other issues, the types of business combinations in which an individual’s status as a highly compensated employee (“HCE”) or a non-highly compensated employee (“NHCE”) should carry over from the acquired entity (which we will refer to as the “Target”) to the acquiring entity (which we will refer to as the “Acquiror”). The Service and the Treasury also requested comment on “the degree of specificity that is desirable or appropriate in describing these transactions”.1

A literal reading of section 414(q)2 suggests that an individual’s status as a HCE should turn on whether that particular individual is either a 5% owner of the relevant employer during the year in question or the preceding plan year, or earned more than the adjusted compensation limits from the relevant employer for the preceding plan year. Our principal recommendation is that the Service and the Treasury abide by the plain meaning of the statute. Stated differently, we recommend against the attribution of an individual’s HCE status with the Target to the Acquiror.

If the Service and the Treasury conclude that they may and should venture beyond the plain meaning of the statute, we urge the adoption of a very straightforward approach. A simple rule that requires a carry over or attribution of HCE status whenever service with a predecessor must be considered under section 414(a) or in the event of a “stock sale”, or an “asset sale” in which the Acquiror is a “successor employer”, should be adequate to address the situation. The minimal potential for abuse does not warrant a complex regulatory scheme that would defeat the statutory effort to simplify the HCE definition.

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1 Other issues raised by Notice 2000-3 are dealt with in a separate comment prepared by other members of the Employee Benefits Committee of the Section of Taxation of the American Bar Association.
2 All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise specified.
Comment

The determination of an individual’s status as a HCE or a NHCE following a merger, stock sale, asset acquisition or other form of business acquisition or combination (all of which will be referred to below as a “Transaction”) is critical to the proper administration of the Acquiror’s benefit programs. As noted above in the Executive Summary, in Notice 2000-3 the Service and the Treasury requested comment on, among other issues, the types of business combinations in which an individual’s status as a HCE or NHCE should be attributed from the Target to the Acquiror. The Service and the Treasury also requested comment on “the degree of specificity that is desirable or appropriate in describing these transactions”.

I. HCE and NHCE Attribution

A. The Issue

Are there any types of Transactions in which an individual’s status as a HCE or NHCE of the Target should be attributed to the Acquiror?

B. Analysis

As amended by the Small Business Job Protection Act of 1996 (the “SBJPA”), section 414(q)(1) provides, in pertinent part, as follows:

(1) In general. 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 –

(i) had compensation from the employer in excess of $80,000, and

(ii) if the employer elects the application of this clause for such preceding year, was in the top-paid group of employees for such preceding year. (emphasis added)

Under section 414(q), an employee’s status as a HCE is determined by reference to the employee’s ownership of, or the compensation paid to the employee by, “the employer.” In order to remain true to the language of section 414(q), an employee’s status as a HCE of the Target may be attributed or carried over to the Acquiror only if the Target and the Acquiror are somehow considered to be the same “employer” for the relevant year. For example, if the employee’s HCE status is dependent on the employee’s compensation, the Target and the Acquiror must be the same “employer” for the preceding year.

The term “employer,” as used in section 414(q) and other provisions of the Code relating to the administration of qualified plans, generally refers to the entity employing the individual, determined on a controlled group and affiliated service group basis as described in sections
414(b), (c), (m) and (o). Applying sections 414(b), (c), (m) and (o) does not lead to the conclusion that the Target and the Acquiror are to be treated as a single entity or the same entity for periods of time prior to the Transaction. In fact, a combined reading of these sections with section 414(a) leads to the opposite conclusion. If the Acquiror and the Target are to be treated as a single entity or the same entity for periods of time prior to the Transaction, the predecessor service provisions of section 414(a) are superfluous.

Grafting a HCE attribution concept onto the clear language of section 414(q) frustrates the SBJPA simplification effort and is unwarranted in the absence of a compelling need to stem abusive practices, particularly since the attribution or carryover of HCE status will create very significant nondiscrimination testing and compliance issues for employers and plans.

Regardless of the form of the Transaction, locating and understanding the Target’s records becomes an immediate concern if an individual’s status as a HCE with the Target is carried over to the Acquiror. These records are often unavailable, making discrimination testing (including actual deferral percentage and actual contribution percentage testing) of the Acquiror’s benefit programs problematic if not impossible. In the end, the qualified status of the Acquiror’s plans may be in jeopardy. Placing the Acquiror in this unenviable position is inconsistent with the clear and pragmatic public policy in favor of accommodating transactions involving otherwise compliant plans, as reflected in the analogous provisions of section 410(b)(6)(C).

The carryover of HCE status also is not necessary to curb inappropriate practices. Plan sponsors do not engage in business reorganizations to manipulate HCE status. Moreover, the opportunity for aggressive planning following a business reorganization is not any greater or more alluring than the opportunity for aggressive planning when a relatively highly compensated individual is first employed in any other context. In our experience it is the rare employer that

3 The temporary regulations promulgated under section 414(q) of the Code prior to amendment by the SBJPA specifically define “employer” as “the entity employing the employees and includes all other entities aggregated with such employing entity under the aggregation requirements of section 414(b), (c), (m), and (o).” Temp. Treas. Reg. § 1.414(q)-1T, Q&A-6(a).

4 Prior to amendment by the SBJPA, section 414(q) of the Code provided for a somewhat complicated HCE definition. Congress decided that such complexity was unnecessary and amended section 414(q) to ease administrative burdens on plan sponsors. In the House Report for the SBJPA, the change in the law was justified because “the administrative burden on plan sponsors to determine which employees are highly compensated can be significant. The various categories of highly compensated employee require employers to perform a number of calculations that for many employers have largely duplicative results.” 104th Congress; 2nd Sess., House Rpt. 104-586. In substantial part, the amendment achieved simplicity by explicitly eliminating the provision contained in the pre-SBJPA version of section 414(q) that defined HCE status by reference to compensation or ownership “during the year or the preceding year . . . .” See section 414(q)(1) of the Code (prior to amendment by the SBJPA). Thus, after amendment, only compensation paid by the employer during the preceding year is relevant.

5 Consider the case of an employee who, absent any underlying business transaction or reorganization, resigns from one employer and accepts a job with another, unrelated, employer. Clearly, in such a situation, under section 414(q) the employee’s new employer is not required to consider any compensation paid by the former employer for purposes of determining the employee’s HCE status. Regardless of how much money that employee is paid during her first year of employment, she will not be a HCE until she has been paid more than the adjusted compensation limits during the preceding year.
extends extraordinary qualified plan benefits to the newly hired highly compensated individual. We also wonder why an Acquiror would want to be more generous to the highly compensated employees of the vanquished Target than to its own employees.

The potential for abuse also is very short lived. In the typical situation HCE status may be delayed for no more than a year. Other provisions of the Code (e.g., sections 402(g), 415(b), 415(c), and 401(a)(17)) also limit the significance of the potential abusive practices.

C. Recommendation No. 1

We recommend that the Service and the Treasury refrain from requiring attribution of an employee’s HCE status with the Target to the Acquiror. Our suggested approach is straightforward and consistent with the plain meaning of the statute. It also avoids introducing complexity to an area that Congress sought to simplify.

As noted above, in our experience, plan sponsors do not engage in Transactions in order to manipulate HCE status. Nevertheless, if the Service and the Treasury conclude that additional measures are necessary to combat the use of Transactions to avoid or delay HCE status, simple anti-abuse guidance should suffice.

D. Recommendation No. 2

If the Service and the Treasury conclude that they may and should venture beyond the plain meaning of section 414(q), we suggest the use a fairly simple, straightforward rule. The Acquiror should be required to carry over an individual’s HCE or NHCE status from the Target only in the following three instances: (1) service with the Target must be considered as service with the Acquiror for purposes of section 414(a)(1) or, after the issuance of final regulations, section 414(a)(2), and the employee received the requisite amount of compensation; (2) the Transaction is a “stock sale”; or (3) the Transaction is an “asset sale” and the Acquiror is deemed to be a “successor employer” of the Target.6

1. Definitions of “Asset Sale” and “Stock Sale”

Rather than developing new or different definitions of “stock sale”, “asset sale” and “successor employer”, we suggest the use of the definitions applicable for COBRA purposes. Presently, the definitions of “asset sale” and “stock sale” are set forth in Prop. Treas. Reg. § 54.4980B-9, Q&A-1 and the functional definition of “successor employer” is set forth in Prop. Treas. Reg. § 54.4980B-9, Q&A-8(c).7

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6 Prior to the SBPJA, individual members of the Section’s Committee on Employee Benefits filed a comment suggesting a more complex and detailed approach to this issue. We are taking a different tack due to the effort made in the SBPJA to simplify the definition of HCE.

7 If the proposed regulations are modified before being issued in final form, we would recommend using the modified definitions as long as they are similar in scope to the proposed definitions.
If we were working on a clean slate, we might define “stock sale”, “asset sale”, and “successor employer” differently. We also recognize that one might argue that the definitions used for purposes of the COBRA continuation requirements are inappropriate for purposes of identifying the types of Transactions that warrant the attribution of HCE status. Nevertheless, parties to business transactions and reorganizations will need to assess whether the particular Transaction is either a “stock sale” or an “asset sale” and whether the Acquiror is a “successor employer” for purposes of COBRA continuation coverage. It makes little sense and adds unnecessary complexity to use a different set of definitions for HCE attribution purposes.

2. **Identifying the HCEs**

Unless the Acquiror has made the top paid group election available under section 414(q)(1)(B)(ii), a Target employee should be considered to be a HCE of the Acquiror only in the limited situations described above and only if that particular employee was a HCE of the Target. This status attribution or carryover would be utilized by the Acquiror for the year in which the Transaction occurs and, at the option of the Acquiror, for the next year. Any guidance issued by the Service and the Treasury should specifically state that the Acquiror may reasonably rely on good faith representations made by the Target regarding HCE status, compensation and ownership information.

If the Target had not determined an employee’s HCE status or if the Acquiror has made the top paid group election, the Acquiror should be allowed to determine the employee’s HCE status in either of two ways. If the records are available, the Acquiror should be allowed to use the compensation and stock ownership records of the Target for periods of employment prior to the Transaction. If the compensation records are unavailable or if the Acquiror otherwise chooses to do so, the Acquiror should be allowed to construct a compensation history for the employee by projecting the employee’s initial rate of pay from the Acquiror over the appropriate period. For example, the Acquiror would annualize the employee’s initial rate of pay in order to construct the compensation history for the year prior to the year of the Transaction. Of course, the Acquiror should be precluded from engaging in abusive practices, such as artificially reducing an employee’s initial rate of pay only to increase it in the next year.

3. **Limit on Carry Over**

With our Recommendation No. 2, the Acquiror would only be required to track data relevant to an individual’s HCE status, such as compensation and ownership. Other elements of qualified plan participation, such as contributions for purposes of ADP and ACP testing, should not be carried over to or have any impact on the Acquiror’s plans.
II. **Specificity**

A. **The Issue**

How much specificity should be included in the guidance?

B. **Analysis and Recommendation**

As noted above, plan sponsors do not engage in Transactions in an effort to impact HCE determinations and do not provide extra or enhanced qualified plan benefits to newly hired HCE’s that cannot be provided to existing HCEs.

Since Transaction related abuses are neither prevalent nor particularly significant, we do not believe that detailed, complex guidance is necessary. Instead, either no guidance or a simple rule, even one that is broader than we think appropriate (such as one using the “asset sale” and “successor employer” concepts from the COBRA regulations), is preferable to complex guidance trying to cover every conceivable situation.