Step-by-Step Approach for

IDENTIFYING HIGHLY COMPENSATED INDIVIDUALS & PARTICIPANTS

For Purposes of the Eligibility and C&B Tests under Code §125

STEP 1

Determine Who the Employer Is and Which Employees Must Be Counted. Apply the controlled group rules and affiliated service group rules to determine which entities must be aggregated and treated as a single employer. List all employees of the aggregated entities for the preceding plan year. Include leased employees, unless the exception for safe harbor plans sponsored by the leasing organization applies. Do not include nonresident aliens with no U.S. source income.

STEP 2

Determine Each Employee's Compensation for the Preceding Plan Year. This includes total compensation from the employer. This definition includes salary deferral and salary reduction amounts under a 401(k) plan, a cafeteria plan, a qualified transportation benefit plan, a SARSEP, a SIMPLE plan, a Code §403(b) tax-sheltered annuity, and a Code §457 plan—so add those amounts back in.

STEP 3

Identify the Employees With Excess Compensation for the Preceding Year. Did any employee receive compensation in excess of the applicable dollar threshold in the preceding plan year or, if the employer has a fiscal-year plan and makes the calendar-year data election, in the calendar year beginning in the prior plan year? If so, then the employee is highly compensated for the current year. Apply the compensation threshold that corresponds to the year for which compensation is considered.

STEP 4

Identify the Employees in Their First Year of Employment With Excess Compensation for the Current Year. Repeat Steps 1, 2, and 3 for employees in their first year of employment, using compensation for the current year and the corresponding compensation threshold, to determine whether any of these employees are highly compensated for the current year.

STEP 5

Determine the Number of Employees in the Top-Paid Group. After determining who is highly compensated under Steps 3 and 4, assess whether the top-paid group election would alter the result. Begin by determining the number of employees in the top-paid group. Using the Step 1 list of all employees, add the names of employees in their first year of employment (see Step 4). Then strike the names of employees who:

- have not completed six months of service;
- normally work less than 17-1/2 hours per week;
- normally work during not more than six months during any year;
- have not attained age 21; or
- are employees who are covered by a collective bargaining agreement (this exclusion applies only if at least 90% of all employees are covered by a collective bargaining agreement, and the plan being tested covers only nonunion employees).

The first four exclusions may be modified or eliminated; the fifth exclusion may be eliminated. Multiply the number of remaining employees by 20%; the resulting figure is the "20% number."

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STEP 6

Determine Which Employees Are in the Top-Paid Group. Next, list all employees in order of descending compensation—i.e., the highest paid to the lowest paid. Include the employees that were excluded in Step 5, except the employees excluded under the collective bargaining exclusion. (Use compensation for the preceding plan year unless the employee is in his or her first year of employment, in which case compensation for the current year should be used.) Stop after listing the number of employees that corresponds to the "20% number." These employees belong to the top-paid group.

STEP 7

Identify the Highly Compensated. If the top-paid group approach is helpful (i.e., if it reduces the number of highly compensated individuals/participants and that improves testing results), then the employer should consider making the top-paid group election, subject to the restrictions about consistency across all plans and the need to make plan amendments, as discussed earlier. Those who are highly compensated for the period will have compensation exceeding the applicable dollar threshold and will be in the top-paid group (if so elected).

STEP 8

(Highly Compensated Individuals and Participants Under Code §125): Add the More-Than-5% Shareholders, Officers, and Spouses and Dependents to Those Exceeding the Compensation Threshold. Determine whether there are any more-than-5% shareholders during the current or preceding year. If so, then those individuals must be included as highly compensated individuals/participants. Also add all those who were officers during the preceding year, or in the current year in the case of an individual's first year of employment. Finally, the spouses and dependents of those exceeding the compensation threshold, of more-than-5% shareholders, or of officers, must be included.

By completing Steps 1–8, you have identified the highly compensated individuals and participants for Code §125(b)(1) testing.

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