



# How Do We Identify HCEs for the First Year our Company Exists?

## Facts

We established our company on February 1st of this year, and now we are planning to launch our 401(k) plan. We know there are number of tests and determinations that require us to look at company history, but as a new company, we don't really have much of a history to look at.

## Question

As a brand-new company with no prior year information to consider, how do we determine who our highly compensated employees are? What about other tests and determinations?

## Answer

Great question. Fortunately, the IRS rules do not require jumping through too many hoops here. You hit one of the main points – highly compensated employees – so we will start there.

## Highly Compensated Employees (HCEs)

Under the basic definition, an **HCE** is anyone who meets either of two criteria:

- He or she owns more than 5% of the company at any point during the current year or the immediately preceding year, or
- He or she had compensation from the company that exceeded the applicable dollar limit (\$125,000 for 2019, indexed for inflation) in the immediately preceding year.

Since you just established your company this year, there is no immediately preceding year to consider. That means the only individuals who could be considered HCEs for this first year are those who own more than 5% of the company at any point during the year.

We should note that the compensation threshold noted above is absolute in that it is not pro-rated. We only mention this, because it can be a question when you are trying to make HCE determinations in year two based on compensation paid in year one. Even though the company only had 11 months in its first year (February 1 – December 31), you would still use the full \$125,000 (as indexed for inflation) rather than pro-rating it.

One additional variation on the theme (even though you didn't specifically ask): Rather than starting the company on February 1<sup>st</sup> of this year, let's assume you started it on December 1<sup>st</sup> of last year. In that case, there is now a look-back year to consider. For the ownership component, anyone who earned more than 5% of the company at any time during that one month of last year would be HCE. For the compensation component, we would still apply the full \$125,000 threshold even though there the company was only in business for one month in the prior year.



## ADP/ACP Testing

The [ADP and ACP tests](#) are required each year to ensure a plan does not discriminate in favor of HCEs with respect to deferrals and matching contributions. The HCE contributions for the current year are limited based on the non-HCE contributions. Without going too far into the weeds on how those tests work, one option is to base the current year HCE limitation on non-HCE contributions made in the immediately previous year. Obviously, a brand new plan will not have any prior year contributions on which to base the test. In those situations, the IRS says to assume a prior year non-HCE average contribution rate of 3%.

## Key Employees

[Key employees](#) are generally the owners and officers of the company. Similar to determining who the HCEs are, identification of key employees includes both an ownership test and a compensation test. However, when it comes to key employees, we only look to the 12-month period that ends on the last day of the current plan year. Again, the ownership tests pick up anyone who met the applicable thresholds at any time during the year, and the dollar limits that apply to the compensation test are not pro-rated if the company was not in existence for that full 12-month period.

## Top Heavy Determination

The [top heavy determination](#) compares the accumulated account balances of all key employees to the overall total plan assets. If the key employee balances exceed 60% of the total as of the last day of the previous year, then the plan is top heavy for the current year. What happens when there is no plan in the prior year? The rules dictate that for a brand-new plan, the last day of the first year is the date used to determine whether the plan is top heavy for both the first and second plan years. So, in this situation with you starting the plan this year, if the aggregate account balances for the key employees exceeds 60% of the overall total on December 31<sup>st</sup> of this year, the plan will be considered top heavy for both this year and next year.

We know that all of this can get a bit convoluted. That's where we come in. If you have any questions about how the timing of starting your company and/or your plan might impact any of these important determinations, give us a call. We are glad to gather the facts and walk through the situation with you.

## Related Resources

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■ [DWC 401\(k\) Q&A Topic Archive: Highly Compensated Employees](#)



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