Executive Summary

This comment responds to the IRS request for comments on Notice 97-45, concerning the definition of highly compensated employee as amended by the Small Business Job Protection Act of 1996. The comment requests a change in the requirements for making the top-paid group election and the calendar year data election, requests a change in the operation of the consistency requirement, and requests some rewording of some potentially confusing wording regarding the calendar year data election for calendar year plans.

Comment

Notice 97-45 provides guidance relating to the definition of highly compensated employee under §414(q) of the Code, as amended by the Small Business Job Protection Act of 1996. The notice provides guidance on how an employer can make the election to determine that an employee is a highly compensated employee because of compensation in excess of $80,000 only if the employee is also one of the highest paid 20 percent of an employer’s workforce (the top-paid group election). The notice also provides guidance on a new calendar year data election that allows employers sponsoring employee benefit plans with fiscal plan years to determine the highly compensated employees using calendar year data. Finally, the notice provides transition relief from certain requirements of the top-paid group election and the calendar year data election.
The notice also provides guidance concerning the plan document and plan amendment requirements for certain plans. If a plan contains a definition of highly compensated employee as one of the plan terms, the notice requires that the plan document language reflect whether the employer has made the top-paid group election or calendar year data elections. Specifically, section VII(1) of the notice indicates that if an employer makes either the top-paid group election or the calendar year election for a determination year, a plan that contains the definition of HCE must reflect the election. If the employer changes either election, the plan must be amended to reflect that change.

Requiring a plan amendment whenever the 20 percent rule election is changed will impose a needless burden on plans to incorporate the election right in the definition of highly compensated employee. Also, as a practical matter, such a plan document requirement will generally impose a greater standard for making or changing an election for some plans instead of others. Many defined benefit plans do not contain a definition of highly compensated employee. Alternatively, most (if not all) §401(k) plans have plan documents that do contain a definition of highly compensated employee (Our experience is that the IRS will not give a determination letter to a §401(k) plan document that does not have a definition of highly compensated employee). Accordingly, it will be easier for sponsors of defined benefit plans to change an election concerning the determination of HCEs that it will be for the sponsors of §401(k) plans. Since many employers sponsor both a defined benefit plan and a §401(k) plan, the notice sets up a potential trap for the unwary by establishing different standards for different plans sponsored by the same employer.

There are several alternative ways to deal with this issue that do not create a different standard for making the election based on whether the plan document contains a definition of highly compensated employee. A plan provision that allows the employer to elect the top-paid group election or the calendar year data election should be sufficient to satisfy the requirement that the plan document contain sufficient provisions to determine the highly compensated employees. On a similar issue, many §401(k) plan documents give the employer the ability to choose the §414(s) definition of compensation that will be used in the ADP test. Such a plan provision satisfies the requirement that the plan document cover the applicable terms without requiring a plan amendment when the employer changes the definition of compensation used in the ADP test. The IRS on determination letter review has not challenged plan documents containing such a provision.

Alternatively, the IRS could allow a plan document to incorporate the definition of highly compensated employee from section 414(q) of the Code by reference, including any elections made by the employer regarding the top-paid group election or the calendar year data election. Again, such a provision would allow the plan to be operated in accordance with its terms, including the nondiscrimination testing that relies on the determination of the highly compensated employees, without requiring a plan amendment whenever an election is changed by an employer.

It is our understanding that the IRS added the plan amendment requirement in order to enforce the consistency requirement established by Section VI(2). While having a consistent election is clearly desirable, it is unclear how the plan amendment requirement
will ensure this result. It is even possible that the plan amendment requirement can result in a situation at odds with the consistency requirement. For example, an employer with separate divisions maintaining separate plans could amend one plan to incorporate the top paid group election and fail to amend the other plan. Such a situation appears to force the IRS to choose between enforcing the consistency requirement of Section VI(1) and the plan amendment requirement of Section VII(1). A plan provision that allows the employer to elect the top-paid group election or the calendar year election, for example, would still have to satisfy the consistency election for any such election by the employer.

Another issue in the notice concerns Section VI(1), which requires that "a calendar year data election apply consistently to the determination year of plans of the employer, other than a plan with a calendar year determination year, that begin within the same calendar year." Combined with Section V(2), which indicates that a fiscal year plan will determine HCEs based on data from the calendar year beginning within the look-back year, these requirements actually create inconsistency for an employer sponsoring calendar year plans and fiscal year plans. The fiscal year plans will all be looking to the calendar year that is subsequent to the year the calendar year plan is looking.

For example, assume an employer sponsors a calendar year plan and a plan with a June 1 to May 31 plan year. If the employer makes the calendar year data election for determination years beginning in 1998, the two plans will use data from different calendar years. The plan year beginning June 1, 1998 will use data from the calendar year (1998) beginning within the look-back year (i.e., June 1, 1997 to May 31, 1998) to determine HCEs, while the 1998 calendar year plan will determine HCEs based on 1997 data.

Alternatively, if the Section V(3) consistency requirement required that "a calendar year election made by an employer must apply consistently to the determination years of all plans of the employer that end in the same calendar year," then the inconsistency would be resolved. Both the 1998 calendar plan year and the plan year ending May 31, 1998 would use calendar 1997 data to determine HCEs. Note that this suggested change does not change the calendar year that any fiscal year plan looks to for data. It simply changes which plan years are grouped together for the consistency requirement so that all such plans use data from the same calendar year for determining HCEs. In other words, the June 1, 1997 to May 31, 1998 plan year will be grouped with the 1998 calendar year plan for purposes of the consistency requirement, rather than grouping the June 1, 1998 to May 31, 1999 plan year with the 1998 calendar year. Similar changes are also suggested for the top paid group consistency requirement.

Finally, there is some confusion created by the notice on the effect of a calendar year election on a calendar year plan. As the notice reads, it is unclear in some parts of the notice whether a calendar year plan can make a calendar year data election or whether it is even necessary. For example, Notice 97-45, section V(3) indicates that "a calendar year data election would have no effect on the HCE determination for a calendar year plan." It would not be incorrect, and potentially more clear for employers and their advisors to indicate that the calendar year data election is inapplicable for calendar year plans.

Section VI (1) indicates that "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." [Emphasis added.] The reference to plans with a calendar year determination year could be read to require that such plans must make a calendar year election, but that it will not apply. Additionally, two of the examples contain confusing phrasing concerning the calendar year data election and calendar year plans. Section IX, Example 5 indicates that "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." In fact, a calendar year data election would have no effect on Plan Q since it has a calendar plan year. Example 7 indicates in paragraph (a) that "Employer E fails to make the calendar plan year election for Plan T," a calendar year defined benefit plan. Though the example clearly indicates that the consistency requirement is met for the non-calendar year plans of Employer E that have made the calendar year data election, the use of the words "fails" implies the calendar year data election could or should have been made for Plan T.

There are several alternatives for clarifying the applicability of a calendar year data election for a calendar year plan. An alternative phrasing for section VI (1) would be to delete the emphasized phrase from the sentence and add an additional sentence at the end of the section to the effect that plans with a calendar determination year will already be determining HCEs on a consistent basis with plans that make the calendar year data election. Suggested alternative wording for Example 5 would be to simply remove the reference to the calendar year data election. If it has been clearly indicated earlier in the document that the election is inapplicable to calendar year plans, there is no need to mention it in the example. Alternatively, a comment to that effect can be made. For Example 7, the second sentence can be replaced with a comment that the calendar year data election is inapplicable to Plan T.

These suggestions regarding the phrasing of the notice with regard to the calendar year data election are merely suggestions. It is important, however, to clarify the treatment of calendar year plans.