DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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CC:TEGE:EB:QP1:LMarshall
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[redacted]

Dear [redacted]:

This letter is in response to your letter dated December 4, 2000, regarding the interaction between your benefit under your employer's pension plan and the Highly Compensated Employee rules for qualified pension plans. You have asked: (1) whether the IRS imposes upon employers a cap on overtime earnings for use in computing pension allotments; and (2) whether the "HCE threshold" for 1993 computes overtime to be not more than $3,925.00. With your letter, you enclosed correspondence from your employer containing some information about the benefits provided under your employer's pension plan.

The Internal Revenue Code imposes a cap upon the total compensation each year that can be used to determine a participant's benefit from a qualified retirement plan. For 1993, this cap was $235,840. The Internal Revenue Code and IRS regulations would not prohibit any 1993 overtime pay that, together with other 1993 compensation, is below this limit from being counted as compensation for purposes of determining plan benefits. However, the Internal Revenue Code and IRS regulations do not require any particular item of compensation (including all or any portion of overtime pay) to be counted as compensation for purposes of a plan's benefit formula.

Section 414(s) of the Internal Revenue Code provides rules governing the manner in which an employer is permitted to define compensation for certain purposes in applying the qualified plan rules. For example, a definition of compensation permitted under § 414(s) must be used in applying the nondiscrimination requirements, under which contributions or benefits must not discriminate in favor of highly compensated employees. The Internal Revenue Code and IRS regulations do not require a plan to use the § 414(s) definition (or any other particular definition of compensation) for purposes of determining plan benefits. However, to simplify the process of nondiscrimination testing, many plans use the same definition of compensation for purposes of determining benefits under the plan formula or formulas as the compensation definition that plan uses for purposes of nondiscrimination testing.

Therefore, many plans use a definition of compensation permitted under § 414(s) for purposes of determining plan benefits.

With your letter, you enclosed a page from current § 1.414(s)-1 of the Income Tax Regulations but noted that it did not apply during 1993. However, under § 1.414(s)-1(j)(3), an employer could choose to apply the current regulations for 1993. In your note on the page you enclosed from § 1.414(s)-1, you asked us to explain the rule of § 1.414(s)-1(d)(1) that a definition of compensation permitted under § 414(s) must not by design favor HCEs, must be reasonable within the meaning of § 1.414(s)-1(d)(2), and must satisfy the nondiscrimination requirement in § 1.414(s)-1(d)(3). As you have highlighted, a reasonable definition of compensation within the meaning of § 1.414(s)-1(d)(2) can exclude all or any portion of overtime pay. The nondiscrimination requirement in § 1.414(s)-1(d)(3) is a numerical test designed to require that exclusions from compensation (such as the exclusion of all or a portion of overtime pay) do not disproportionately affect nonhighly compensated employees (NHCEs).

Section 414(q) of the Code specifies which employees are treated as HCEs for purposes of the qualified plan rules. In general, for 1993, an employer was required to treat all employees with compensation over $96,368, and some employees with compensation over $64,245, as HCEs under section 414(q). Alternatively, under the simplified method, an employer could elect to treat all employees with compensation over $64,245 as HCEs for purposes of § 414(q). Overtime pay is required to be counted as compensation to determine whether an employee is an HCE.

From the employer correspondence you enclosed, it appears that, for 1993, your employer's pension plan provided that overtime pay would only be counted in compensation under the plan's benefit formula up to an amount determined so that total compensation would not exceed $64,245 (which was one of the HCE thresholds for 1993). It appears that this plan provision limited the overtime pay counted in your compensation to $3,925 for 1993. The Internal Revenue Code and IRS regulations did not require the plan to limit the overtime pay used for to determine your benefit in this manner. However, the Internal Revenue Code and IRS regulations also did not prevent your employer's plan from being drafted to limit the overtime pay used to determine your benefit in this manner.

A plan is not required to use the same definition of compensation for nondiscrimination testing purposes as is used for purposes of determining plan benefits. Furthermore, we have no information on what methods your employer used in testing the plan for nondiscrimination for 1993. However, using the limit on overtime pay that you and your employer have described in determining compensation for nondiscrimination purposes probably would not cause the compensation definition to violate section 414(s). For example, if an employer used the simplified method for determining highly compensated employees for 1993, all employees affected by this limit on overtime pay used in determining compensation for nondiscrimination testing

would be HCEs. Thus, if an employer used this simplified method for 1993, this limit on overtime pay counted in compensation would not disproportionately affect NHCEs, and would not cause the compensation definition used for nondiscrimination testing to violate section 414(s).

We hope this information is helpful to you. This letter is a general information letter only. It is not a ruling and may not be relied upon as a ruling.

If you need further assistance or explanation of any of the matters discussed in this letter, please call Linda Marshall (I.D. No. 50-04632) of my staff at (202) 622-6090 (not a toll-free call).

Sincerely,

Michael J. Roach

MICHAEL J. ROACH
Branch Chief, Qualified Plans Branch 1
Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities)