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Who's In Your Top 25?

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Did you know that if you have a defined benefit plan that offers lump sum distributions and your plan is less than 110% funded, that many (or all) of your highly compensated employees may be restricted from receiving a lump sum distribution from the plan?

Well, it's true! Pursuant to IRS regulations, the "Top 25" most highly compensated or former highly compensated employees are generally restricted from receiving a lump sum distribution from a defined benefit plan if the plan would be less than 110% funded *after* the distribution is made.

How do I determine the "Top 25" employees?

To determine who is on this list, you need to essentially rank, from highest to lowest, all of the W-2 earnings (including pre-tax deferrals) ever paid to employees during a plan year. The 25 employees at the top of the list are potentially your "Top 25", assuming the salary they earned was over the IRS limit for determining highly compensated employees for the year. A list of historical limits under Section 414 (q) of the Internal Revenue Code is as follows:

<u>Year</u>	<u>Limit</u>
2009-2011	\$110,000
2008	\$105,000
2006-2007	\$100,000
2005	\$ 95,000
2002-2004	\$ 90,000
2000-2001	\$ 85,000
1998-1999	\$ 80,000

It is important to note that an employee can be on the "Top 25" list, even if they have died, retired or have already received a distribution from the plan. Therefore, it is entirely possible to have less than 25 participants in the plan who could potentially be restricted. It is also possible depending on the size of your organization, that you have not historically ever had 25 highly compensated employees, in which case you will have a smaller number of employees who could potentially be restricted.

In addition, it is possible that a current employee may not be on the "Top 25" list, even though they are earning more than a former employee who is on the list. For example, if an employee who has never been highly compensated earns \$105,000 in 2011, they would still not be considered a highly compensated employee and would not be on the "Top 25" list. However, a former employee who earned \$90,000 in 2000 could be on the list, since they were earning in excess of the limit for 2000 and would have been considered highly compensated for that year.

What happens if an employee is on the "Top 25" list?

Assuming your defined benefit plan offers lump sum distributions upon termination, retirement, death or disability, an employee on the "Top 25" list *may not receive a lump sum distribution*, unless the plan would be at least 110% funded *after* the distribution. If an affected employee elects to begin receiving distributions from the plan, their options are:

1. Elect a monthly annuity instead of a lump sum distribution;
2. Elect to defer commencement of their benefits (but not beyond age 70 1/2) until either the plan is funded well enough to pay the lump sum, or until the employee is no longer on the "Top 25" list; or
3. Elect a lump sum distribution, but receive monthly annuity payments until the earlier of:
 - o the date at which the plan is funded well enough to pay the lump sum;
 - o the date at which the employee is no longer on the "Top 25" list; or
 - o the date at which the total monthly payments received by the employee are actuarially equivalent to the original lump sum amount due.

If either of the first two bullets occur first, the employee would

receive a lump sum distribution that is actuarially equivalent to the remaining monthly payments due to them at the date the restriction is lifted. If the employee dies before this occurs, their beneficiary would continue to receive the monthly payments until the earlier of the three bullets occurs.

How does an employee come off the "Top 25" list?

An employee can only come off the "Top 25" list when there are at least 25 more highly compensated employees (or former highly compensated employees) ahead of them on the list. *Therefore, it is very important to keep your "Top 25" list updated each year.*

Are there any notification requirements?

The IRS currently does not require notification of the potential lump sum restrictions for those employees on the "Top 25" list until the time at which an affected employee elects to begin receiving benefits from the plan. However, we would recommend providing notification to affected employees in advance so that they can adjust their financial planning for retirement, if necessary.

If you have any questions regarding preparation or maintenance of your "Top 25" list, notifications to affected participants, or determination of your plan's funded status, please contact your Harbridge Consultant.

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