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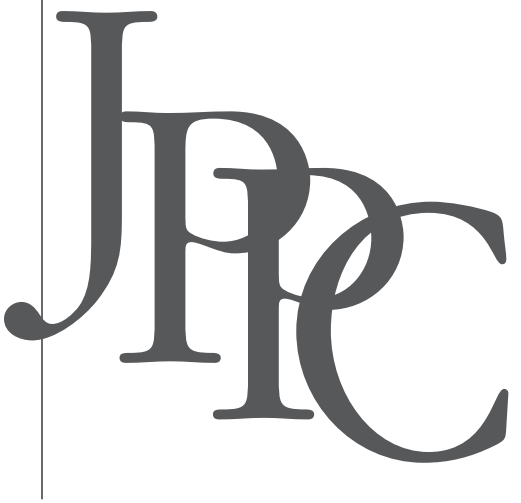

Topping the Top 25 Highly Compensated Employee Lump-Sum Restrictions

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INTRODUCTION

The nondiscrimination regulations under Internal Revenue Code (Code) section 401(a)(4) impose restrictions on the amount a defined benefit plan[1] can pay prior to termination of the plan as a lump sum or any other form of distribution to certain highly compensated employees.[2] This article describes those restrictions and alternatives that can permit payment in excess of the restrictions, and attempts to clarify certain aspects of the restrictions based on the Code, regulations, private letter rulings and informal guidance from the Internal Revenue Service (IRS) and Department of Treasury (Treasury).[3]

BENEFIT PAYMENT RESTRICTIONS

The payment of benefits[4] to, or on behalf of, a *restricted employee* (as defined below) in any year from a defined benefit plan[5] generally must not exceed an amount equal to the payments that would be made to, or on behalf of, the restricted employee during that year in the form of—

- A straight life annuity that is the actuarial equivalent of the accrued benefit and other benefits to which the restricted employee is entitled under the plan (other than a social security supplement); and

- A social security supplement, if any, that the restricted employee is entitled to receive.[6]

The amount that can be paid under the above restrictions is referred to as the *unrestricted amount* and the amount exceeding the unrestricted amount is referred to as the *restricted amount*.

Payment Form

A restricted employee can elect a lump sum or other form of payment offered under the plan, but the amount actually paid must be limited to the above unrestricted amount unless and until the employee is no longer a restricted employee or one of the regulatory exceptions to the restrictions (described below) applies.[7] Contrariwise, if benefit payments commence to a participant, either because the participant is not a restricted employee or one of the regulatory exceptions to the restrictions applies, the restrictions would apply to any benefits that have not yet been distributed if and when none of the regulatory exceptions apply and the participant is a restricted employee.[8]

Impact of Death or a QDRO on Benefit Payment Restrictions

If a restricted employee dies, the restrictions continue to apply to the employee's beneficiary until the employee is no longer a restricted employee or one of the regulatory exceptions to the restrictions applies, because the restrictions apply to "benefits to or on behalf of a restricted employee. . . ."[9] For the same reason, the restrictions apply on a pro-rated basis to the restricted employee and alternate payee under a qualified domestic relations order (QDRO).[10]

Rollover Eligibility

Even if the restricted employee elects a lump sum (or other rollover eligible form of distribution), payment of the unrestricted amount as an annuity in accordance with the benefit payment restrictions is not rollover eligible.[11] If and when the benefit payment restrictions are lifted, the remaining lump sum, including interest at the rate used to determine the lump sum, would generally be eligible for rollover (unless not otherwise rollover eligible, such as a required minimum distribution amount).[12] Note, however, it may be possible to roll over the entire amount, including both the restricted and unrestricted amounts, if repayment to the plan is secured as described toward the end of this article.

REGULATORY EXCEPTIONS TO BENEFIT PAYMENT RESTRICTIONS

The regulations provide that the benefit payment restrictions described above do not apply if any one of the following three requirements are met:[13]

1. The value of plan assets is at least 110 percent of the value of current liabilities after taking into account payment to, or on behalf of, the restricted employee of all benefits payable to, or on behalf of, the restricted employee;
2. The value of benefits payable to, or on behalf of, the restricted employee is less than one percent of the value of current liabilities before distribution of the benefits; or
3. The value of benefits payable to, or on behalf of, the restricted employee is not more than the largest involuntary cashout amount permitted (currently $5,000) under Code Section 411(a)(11)(A).

Effect of Funding Rule Changes

After enactment of the Pension Protection Act of 2006 (PPA), practitioners wondered how the significant funding rule changes

required by PPA would affect the regulatory exceptions to the benefit payment restrictions. For purposes of the pretermination restrictions, "any reasonable and consistent method may be used for determining the value of current liabilities and the value of plan assets."[14] Until additional formal guidance is issued, it would be reasonable to continue to use a method consistent with prior practice (*i.e.*, a current liability type approach) or to replace current liability with the "funding target" concept introduced by PPA.[15] It also would be reasonable to use the Moving Ahead for Progress in the 21st Century Act (MAP-21) segment rates (reflecting stabilization) after MAP-21 became effective or continue using pre-MAP-21 segment rates (without stabilization).[16] A similar interpretation would be reasonable for changes to the segment rates under the Highway and Transportation Funding Act of 2014 (HATFA) and, presumably, the Bipartisan Budget Act of 2015 (BBA-2015).[17]

RESTRICTED EMPLOYEE

The regulations define *restricted employee* generally to mean any highly compensated or former highly compensated employee. However, a highly compensated employee or former highly compensated employee need not be treated as a restricted employee in the current year if not one of the 25 nonexcludable employees and former employees of the employer having the largest amount of compensation in the current or any prior year.[18] If enough other nonexcludable employees subsequently have years of compensation exceeding a restricted employee's highest year of compensation, the restricted employee will eventually move out of the top 25.

A *former highly compensated employee* (former HCE) is a former employee who was a highly compensated employee of the employer, either at separation from service or after having attained age 55.[19] An individual who ceases performing services as an employee for an employer during a plan year is both an employee and a former employee for the plan year.[20] Thus, an employee who is an HCE for the plan year in which the employee terminates employment is also a former HCE for that plan year.[21]

Employer

Restricted employees are determined on a controlled group (or affiliated service group) basis, because *employer* is defined as "the employer maintaining the plan and those employers required to be aggregated with the employer under sections 414(b), (c), (m), or (o)" for purposes of both the nondiscrimination regulations, which includes

the pretermination restrictions, and the regulations under Code section 414(q) for determining highly compensated employees.[22] As noted in the discussion of qualified separate lines of business (QSLOBs) below, this is true even if an employer is treated as operating QSLOBs for purposes of coverage and nondiscrimination testing.[23]

Multiple Employer Plan

In the case of a multiple employer plan, the restrictions apply separately with respect to each employer (controlled group) participating in the plan rather than with respect to the 25 most highly compensated employees participating in the multiple employer plan.[24] Even though restricted employees are determined separately with respect to each employer participating in a multiple employer plan, the determination of whether the regulatory exceptions to the benefit payment restrictions (described above) apply is based on the multiple employer plan as a single plan within the meaning of Code section 414(l) when there are no separate asset pools and all assets of the plan are available on an ongoing basis to pay benefits to employees who are covered by the plan and their beneficiaries.[25]

Highly Compensated Employee

Code section 414(q) defines highly compensated employee (HCE) generally as any employee who—

- Was a 5-percent owner of the employer, as defined by Code section 416(i)(1), at any time during the year or the preceding year; or

- Had compensation, within the meaning of Code section 415(c)(3), exceeding the adjusted dollar threshold for the preceding year ($120,000 in 2018 for determining HCEs in 2019).

An employer may elect to limit who are HCEs for a particular year to employees in the group consisting of the top 20 percent of employees of the employer when ranked based on compensation paid during such year.[26]

The definition of highly compensated employee for purposes of the nondiscrimination regulations is "a highly compensated employee as defined in § 1.410(b)-9 who benefits under the plan for the plan year (within the meaning of § 1.410(b)-3)."[27] Treasury Regulation section 1.410(b)-9 defines HCE as an employee who is an HCE as defined by Code section 414(q). Subject to certain limited exceptions, an employee

is treated as benefiting under a defined benefit plan for a plan year if and only if for that plan year the employee has an increase in accrued benefits.[28] Therefore, a literal reading of the definition of HCE for purposes of determining restricted employees is an HCE as defined by code Section 414(f), but only one who benefits under the plan for the plan year.

At least one practitioner has suggested that such a literal reading of the definition of highly compensated employee for purposes of the nondiscrimination regulations could permit an unrestricted payment in a plan year during which an otherwise restricted employee terminated employment, provided the employee did not benefit under the plan for that plan year. However, as noted above, the regulations indicate that, with respect to the plan for the plan year of employment termination, the employee is both an HCE who did not benefit and a former HCE. The nondiscrimination regulations do not include benefiting under the plan for the plan year as part of the definition of former HCE.[29] Assuming this to be a correct interpretation of the regulations, the employee is a restricted employee as a former HCE for that plan year, even if not benefiting as an HCE for the plan year.

Even so, it is not clear that the definition of HCE provided in the nondiscrimination testing regulations is the intended definition for purposes of determining restricted employees, as it could produce somewhat erratic results. Under that HCE definition, a restricted employee who failed to accrue a benefit in a single plan year would drop out of the list of 25 restricted employees and a different HCE or a former HCE would be added to the list for that year only. Also based on that definition, one of the most highly paid employees of the employer who never participated in the plan (*i.e.*, never benefited under the plan) would not be a restricted employee until that employee terminated employment and become a former HCE. Taking this thought a step further, suppose Participants A and B are an employer's two most highly paid employees. Participant A participates in the employer's defined benefit plan X, but never participates in the employer's plan Y, and Participant B participates in the employer's defined benefit plan Y, but never participates in the employer's plan X. Based on a literal read of the HCE definition provided in Treasury Regulation section 1.401(a)(4)-12, Participant A would not be an HCE or a restricted employee with respect to Plan Y and Participant B would not be an HCE or a restricted employee with respect to Plan X, because neither A nor B benefit under the plan covering the other during any plan year in which the determination of restricted employees is made. Thus, it seems that restricted employees under this literal reading would be determined with respect to the plans rather than the employer, at least until they terminate employment and become former HCEs. When Participant A becomes a former

HCE, Participant A becomes a restricted employee with respect to both Plans X and Y. The same happens to Participant B when Participant B becomes a former HCE. Presumably, such results were not the intention of the pretermination restriction regulations.

It would be more consistent in practice, and more consistent with the available guidance from IRS and Treasury that determination of the group of restricted employees be made with respect to the employer rather than a plan, for the applicable definition of HCE to be the definition of HCE under Code section 414(q) without requiring the HCE benefit under the plan for the plan year. For purposes of benefits amount testing (*i.e.*, testing increases in accrued benefits) under the nondiscrimination testing regulations (as opposed the coverage testing regulations under Code section 410(b)), it makes sense to only consider those employees who are benefiting under the plan being tested.[30] However, the pretermination restrictions are concerned with *distributions* that discriminate in favor of HCEs rather than benefit increases that discriminate in favor of HCEs.[31]

One potential argument exists in favor of using a literal interpretation of the definition of HCE in the nondiscrimination testing regulations for purposes of determining who are restricted employees. By excluding those active employees who never participate in a plan, the pretermination restrictions might arguably better protect against discrimination in favor of highly compensated participants under a plan when the regulatory exceptions to the benefit payment restrictions (described above) do not apply due to the funding of the plan relative to the payment to the restricted employee. Those HCEs without a benefit under the plan would not be considered in determining the 25 restricted employees until they became former HCEs. For example, consider an employer which sponsors two defined benefit plans and, to make the example simpler, suppose there are no former HCEs to consider. Further suppose that the 25 highest paid employees (all of whom are HCEs under Code section 414(q)) each participate in Plan A and the next highest paid HCE (Participant P) participates in Plan B. If the definition of HCE under Code section 414(q) is applied rather than the definition of HCE in the nondiscrimination testing regulations, Participant P is not a restricted employee and can receive a lump sum even if Plan B is poorly funded and the regulatory exceptions to benefit payment restrictions do not apply with respect to Plan B. But if a literal interpretation of the definition of HCE in the nondiscrimination testing regulations is applied, none of the 25 highest paid employees who participate in Plan A are restricted employees with respect to Plan B, but Participant P would be a restricted employee with respect to Plan B and would not receive a lump sum distribution if the regulatory exceptions to benefit payment restrictions do not apply

with respect to Plan B. Of course, if there were 25 former HCEs of the employer with greater compensation than Participant P, the pretermination benefit restrictions would not apply to Participant P in either case, even if the regulatory exceptions to benefit payment restrictions do not apply with respect to Plan B. The dichotomy in treatment of HCEs and former HCEs in determining restricted employees when using a literal interpretation of the definition of HCE in the nondiscrimination testing regulations seems unintentional.[32]

Nonexcludable Employee

A highly compensated employee or former highly compensated employee need not be treated as a restricted employee in the current year if not one of the 25 *nonexcludable*[33] employees and former employees of the employer having the largest amount of compensation in the current or any prior year.[34] A nonexcludable employee[35] is—

- An individual who performs services for the employer who is either a common law employee of the employer;

- A self-employed individual who is treated as an employee pursuant to Code section 401(c)(1); or

- A leased employee (not excluded under Code section 414(n)(5)) who is treated as an employee of the employer under Code section 414(n)(2) or 414(o)(2);

other than an employee who is excludable with respect to the plan as determined under Treasury Regulation section 1.410(b)-6. A nonexcludable employee may be either a highly or nonhighly compensated nonexcludable employee, depending on the nonexcludable employee's status under Code section 414(q).[36]

Unless otherwise provided, this definition governs in applying the nondiscrimination regulations under Code section 401(a)(4).[37] Treasury Regulation section 1.401(a)(4)-1(c)(4)(iv) states that "Except as otherwise specifically provided, references to satisfying section 410(b) in §§ 1.401(a)(4)-1 through 1.401(a)(4)-13 mean satisfying § 1.410(b)-2 (taking into account any special rules available in satisfying that section, other than the permissive aggregation rules of § 1.410(b)-7(d))." The only reference to satisfying Code section 410(b) in the pretermination restrictions is that the restrictions apply to a plan within the meaning of Treasury Regulation section 1.410(b)-7(b), *i.e.*, a Code section 414(l) plan.[38]

Excludable Employee

Treasury Regulation section 1.410(b)-6 lists the following as excludable employees but, as explained below, not all of these are necessarily excludable employees for purposes of determining who are restricted employees:

(a) Employees of a qualified separate line of business (QSLOB);
(b) Employees of certain governmental or tax-exempt entities;
(c) Employees who do not satisfy minimum age and service conditions;
(d) Eligible employees who terminate midyear without enough service to accrue a benefit;
(e) Employees who are nonresident aliens with no U.S. source income from the employer;
(f) Collectively bargained employees;
(g) Former employees previously excludable or who terminated before a specified date; and
(h) Former nonhighly compensated employees treated as employees.

There is little explicit guidance, either formal or informal, as to whether most of the above-listed excludable employees are excludable for purposes of determining who are restricted employees and how the rules for each group of excludable employees would apply for purposes of determining who are restricted employees.

Employees of a QSLOB

Because employees of a QSLOB are listed as excludable for purposes of the nondiscrimination testing regulations, some practitioners have concluded that they are excludable for purposes of determining who are restricted employees, *i.e.*, that restricted employees can be determined for each QSLOB independently of other QSLOBs.[39] However, in private letter ruling (PLR) 200248029, the IRS stated that, although the regulations under Code section 401(a)(4) must generally be satisfied on a QSLOB by QSLOB basis if a QSLOB election is made, the determination of restricted employees "is not made on a QSLOB basis, but rather is made taking into account all current and former employees of the employer."[40] The QSLOB regulations say that an employer operating QSLOBs can apply certain requirements of the Code "separately with respect to the employees of each qualified separate line of business" such as "the minimum coverage requirements of section 410(b) (including the nondiscrimination requirements of Code section 401(a)(4)). . . ."[41] However, the pretermination restriction regulation states that the definition of restricted employee generally includes any HCE or former HCE

and specifically provides for an employer-wide exclusion that "an HCE or former HCE need not be treated as a restricted employee in the current year if the HCE or former HCE is not one of the 25 (or larger number chosen by the employer) nonexcludable employees and former employees *of the employer* with the largest amount of compensation in the current or any prior year." [Emphasis added.] The connection of the requirements of 401(a)(4) with QSLOBs is through Code section 410(b) requirements for testing purposes,[42] and the pretermination restrictions have no connection to Code section 410(b) testing requirements other than that the restrictions apply to a plan within the meaning of Treasury Regulation section 1.410(b)-7(b), *i.e.*, a Code section 414(l) plan.

Employees of Certain Governmental or Tax-Exempt Entities

Treasury Regulation section 1.410(b)-6(g) provides that employees of certain governmental and tax-exempt entities may be treated as excludable for purposes of testing either a Code section 401(k) plan or a Code section 401(m) plan that is provided under the same general arrangement as a Code section 401(k) plan. Because these employees are excludable only for purposes of testing a Code section 401(k) or 401(m) plan and not for purposes of testing a defined benefit plan, presumably they would not be excludable employees for purposes of determining who are restricted employees under the pretermination restrictions applicable only to defined benefit plans. Whether Code section 401(a)(4) applies to a governmental *plan* is a different matter.[43]

Employees Who Do Not Satisfy Minimum Age and Service Conditions

Treasury Regulation section 1.410(b)-6(b) provides, in general, that, "If a plan applies minimum age and service eligibility conditions permissible under section 410(a)(1) and excludes all employees who do not meet those conditions from benefiting under the plan, then all employees who fail to satisfy those conditions are excludable employees with respect to that plan. An employee is treated as meeting the age and service requirements on the date that any employee with the same age and service (including service permitted to be taken into account for purposes of nondiscrimination testing under § 1.401(a)(4)-11(d)(3) would be eligible to commence participant in the plan, as provided in section 410(b)(4)(C)." Although the available guidance is not clear, presumably this exclusion is not applicable, because the determination of restricted employees is based on HCEs and former HCEs across the entire controlled group and not whether they met the service requirements to participate in a plan. Even though perhaps not a common occurrence, it is possible for an employee to be an HCE yet not satisfy the minimum age

and service eligibility conditions permissible under section 410(a)(1). The employee might be a 5-percent owner in a year prior to meeting the required age and service conditions or have sufficient compensation in a prior year to be an HCE but not have enough hours to enter the plan the following year (or six-month delayed entry date).[44]

Eligible Employees Who Terminate Midyear Without Enough Service to Accrue a Benefit

Treasury Regulation section 1.410(b)-6(f) provides that an employee may be treated as an excludable employee for a plan year with respect to a particular plan if the following conditions are met:

- The employee does not benefit under the plan for the plan year;
- The employee is eligible to participate in the plan;
- The plan has a minimum period of service requirement, or a requirement that an employee be employed on the last day of the plan year, to accrue a benefit for the plan year;[45]
- The employee fails to accrue a benefit solely because of the failure to satisfy the minimum service or last day requirement;
- The employee terminates employment during the plan year with no more than 500 hours of service (or, in the case of a plan using elapsed time service, 91 consecutive calendar days or 3 consecutive calendar months) and the employee is not an employee as of the last day of the plan year; and
- The exclusion is applied to all employees with respect to a plan for the plan year, if applied to any employee with respect to the plan for that plan year.

Although the available guidance is not clear, presumably this exclusion is also not applicable, because the determination of restricted employees is made for the entire controlled group and not with respect to a particular plan. Further, as noted in the discussion of highly compensated employees above, the regulations indicate that, with respect to the plan for the plan year of employment termination, an HCE who did not benefit for the plan year is also a former HCE for that plan year.[46] Assuming this to be a correct interpretation of the regulations, the employee is a restricted employee as a former HCE for that plan year, even if not benefiting as an HCE for the plan year.

Nonresident Aliens With No U.S. Source Income From the Employer

Treasury Regulation section 1.410(b)-6(c)(1) provides that, "An employee who is a nonresident alien (within the meaning of section 7701(b)(1)(B)) and who receives no earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3)) is treated as an excludable employee."[47] Presumably, this exclusion is applicable to the determination of restricted employees because the exclusion is made with respect to the employer and the exclusion for purposes of Code section 401(a)(4) is expressly provided by the language of Code section 401(a)(4) itself.[48] Treasury Regulation section 1.410(b)-6(c)(2) goes on to provide that a nonresident alien who does receive U.S. source earned income from the employer is permitted to be excluded if all the employee's earned income from sources within the United States is exempt from U.S. income tax under an applicable income tax convention and only if all employees described in Treasury Regulation section 1.410(b)-6(c)(1) are so excluded. Presumably, this permissive exclusion would apply for purposes of determining restricted employees as well.

Collectively Bargained Employees

Treasury Regulation section 1.410(b)-6(d)(1) provides the following general rule:

> A collectively bargained employee is an excludable employee with respect to a plan that benefits solely noncollectively bargained employees. If a plan (within the meaning of § 1.410(b)-7(b)) benefits both collectively bargained employees and noncollectively bargained employees for a plan year, § 1.410(b)-7(c)(4) provides that the portion of the plan that benefits the collectively bargained employees is treated as a separate plan from the portion of the plan that benefits the noncollectively bargained employees. Thus, a collectively bargained employee is always an excludable employee with respect to the mandatorily disaggregated portion of any plan that benefits noncollectively bargained employees.

Code section 401(a)(4) expressly provides that, for purposes of Code section 401(a)(4), "there shall be excluded from consideration" "employees who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more

employers, if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers…."[49]

It would seem, then, that collectively bargained employees are excluded from the determination of restricted employees because the exclusion is expressly provided for purposes of Code section 401(a)(4) by the language of Code section 401(a)(4). What makes this conclusion less than clear is the reference to being excludable with respect to a plan, rather than with respect to the employer, and reference to the mandatory disaggregation rule of Treasury Regulation section 1.410(b)-7(c)(4). According to PLR 200449043, "It is not necessary to apply the mandatory disaggregation rules of section 1.410(b)-7(c)(4) as required in the definition of 'plan' under section 1.401(a)(4)-12 of the regulations because that section also states that its definitions only govern unless otherwise provided, and section 1.401(a)(4)-5(b)(1) provides that the pre-termination restrictions apply to a plan within the meaning of section 1.410(b)-7(b)." Perhaps the last sentence of the block quote above, to the effect that collectively bargained employees are excludable with respect to employees who are not collectively bargained for any plan, along with the express exclusion of collectively bargained employees for purposes of Code section 401(a)(4) is sufficient to conclude that collectively bargained employees are excluded from the determination of restricted employees.[50]

Former Employees Previously Excludable or Who Terminated Before a Specified Date

Treasury Regulation section 1.410(b)-6(h) provides that, "For purposes of applying section 410(b) with respect to former employees, all former employees of the employer are taken into account, except that the employer may treat a former employee described [below] as an excludable former employee."

- A former employee who became a former employee either prior to January 1, 1984 or prior to the tenth calendar year preceding the calendar year in which the current plan year begins and prior to the earliest calendar year in which any former employee who benefits under the plan in the current plan year became a former employee; or

- A former employee who was an excludable employee under (a) through (f) above during the plan year in which the former employee became a former employee.

If either of these former employee exclusions is applied, it must be applied to all former employees for the plan year on a consistent basis. However, because these exclusions are "for purposes of applying section 410(b)," presumably these exclusions do not apply with respect to determining restricted employees under Code section 401(a)(4). As noted above, "Except as otherwise specifically provided, references to satisfying section 410(b) in §§ 1.401(a)(4)-1 through 1.401(a)(4)-13 mean satisfying § 1.410(b)-2 (taking into account any special rules available in satisfying that section, other than the permissive aggregation rules of § 1.410(b)-7(d))." The only reference to satisfying Code section 410(b) in the pretermination restrictions is that the restrictions apply to a plan within the meaning of Treasury Regulation section 1.410(b)-7(b), *i.e.*, a Code section 414(l) plan.[51] Other than that, there is no application of the Code section 410(b) rules required by the pretermination restrictions.

Former Nonhighly Compensated Employees Treated as Employees

Treasury Regulation section 1.410(b)-6(i) provides that, "An employer may treat as excludable employees all formerly nonhighly compensated employees who are treated as employees of the employer under § 1.410(b)-9 solely because they have increases in accrued benefits under a defined benefit plan that are based on ongoing service or compensation credits (including imputed service or compensation) after they cease to perform services for the employer." Presumably, even if the employer chooses not to treat these employees as excludable, they would be excludable employees for purposes of determining who are restricted employees because former nonhighly compensated employees are neither current HCEs nor former HCEs.

Compensation

The regulations do not expressly state what *compensation* should be used in determining who is a restricted employee. Definitions for purposes of the nondiscrimination regulations under Code section 401(a)(4) include a definition of *plan year compensation* as "section 414(s) compensation for the plan year determined by measuring section 414(s) compensation during one of the periods described in … this definition."[52] Because the pretermination restrictions appear in the nondiscrimination regulations, it would seem that any nondiscriminatory definition of compensation permitted by Code section 414(s) and the regulations thereunder could be used.[53] Of course, anti-abuse provisions require that the nondiscrimination regulations "must be interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of HCEs."[54] Thus the choice of a compensation

definition should not be manipulated to discriminate in favor of HCEs and, presumably, should be applied on a consistent basis.

However, the determination of who is an HCE uses one of the four total compensation definitions under Code section 415, which are among the permitted Code section 414(s) nondiscriminatory compensation definition possibilities. Given that the definition of restricted employee considers HCEs "with the largest amount of compensation," using one of the Code section 415 compensation definitions may be the intent of the pretermination restrictions and a more prudent choice. Nevertheless, the author is not aware of any IRS or Treasury guidance further specifying what definitions of compensation are permitted when determining restricted employees.

ALTERNATIVES TO BENEFIT PAYMENT RESTRICTIONS

An employer can avoid application of the benefit payment restrictions by either increasing the plan's funding to exceed 110 percent of current liabilities or increase the plan's current liabilities to make the lump-sum distribution less than 1 percent of the plan's current liabilities. Increasing the plan's funding may not be consistent with the employer's current funding policy. Increasing current liabilities will generally result in increased required contributions (or, alternatively, a restructuring of the employer's retirement plans) and is typically not considered unless the restricted lump sum is barely above 1 percent of current liabilities.

Securing the Restricted Amount to Exceed Benefit Payment Restrictions

Even if the benefit payment restrictions apply, distribution of the entire lump sum (or other restricted form of benefit payment) can be made if sufficient security is provided to the plan to provide for repayment of the restricted amount if the plan terminates without sufficient assets to cover all benefit liabilities. At any point in time, the restricted amount that would need to be repaid is the excess of the accumulated amount of distributions made, plus reasonable interest, over the accumulated amount of permitted annuity payments, plus reasonable interest.[55]

Revenue Ruling 92-76

Revenue Ruling 92-76 permits a plan to distribute restricted amounts provided that an agreement has been established to secure repayment to the plan of any amount necessary for the distribution of

assets upon plan termination. Such repayment agreement may provide that the employee will either:

- Deposit in escrow, with an acceptable depositary, property having a fair market value equal to at least 125 percent of the restricted amount;

- Post a bond equal to at least 100 percent of the restricted amount furnished by an insurance company, bonding company or other surety approved by the U.S. Treasury Department as an acceptable surety for federal bonds; or

- Obtain a bank letter of credit in an amount equal to at least 100 percent of the restricted amount.

Private Letter Rulings

Several private letter rulings subsequent to Revenue Ruling 92-76 set forth options to secure repayment to the plan, some of which include rolling over the restricted employee's benefit to an individual retirement arrangement (IRA).[56] A combination of the above methods to secure repayment may be employed.[57] It may be possible for the employer to bear the cost of obtaining a letter of credit, setting up escrow, or obtaining a bond.[58]

IN CONCLUSION

This article is an attempt to bring together in one place much of the available guidance regarding the top 25 highly compensated employee lump-sum restrictions and provide thoughtful guesses as to application of the rules in some areas where the available guidance is unclear. It is the author's hope that the IRS and Treasury will be able to provide additional guidance, preferably in the form of more formal guidance, that would reduce uncertainty and result in more consistency in determining who are restricted employees. For instance, based on the available guidance, it appears that nonresident aliens with no U.S. source income from the employer and collectively bargained employees are to be excluded when determining who are restricted employees and that only those two groups are to be excluded, but that is only a supposition. Limiting active HCEs in the nondiscrimination regulations to those who benefit in the plan year for purposes of determining who are restricted employees appears to provide different results than simply using the definition of HCEs provided by Code section 414(q). Confirmation from

the IRS and Treasury as to which HCE definition is appropriate would further reduce uncertainty and, possibly, manipulation of the top 25 rules. Additional guidance now may be particularly useful in light of the increased interest in lump-sum windows being offered to retirees and terminated vested participants. Plan sponsors should involve legal counsel and other qualified advisors when applying the pre-termination restrictions and may want to consider seeking input from the IRS and Treasury in the form of a PLR or otherwise.

NOTES

1. The restrictions described in this article also apply to a money purchase pension plan with an accumulated funding deficiency or an unamortized funding waiver. *See* Treas. Reg. § 1.401(a)(4)-5(b)(4).
2. Plan provisions must contain the restrictions described in the regulations. See Treas. Reg. §§ 1.401(a)(4)-5(b)(1) and 1.401(a)(4)-5(b)(3). The nondiscrimination regulations also require a plan to provide that, in the event of plan termination, the benefit of any highly compensated employee and any former highly compensated employee be limited to a nondiscriminatory benefit under Code section 401(a)(4). *See* Treas. Reg. § 1.401(a)(4)-5(b)(2). Although not expressly provided in the regulations (other than the heading "Pre-termination restrictions"), presumably in a standard plan termination (as opposed to a Pension Benefit Guaranty Corporation distress termination) the pretermination benefit restrictions do not apply, because each plan participant must receive the entire benefit to which the participant is entitled, including those who are not restricted employees, and the plan must be sufficiently funded to that end. If the plan does not make distributions to all unrestricted employees or, perhaps, if the plan does not receive a favorable determination letter upon plan termination, then this presumption may not be warranted.
3. A private letter ruling (PLR) applies only to the taxpayer who requested it and cannot be used or cited as precedent. Informal guidance from representatives of the IRS or Treasury (such as described in enrolled actuary "Gray Books") cannot be relied upon by any taxpayer as binding on the IRS or Treasury but tends to be indicative of IRS and Treasury thoughts on the issue.
4. Benefit for this purpose "includes, among other benefits, loans in excess of the amounts set forth in section 72(p)(2)A), any period income, any withdrawal values payable to a living employee or former employee, and any death benefits not provided for by insurance on the employee's or former employee's life." *See* Treas. Reg. § 1.401(a)(4)-5(b)(3)(iii).
5. These restrictions apply to a plan within the meaning of Treas. Reg. § 1.410(b)-7(b), *i.e.*, a Code section 414(l) plan. *See* Treas. Reg. § 1.401(a)(4)-5(b)(1).
6. *See* Treas. Reg. § 1.401(a)(4)-5(b)(3)(i).
7. *See, e.g.*, 2003 Enrolled Actuaries Meeting, Questions to Individual IRS/Treasury Staff Members and Summary of Their Responses (Gray Book) Q&A-24(a) and Treas. Reg. § 1.401(a)(4)-5(b)(3)(ii). Gray Book responses only represent the views of the individuals who

provide them, do not necessarily represent positions of the IRS or Treasury, and cannot be relied upon by any taxpayer for any purpose.

8. *See* 1993 Gray Book Q&A-21(b).
9. *See* Treas. Reg. § 1.401(a)(4)-5(b)(3)(i) and 2003 Gray Book Q&A-24(a).
10. *See* 1995 Gray Book Q&A-45 and 2003 Gray Book Q&A-25. For example, assuming the benefit payment restrictions apply to the restricted employee's benefit, an alternate payee entitled to 70% of the restricted employee's benefit would be limited to 70% of the unrestricted amount (annuity amount plus social security supplement, if applicable) even if the alternate payee elected a lump sum.
11. *See* Treas. Reg. § 1.402(c)-2, Q&A-3(b), and 2003 Gray Book Q&A-24(b).
12. *See* Treas. Reg. § 1.402(c)-2, Q&A-5(c) and Q&A-6(a), and 2003 Gray Book Q&A-24. *But see* PLR 201031042.
13. *See* Treas. Reg. § 1.401(a)(4)-5(b)(3)(iv).
14. *See* Treas. Reg. § 1.401(a)(4)-5(b)(3)(v). "The regulation requires that the procedures be consistent for any given plan year. They can be changed in an ensuing year, but must be consistent for all such determinations in that plan year. In addition, the timing of changes must not operate to significantly discriminate in favor of highly compensated employees and former highly compensated employees." *See* 2005 Gray Book Q&A-32.
15. *See* 2008 Gray Book Q&A-30.
16. *See* 2013 Gray Book Q&A-8.
17. *See* 2015 Gray Book Q&A-22. Note that the Gray Books were discontinued after 2015.
18. *See* Treas. Reg. § 1.401(a)(4)-5(b)(3)(ii). The author reads "nonexcludable employees and former employees" to mean "nonexcludable employees and nonexcludable former employees" in this context. A plan can be amended to change this number, but not to be less than 25, at any time without violating Code section 411(d)(6). *See* Treas. Reg. § 1.401(a)(4)-5(b)(3)(ii).
19. *See* Treas. Reg. §§ 1.401(a)(4)-12, 1.410(b)-9, and 1.414(q)-1T, Q&A-4.
20. *See* the definition of *former employee* in Treas. Reg. §§ 1.401(a)(4)-12 and 1.410(b)-9.
21. *See* the definition of *former HCE* in Treas. Reg. § 1.401(a)(4)-12 and the definition of *highly compensated former employee* in Treas. Reg. § 1.410(b)-9.
22. *See* Treas. Reg. §§ 1.401(a)(4)-12, 410(b)-9, and 1.414(q)-1T, Q&A-6, and Code § 414(q)(7).
23. *See* Treas. Reg. § 1.410(b)-6(e). This regulation states that, "for purposes of section 410(b) in accordance with § 1.414(r)-1(b), in testing a plan that benefits employees of one qualified separate line of business, the employees of the other qualified separate lines of business [QSLOBs] of the employer are treated as excludable employees." Treas. Reg. § 1.414(r)-1(a) limits the use of QSLOBs by a defined benefit plan to separate application of the minimum coverage requirements of Code section 410(b) (including the nondiscrimination requirements of Code section 401(a)(4)) and the minimum participation requirements of Code section 401(a)(26) and does not provide that QSLOBs are treated as separate employers for such purposes. In private letter ruling (PLR) 200248029, the IRS stated that the determination of restricted employees "is not made on a QSLOB basis, but rather is made taking into account all current and former employees of the employer." Note that this PLR makes specific reference to the definition of nonexcludable employee. As usual, the PLR states it is directed to the taxpayer who requested it and cannot be used or cited as precedent. Nevertheless, the

PLR is indicative of the IRS position, as are informal comments made by IRS/Treasury representatives at the May 9, 2003 meeting of the Joint Committee on Employee Benefits that the highest paid 25 HCE distribution restrictions apply on an employer-by-employer basis and the QSLOB rules do not treat groups as not being part of the employer or create different controlled groups. *See* Q&A 10: *https://www.americanbar.org/content/dam/aba/migrated/jceb/2003/qa03irs.authcheckdam.pdf*.

24. In PLR 200449043, the IRS stated that "a 'Restricted Employee' in the High-25 Group means one of the 25 nonexcludable HCEs or Former HCEs of each participating employer in Plan X with the largest amount of compensation in the current or any prior plan year."
25. "It is not necessary to apply the mandatory disaggregation rules of section 1.410(b)-7(c)(4) as required in the definition of 'plan' under section 1.401(a)(4)-12 of the regulations because that section also states that its definitions only govern unless otherwise provided, and section 1.401(a)(4)-5(b)(1) provides that the pre-termination restrictions apply to a plan within the meaning of section 1.410(b)-7(b)." *See* PLR 200449043.
26. *See* Code § 414(q)(3) and Treas. Reg. §§ 1.414(q)-1T, Q&A-9, and 1.414(q)-1, Q&A-9(b)(1).
27. *See* Treas. Reg. § 1.401(a)(4)-12.
28. Treas. Reg. § 1.410(b)-3(a)(1).
29. *See* Treas. Reg. § 1.401(a)(4)-12.
30. Coverage testing under Code § 410(b) tests whether who gets benefits (rather than the amount of benefits) discriminates in favor of HCEs and considers both those employees who are benefiting and those who are not.
31. Note that the definition of *employee* in Treas. Reg. § 1.401(a)(4)-12 is "With respect to a plan for a given plan year, employee means an employee (within the meaning of Treas. Reg. § 1.410()b-9) who benefits as an employee under the plan for the plan year (within the meaning of Treas. Reg. § 1.410(b)-3)."
32. Consider PLR 9514028, which makes no distinction between facts presented in the request for a ruling and the IRS recitation of the regulatory requirements with respect to *highly compensated participant versus highly compensated employee* or *25 highest paid employees and former employees* versus *25 highly compensated employees and former employees*. As described in the PLR, the request "represented that section 13.3 of Plan X contains restrictions in accordance with section 1.401(a)(4)-5(b)(3) of the regulations on the benefits Plan X can pay to any highly compensated participant (including a former employee) who is a member of the group consisting of the twenty five highest paid employees and former employees with the greatest annual compensation in the affiliated group." The IRS recitation of the regulations states that, "In any one year, the total number of employees whose benefits are subject to restriction under section 1.401(a)(4)-5(b) may be limited by a plan to a group of not less than 25 highly compensated employees and former employees ... with the greatest compensation in the current or any prior plan year." *See also* PLRs 9743051 and 200414048.
33. One might wonder if the use of the term *nonexcludable* here was superfluous because Treas. Reg. § 1.410(b)-6(a)(1) lists *excludable employees* for purposes of applying Code § 410(b) and Treas. Reg. § 1.401(a)(4)-5(b) does not really apply Code § 410(b). For purposes of this article, the author proceeds on the assumption that *nonexcludable employee* was intended to have the meaning prescribed by Treas. Reg. § 1.410(b)-6(b).

34. *See* Treas. Reg. § 1.401(a)(4)-5(b)(3)(ii). The author reads "nonexcludable employees and former employees" to mean "nonexcludable employees and nonexcludable former employees" in this context. A plan can be amended to change this number, but not to be less than 25, at any time without violating Code section 411(d)(6). *See* Treas. Reg. § 1.401(a)(4)-5(b)(3)(ii).
35. *See* Treas. Reg. § 1.401(a)(4)-12, which provides the definition of nonexcludable employee for purposes of Treas. Reg. § 1.401(a)(4)-5(b)(3)(ii).
36. *See* Treas. Reg. § 1.401(a)(4)-12 definition of nonexcludable employee.
37. *See* introductory sentence to Treas. Reg. § 1.401(a)(4)-12.
38. *See* Treas. Reg. § 1.401(a)(4)-5(b)(1).
39. The logic for this conclusion is, essentially, that Treas. Reg. § 1.410(b)-6(e) provides, if an employer is treated as operating QSLOBs for purposes of Code § 414(b) in accordance with Treas. Reg. § 1.414(r)-1(b), when testing a plan that benefits employees of one QSLOB, the employees of the other QSLOBs of the employer are treated as excludable employees. Treas. Reg. § 1.414(r)-8(c)(1) provides that, in general, for purposes of the QSLOB regulations, the requirements of Code § 410(b) encompass the requirements of Code § 401(a)(4).
40. *See* PLR 200248029. As usual, the PLR is directed only to the taxpayer who requested it and cannot be used or cited as precedent. Nevertheless, the PLR is indicative of the IRS position, as are informal comments made by IRS/Treasury representatives at the May 9, 2003 meeting of the Joint Committee on Employee Benefits that the highest paid 25 HCE distribution restrictions apply on an employer-by-employer basis and the QSLOB rules do not treat groups as not being part of the employer or create different controlled groups. *See* Q&A 10: *https://www.americanbar.org/content/dam/aba/migrated/jceb/2003/qa03irs.authcheckdam.pdf*.
41. *See* Treas. Reg. § 1.414(r)-1(a).
42. *See* Treas. Reg. § 1.414(r)-8(c).
43. Code § 401(a)(5)(G) provides that Code § 401(a)(4) does not apply to a governmental plan within the meaning of Code § 414(d). *See also* D. Schwallie, Governmental Plans Are Different: A Regulatory Review, 34 *Benefits Quarterly* 38 (3rd Quarter 2018).
44. *See* Code § 410(a)(4) and Treas. Reg. § 1.410(a)-7(c)(3).
45. While a defined contribution plan can have a last day requirement, a defined benefit plan cannot. *See* Rev. Rul.76-250 and 29 C.F.R. §2530.200b-1(b).
46. *See* definition of *former HCE* in Treas. Reg. § 1.401(a)(4)-12 and the definitions of *former employee* and *highly compensated former employee* in Treas. Reg. § 1.410(b)-9.
47. Such exclusion of nonresident aliens with no U.S. source income from the employer for purposes of Code § 401(a)(4) is expressly provided for by Code § 401(a)(4).
48. It is interesting to note that nonresident aliens are not excluded from the definition of highly compensated employee under Treas. Reg. § 1.414(q)-1T, Q&A-2, and are only excluded for purposes of determining the total number of employees in the top paid group under Treas. Reg. § 1.414(q)-1T, Q&A-9(b)(1)(ii), but not for purposes of identifying top paid group members under Treas. Reg. § 1.414(q)-1T, Q&A-9(c), despite the language of Code § 414(q)(8), which says that for purposes of Code § 414(q), "employees who are nonresident aliens and who receive no earned income (within the meaning of section 911(d)(2)) from the employer which constitutes income from sources within the United Sates (within the meaning of section 861(a)(3)) shall not be treated as employees." Would this mean that non-U.S. employees of a multinational

company working outside the U.S. who are HCEs are included in determining who are members of the top paid group? Seems doubtful since they are not "employees" based on Code § 414(q)(8).

49. *See* Code §§ 401(a)(4) and 410(b)(3)(A).
50. It is interesting to note that collectively bargained employees are not excluded for purposes of determining HCEs, even though they are generally disregarded for purposes of coverage and nondiscrimination testing under Code §§ 401(a)(4) and 410(b) (*but see* Treas. Reg. § 1.410(b)-6(d)(2)(ii) regarding professional employees). Presumably this is because they are subject to actual deferral percentage (ADP) testing. ADP testing is an express requirement for a qualified cash or deferred arrangement under Code § 401(k)(3) and not indirectly imposed through Code § 401(a)(4). Further, collectively bargained employees are not excluded from determining the 20% top paid group of HCEs unless 90% or more of the employees of the employer are covered under collective bargaining agreements and the plan being tested covers only employees who are not covered under such agreements. *See* Treas. Reg. § 1.414(q)-1T, Q&A-9(b)(iii)(B). Nevertheless, it would seem that Code §§ 401(a)(4) and 410(b)(3)(A) explicitly exclude them from consideration when determining who are restricted employees.
51. *See* Treas. Reg. § 1.401(a)(4)-5(b)(1).
52. *See* Treas. Reg. § 1.401(a)(4)-12.
53. *See* Treas. Reg. § 1.401(a)(4)-1(c)(15).
54. *See* Treas. Reg. § 1.401(a)(4)-1(c)(2).
55. See Rev. Rul. 92-76.
56. *See, e.g.,* PLRs 9514028, 9631031, 9743051, 200414048, and 200606051.
57. *See, e.g.,* PLR 9631031.
58. *See, e.g.,* PLR 9052051.