Can We Reduce the Number of HCEs in our Plan?

Facts

We set up our company 401(k) plan soon after we started our business. At the time, we were a small tech company with only a couple of employees. Over the years the company has grown exponentially, and business has been good to us…really good.

Because of this, the demographics of our company have changed completely. We have too many of our people who are highly compensated employee (HCEs), and it is causing havoc with our nondiscrimination testing. Last year, some employees had to take corrective distributions of their deferrals due to failing the ADP test for the first time.

Question

IIs it possible to reduce the number of HCEs that we have in our plan?

Answer

The short answer is “yes” but just because you can does not mean you should.

As a quick review, an employee is an HCE for a given year if he or she meets either of the two following criteria:

- He or she owns more than 5% of your company at any time during the year in question or the immediately preceding year; or
- He or she received compensation from you in excess of the IRS-specified limit ($120,000 for 2018 and $125,000 for 2019) in the immediately preceding year.

Based on your question, it sounds like your over-abundance of HCEs is based on that second criteria, and that is where you have the ability to take action. There is an election, called the Top Paid Group (or TPG) election. It allows you to amend your plan to limit the number of HCEs by compensation to only those who are in the top 20% of all your employees, ranked by compensation.

The overall employee count must be adjusted to remove certain short-service and/or terminated employees, but once that is done, it is a simple matter of multiplying that count by 20% and rounding up. That is the maximum number of employees who can be HCE based on compensation. Note that if a 5% owner is not in the TPG, he or she is still HCE based on ownership even though not based on compensation.

Sounds like the perfect solution, right? Well, not always. Before jumping in with both feet, it is important to look at exactly which employees will be bumped into the non-HCE category based on the election.

Recall that the ADP (and most nondiscrimination tests for that matter) compare the average contribution rates of the non-HCEs to those of the HCEs. If the HCE average exceeds the non-HCE average by more than the allowable threshold, the test fails and must be corrected.

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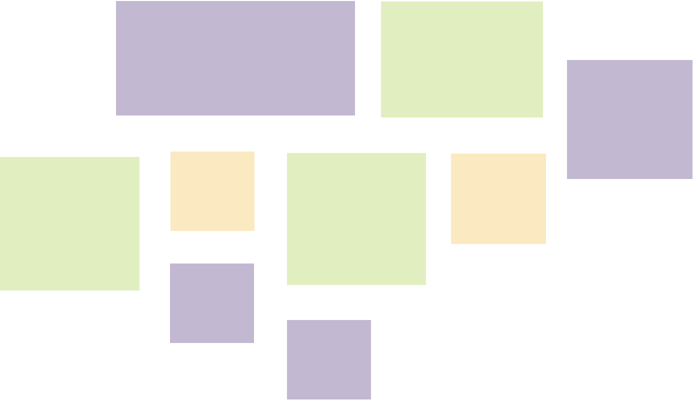

Let's say that Tom is one of your lower-paid HCEs and is not deferring. That helps your ADP test, because it reduces the overall average of the HCE group. If the TPG election bumps Tom into the non-HCE group, the HCE average increases while the non-HCE average decreases, which is exactly the opposite of what you want. Regardless of whether or not the TPG election makes sense for you this year, it is a good idea to monitor ongoing compensation and contribution rates, as any changes could make the TPG election either more or less beneficial from one year to the next.

If you think that the Top Paid Group election could be beneficial and would like a review of your individual plan, please give us a call or send us an email, we'd be more than happy to take a look. If this election turns out to be a good choice for your plan, the deadline to adopt an amendment implementing the change is the last day of the plan in which you want it to be effective.

For more information on highly compensated employees and nondiscrimination testing, please visit our Knowledge Center here and here.

Related Resources

- Nondiscrimination Testing Overview
- Nondiscrimination Testing: ADP & ACP Tests
- Who are Highly Compensated & Key Employees?
- 401(k) Q&A Blog Archive: HCEs

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