Being a Highly Compensated Employee (HCE) in 2019

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If you are a highly compensated employee (HCE), it is recommended that you pay close attention during your employer's annual open enrollment. Some HCE's may be subject to restrictions on contributions made to employer sponsored retirement (401k) plans as well as FSAs, or Flexible Spending Accounts for dependent care.

The IRS defines highly compensated employees as follows:

- Owner of more than 5% of the interest in the business at any time during the year or the preceding year, regardless of how much compensation that person earned or received,

  Or

- For the preceding year, received compensation from the business of more than \$120,000 (if the preceding year is 2015, 2016, 2017 or 2018 and \$125,000 if the preceding year is 2019), and, if the employer so chooses, was in the top 20% of employees when ranked by compensation.

The reason for the caps is to level the playing field, that is, to prevent HCEs from benefitting more than lower paid workers. The IRS has established annual non-discrimination testing to be sure that employer matching for 401ks for non-HCEs is equitable to those in higher pay brackets. Ultimately, the HCE average retirement plan contribution cannot be more than 2% higher than the average contribution made by non-HCEs. For example, if non-HCEs are contributing 4%, then HCEs are capped at 6%. If the non-discrimination tests find that HCEs contributed in excess of the threshold, they are required to receive a refund, which then becomes taxable income.

Similarly, the Dependent Care FSA deductions are reduced for HCEs. Overall enrollment in these plans is often low, which influences the contributions that HCEs can make. Currently, the IRS allows for up to \$5000 per year per family; however, how much HCEs contribute is dependent on non-HCE participation. The HCE maximum has the potential of being significantly less.

The good news is that there are options for minimizing the impact. As the next open enrollment nears, we recommend asking about company sponsored deferred compensation plans, allowing employees to set aside a portion of their salary (and defer the taxes) to be paid out at a later date. Other possibilities include: 1. Making a 401K catch up contribution, which is $6000 for those aged 50 and older, 2. Establishing a Health Savings Account provides tax deferred savings that can be used for medical costs during retirement, and 3. Considering taxable accounts. These may not be the preferred options, but will still allow you to reach your retirement savings goals.

To further discuss how highly compensated employee limits impact you, contact McCloskey Partners at Jaime@McCloskeyPartners.com or 215-716-3035 x 712

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