WATKINS ROSS

Highly Compensated Employees (HCEs)

What is a Highly Compensated Employee?

The IRS defines a Highly Compensated Employee (HCE) as:

- An owner of more than 5% of the company in the current or preceding plan year, regardless of how much compensation that person earned or received. Family attribution rules treat a spouse, child, parent or grandparent of someone who is a 5% owner as an HCE, regardless of that individual's compensation or ownership.

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- For the preceding plan year (also referred to as prior year or look-back year), received compensation from the company of more than $130,000 in 2020. The IRS adjusts the compensation limit annually for cost-of-living increases.

How does being a HCE affect me?

If you are a HCE, you may be limited in the amount you can contribute to your 401(k) plan. Your plan contact may be able to provide you some insight as to what that limit will be for the current plan year.

How do HCE's affect retirement plans?

In order to ensure a 401(k) plan is not favoring owners or highly paid employees, the IRS requires that certain nondiscrimination testing is performed. The Actual Deferral Percentage Test (ADP) measures the employee deferral contributions and the Actual Contribution Percentage Test (ACP) measures the employer matching contributions. ADP/ACP testing must be completed annually.

To run an ADP/ACP test, each eligible participant's total contribution is divided by his compensation to determine a contribution rate. The individual contribution ratios are then averaged for the separate HCE and NHCE groups. The ADP test does not include catch-up contributions.

In order to pass the tests, the HCE average contributions (deferrals or match) must be within a certain percentage of the average contributions of the NHCEs (usually within 2%). If the HCE group exceeds this limit, there may be refunds required per IRS rules. You will be notified next year if a refund will be issued to you.