

The Trials and Tribulations of Compensation Exclusions



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COMPENSATION DEFINITIONS



Owners' Compensation

- **Corporation = W-2**
- **S-Corporation = W-2**
 - S-Corps must pay reasonable compensation to SH-EEs in return for services (“W-2 comp”)
 - “Pass through” income reported on Schedule K-1 is NOT plan compensation
- **Partnership = earned income**
- **LLC = depends on structure**
 - If taxed as corporation = W-2
 - If taxed as partnership = earned income
- **Sole Proprietor = earned income**

Compensation Definitions

- **Code §415 Compensation** = gross comp for full plan year
 - Code §415 / HCEs / Key EEs / Deductions
 - Five percent gateway contribution for cross-testing (may use participation compensation)
- **Contributions/deferrals** = as defined in Plan
 - Full year or period of participation
- **Testing comp** = any Code §414(s) definition
 - Need not be defined in plan document
 - Full year or period of participation

Code §415 Compensation

- **Three main definitions of compensation**
 - W-2 Compensation (Code §§6041 and 6051)
 - Wages for income tax withholding (Code §3401(a))
 - Current includible compensation (Code §415 comp)
 - Can use simplified definition that excludes certain types of “unusual” compensation
- **All three definitions are grossed up to include elective deferrals to:**
 - 401(k) plan/403(b) plan/457(b) plan/SIMPLE
 - 125 cafeteria plan
 - Qualified transportation fringe benefit plan

Compensation Definitions

Type of Comp	W-2 Comp	Federal Withholding Wages	Current Includible Comp (415 Comp)	Simplified 415 Comp
Wages/Salary	Included	Included	Included	Included
Overtime	Included	Included	Included	Included
Bonuses	Included	Included	Included	Included
Commissions	Included	Included	Included	Included
Tips	Noncash tips and tips under \$20 per month are excluded	Same as W-2	Generally included (exclude allocated tips)	Generally included (exclude allocated tips)

Compensation Definitions

Type of Comp	W-2 Comp	Federal Withholding Wages	Current Includible Comp (415 Comp)	Simplified 415 Comp
Elective deferrals	Included	Included	Included	Included
Contributions to qualified plan (other than elective deferrals)	Excluded	Excluded	Excluded	Excluded
Expense reimbursement accountable plan	Excluded	Excluded	Excluded	Excluded
Expense reimbursement non-accountable plan	Included	Included	Included	Included

Compensation Definitions

Type of Comp	W-2 Comp	Federal Withholding Wages	Current Includible Comp (415 Comp)	Simplified 415 Comp
“Qualified” moving expenses	Excluded	Excluded	Excluded	Excluded
“Nonqualified” moving expenses	Included	Included	Included	Excluded
Nontaxable fringe benefits	Excluded	Excluded	Excluded	Excluded
Taxable fringe benefits	Included	Included	Included	Included
Taxable medical or disability benefits	Included	Included	Included	Excluded

Fringe Benefits

- **Examples of nontaxable fringe benefits (see IRS Publication 15-B)**
 - No-additional-cost service provided to EE in ordinary course of business (e.g., free hotel room for hotel EE)
 - Working condition benefits (e.g., company car/cell phones for business use)
 - De minimis benefits (i.e., service or item of small value such as occasional dinner money or cab fare)
 - Cash and cash equivalent fringe benefits (e.g., gift card) are not excludable as de minimis benefit
 - Qualified transportation benefits
 - Onsite gym or other athletic facilities

Medical/Disability Benefits

- **Generally included in income if premiums paid by employer**
 - Should be included as compensation even if benefits paid by third party
 - May be different reporting issues if short-term or long-term disability
- **Health care premiums for two percent shareholder-EEs of S-Corporation**
 - Deductible by S-Corp and reportable as wages on W-2
 - Included in Box 1 of Form W-2 (not in Boxes 3 or 5)

Compensation Definitions

Type of Comp	W-2 Comp	Federal Withholding Wages	Current Includible Comp (415 Comp)	Simplified 415 Comp
Statutory stock options - grant or exercise	Excluded	Excluded	Excluded	Excluded
Non-statutory stock option includible in year granted	Included	Included	Included	Excluded
Non-statutory stock option includible in year of exercise	Included	Included	Excluded	Excluded

Compensation Definitions

Type of Comp	W-2 Comp	Federal Withholding Wages	Current Includible Comp (415 Comp)	Simplified 415 Comp
Group term life insurance > \$50,000	Included	Excluded	Included	Included
Nonqualified plan contributions	Excluded	Excluded	Excluded	Excluded
Nonqualified plan distributions	Included	Included	Excluded unless plan provides otherwise	Excluded unless plan provides otherwise
Differential wage payments (HEART Act)	Included	Included	Included	Included

Post-Severance Compensation

- **Post-severance compensation = may include payments made after severance of employment if:**
 - Compensation is regular compensation or payment for unused sick, vacation or other leave
 - Payment is made by the later of 2½ months after severance from employment or the last day of the limitation year in which the severance occurs, and
 - The amounts would have been paid and included in 415 comp if EE had not terminated employment
- **Severance pay not included in compensation = may not use for deferrals**

Post-Severance Compensation

- **Must include “trailing compensation” that meets 2½-month rule**
- **May exclude post-severance compensation that is payment of unused leave or nonqualified deferred compensation**
 - Exclusion applies at 415 level so satisfies 414(s) compensation
- **May exclude post-severance salary continuation for military service (other than differential wage payments covered by HEART Act)**

Post-Severance Compensation

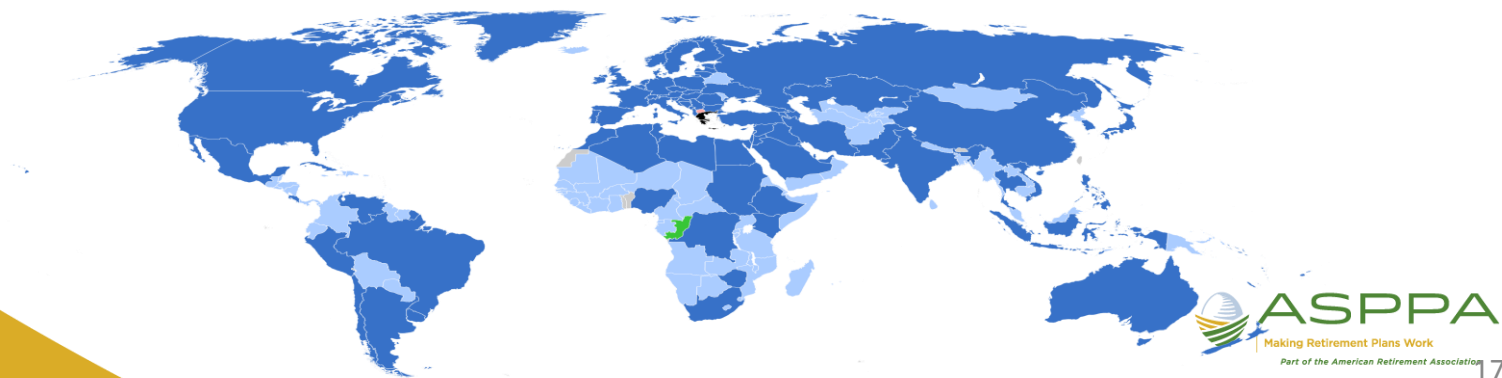
- **Jack terminates employment with ABC Corp on 12/28/15 and receives his last paycheck on 1/10/16. Included in the last paycheck are payments for services, unused vacation/sick pay, and severance pay.**
 - For what year is the last paycheck included as compensation?
 - Can Jack defer on the amount received in his last paycheck?
 - Will Jack be entitled to an employer contribution based on the amount of his last paycheck?
 - Could the plan be amended to exclude amounts paid after severance of employment?

Foreign Compensation

- **Treas. Reg. §1.415(c)-2(g)(5)(i) = "amounts paid to an individual as compensation for services do not fail to be treated as compensation ... merely because those amounts are not includible in the individual's gross income on account of the location of the services"**
- **Treas. Reg. §1.415(c)-2(g)(5)(ii) allows plan to exclude compensation paid to nonresident aliens who are not participants in the plan**
 - Further implies that other foreign compensation is included in 415 compensation

Foreign Compensation

- **Plan may exclude compensation paid by a non-signatory related employer that would allow the plan to exclude foreign compensation**
- **Presumably, definition of compensation would be subject to testing under Code §414(s) for purposes of determining whether such compensation is nondiscriminatory for purposes of 401(a)(4) and ADP/ACP testing**



Allocation Compensation

- **Generally, may use any definition of compensation for allocations**
- **Must use nondiscriminatory compensation for:**
 - Uniform allocation safe harbor
 - Permitted disparity safe harbor
 - Safe harbor 401(k) contributions
- **Must use nondiscriminatory definition of compensation when testing plan contributions**
- **To be nondiscriminatory = must meet definition under Code §414(s)**

Code §414(s) Compensation

- **For nondiscrimination test (e.g., ADP/ACP test) = must use nondiscriminatory definition of compensation under Code §414(s)**
 - Plan need not define compensation for testing purposes
 - If plan does define testing compensation = must follow definition under plan
- **Start with Code §415 compensation and may exclude any of the following:**
 - All elective deferrals (including Roth contributions)
 - All fringe benefits, reimbursements, moving expenses, deferred comp and welfare benefits
 - Amounts payable only to HCE

Compensation Ratio Test

- **If exclude compensation other than safe harbor exclusions = must pass compensation ratio test**
 - Determine compensation % for each EE
 - Compensation % = $\frac{\text{plan comp}}{\text{total comp}}$
 - Compare average for HCEs and NHCEs
 - HCE average cannot exceed NHCE average by more than a “de minimis” amount
 - Three percent difference is generally considered de minimis

Flexibility in Compensation

- **XYZ Corp maintains a 401(k) plan for its EEs. The plan defines comp for deferral purposes as gross comp for full plan year.**
 - Joe, CEO of XYZ makes \$500,000 per year and defers \$18,000 into plan for 2015. Remaining four HCEs make over \$125,000 and defer between \$10,000 and \$18,000 into the plan.
 - Sally, an NHCE, first becomes a participant in the plan in July 2015 and defers \$2,000 (five percent of her \$40,000 annual compensation).
 - XYZ declares a bonus twice a year (in June and December). Generally, bonuses are only paid to NHCEs.

Fringe Benefits

- **What are fringe benefits?**

- No definition in Code/Regulations (see IRS Publication 15-B)
- Any “unusual” type of compensation
 - Car allowance
 - Moving expenses
 - Taxable medical/disability payments?
 - Life insurance above \$50,000?
 - Holiday bonus/gifts



- **Is it a good idea to exclude all fringe benefits from compensation?**

Rev. Proc. 2015-28

- **ABC Company fails to allow EEs to defer on bonuses even though the plan includes bonuses in definition of compensation**
 - If missed deferrals begin within three months from date of failure = no corrective QNEC required
 - If deferral failure extends beyond three months (but not beyond end of second plan year) = corrective QNEC equal to 25 percent (instead of 50 percent) of missed deferral
 - ER must send 45-day notice to affected EEs
 - ER must make QNEC for missed match, plus earnings, by end of second PY following failure

Compensation Limit

- **401(a)(17) limit = \$265,000 for 2015/2016**
- **Applies in determining an EE's allocation under the Plan and for purposes of non-discrimination testing = e.g., ADP/ACP tests**
- **Failure to apply Code §401(a)(17) limit**
 - ER may correct by contributing additional amount on behalf of other EEs, including earnings
 - Could ER treat excess amounts as forfeiture?



Application to Deferrals

- **How does compensation limit apply to deferral elections?**
- **Example: Julie's compensation for 2015 is \$300,000. Julie elects to defer five percent of compensation. How much has Julie deferred for 2015?**
 - \$15,000 [5% x \$300,000]
 - \$13,250 [5% x \$265,000]
- **Would answer change if plan contained five percent of compensation deferral limit?**

Short Plan Year

- **Highly compensated EE determination**
 - Determine HCEs separately for short plan year
 - Look-back year to apply compensation test is always 12-month period = no need to prorate dollar amount under HCE compensation test
- **Section 415 limits = (\$53,000 or 100 percent of compensation)**
 - If have short limitation year = dollar limit is prorated based on following fraction:
$$\frac{\text{number of months in short period}}{12}$$

Short Plan Year

- **Compensation dollar limit**
 - Prorate limit if compensation period of less than 12 months is used to determine allocations
 - Proration not required where using compensation while a participant = as long as have 12-month PY
- **Be careful of first year of plan = may have short plan year**
 - Can adopt plan retroactively to January 1
 - Have special effective date for salary deferrals
 - Alternatively, can use calendar year ending in PY
 - Problem with SH 401(k) plans since cannot adopt retroactively = can fix with plan design

Minimum Gateway Requirements

- **To use cross-testing to demonstrate compliance with nondiscrimination test under Code §401(a)(4) = must provide special minimum gateway contribution**
 - Only permits use of cross-testing = plan still must satisfy coverage/nondiscrimination tests
 - Gateway is lesser of five percent of compensation or one-third of largest allocation to HCE
 - Method for providing gateway contribution need not be set forth in plan = as long as all NHCEs receive gateway contribution, plan may use cross-testing

Minimum Gateway Requirements

- **Compensation differs for five percent and one-third gateway**
 - One-third gateway based on allocation rate = can use any definition of compensation that satisfies 414(s)
 - Five percent gateway based on 415 compensation = generally total compensation
- **Example = Plan defines compensation as net compensation (total comp reduced by deferrals, etc.)**
 - Although definition is 414(s) safe harbor = does not meet 415 definition (grossed-up)
 - Gateway may be based on comp while a participant

Related ERs

- **Must aggregate compensation of employers for 415 purposes**
 - Get single 415 limit for related employers
 - Be careful if plan is top-heavy
 - Also must aggregate for HCE determination
- **Must aggregate compensation of related ERs for determining contribution under plan**
 - May exclude but will be subject to 414(s) testing
 - Special rules may apply to self-employed individuals

Example

- **Parent Corp and Sub Corp are related ERs. Parent maintains 401(k) plan for its EEs. Sub does not maintain a plan and does not participate in Parent's plan. Parent's plan excludes all comp with Sub Corp for Plan purposes. Sarah earns \$75,000 with Parent and \$65,000 with Sub in 2014 and 2015.**
 - **Is Sarah an HCE under Parent plan for 2015?**
 - Yes! All compensation with a related ER must be included for purposes of calculating 415 compensation
 - Since HCE determination is based on 415 comp = Sarah earned \$140,000 in look-back year

Example

- **Parent's plan excludes all compensation with Sub Corp for Plan purposes. Sarah earns \$75,000 with Parent and \$65,000 with Sub.**
 - Is Sarah entitled to a contribution with respect to Sub compensation?
 - No! Plan may exclude compensation of related ERs for allocation purposes
 - Would answer change if Parent plan is top-heavy?
 - Top-heavy contribution is based on 415 compensation so would have to aggregate compensation
 - May Parent include Sub comp for ADP/ACP testing?
 - Yes, may use any definition that satisfies Code §414(s)

EARNED INCOME



Who is Self-Employed?

- **Any individual who has “earned income”**
 - Sole proprietors
 - Partners
 - Members of LLC treated as a partnership
 - Independent contractors may be self-employed
- **Sole proprietor is the employer for qualified plan purposes**
- **Partnership/LLC is the employer for qualified plan purposes**
- **Shareholder of S-Corp is NOT self-employed**

What is Earned Income?

- **Earned income is used to determine SEI's deductible contribution**
- **Start with net profits from trade or business (line 31 from Schedule C or Line 14 of Schedule K-1)**
 - Gross income less expenses, including contributions to qualified plan for EEs and EE wages
 - Net profits is also reduced by deferrals made by employees (other than self-employed individual)
 - Net profits is not reduced for contributions on behalf of self-employed individual

What is Earned Income?

- **Determine net earnings from self-employment (NESE)**
 - Net profits reduced by one-half of the individual's self-employment tax (§164(f) deduction)
 - Use Schedule SE to calculate one-half of self-employment tax deduction
- **Determine earned income**
 - NESE is reduced by the plan contribution for the SEI
 - Elective deferrals may or may not reduce NESE depending on definition of compensation

Profit Sharing Plan Deduction

- **George is sole EE of Vandelay Exports. His net earnings from self-employment for 2015 is \$100,000. How much of a deductible contribution can George receive for 2015?**
 - \$20,000 (20% x \$100,000) [25% x (\$100,000 – \$20,000)]
- **What if Vandelay Exports is an LLC?**
 - Same answer if LLC is taxed as partnership
- **What if Vandelay Exports is a C-Corp?**
 - $25\% \times \$100,000 = \$25,000$

Equivalency Rates (Pub. 560)

Contribution %	% of NESE	Contribution %	% of NESE
2%	1.9608%	14%	12.2807%
3%	2.9126%	15%	13.0435%
4%	3.8462%	16%	13.7931%
5%	4.7619%	17%	14.5299%
6%	5.6604%	18%	15.2542%
7%	6.5421%	19%	15.9664%
8%	7.4074%	20%	16.6667%
9%	8.2569%	21%	17.3554%
10%	9.0909%	22%	18.0328%
11%	9.9099%	23%	18.6992%
12%	10.7143%	24%	19.3548%
13%	11.5044%	25%	20%

Sole Proprietor - Employees

- **Sam Smith is sole proprietor. Sam has two EEs, Mary and Bill, who earned \$50,000 and \$30,000 in 2015. Sam maintains a PS plan with pro rata allocation formula. If Sam makes a ten percent contribution to the plan, what is Sam's earned income/contribution?**
 - To determine contribution = must determine Sam's earned income
 - To determine EI = must reduce NESE by wages and contributions for common law EEs
 - Once determine NESE = same rules apply as for sole proprietor w/out EEs

Sole Proprietor - Employees

- **Suppose Sam wishes to contribute \$20,000 to the profit sharing plan for 2015. How is that contribution allocated amongst Sam and the two employees?**
 - Need to calculate contribution for employees before the Code §164(f) deduction can be calculated. Computer software may be used to determine appropriate allocation.



Sole Proprietor - Employees

- **Difficulties arise where have to determine allocation**
- **Cannot determine allocation to employees until know SEI's earned income**
- **Cannot determine earned income until know allocation for employees**
- **Computer software can perform calculations to determine appropriate allocation**

Partnerships

- **Starting point – Line 14 of Schedule K-1**
- **Process basically same as for sole proprietors**
 - Partner's earned income reduced for partner's share of deduction for contributions for common law EEs
 - Each partner's 164(f) deduction calculated
 - Then use the algebraic formula
- **Each partner's contribution is determined separately and allocated to that partner's distributive share**

Partnership Plans

- **Plan must be maintained by partnership for partners**
- **Partners deemed to earn compensation on last day of partnership year**
- **Must enter into salary deferral election before end of plan year**
 - Any deferrals will be allocated for plan year that includes last day of partnership year
 - Must have performed services for which deferrals are being made

Allocation / §414(s) Comp

- **Earned income for self-employed individual should be determined consistently with compensation for common law EEs**
 - If “net” compensation is used for allocation or for nondiscrimination testing, “net” earned income also must be used for self employed individual
 - No alternative to earned income for Code §414(s) purposes
 - Adjustment to earned income necessary if plan uses alternative definition for common law EEs when testing
 - Multiply earned income by NHCE compensation ratio

Earned Income Adjustment

- **Sam is a sole proprietor. He maintains a new comparability profit sharing plan for his EEs. For purposes of determining contributions, the plan excludes overtime and bonuses.**

	Total Comp	Bonus/ Overtime	Plan Comp	Comp Ratio	Avg. %
Bill	\$70,000	\$10,000	\$60,000	85.71%	
Mary	\$60,000	\$5,000	\$55,000	91.67%	
Sue	\$30,000	\$3,000	\$27,000	90.00%	89.13%

- **If Sam's unadjusted earned income = \$115,000**
 - Adjusted EI = \$102,500 ($\$115,000 * 89.13\%$)
 - What if Sam earned \$300,000?

Partial Year Compensation

- **Plan compensation – only while a participant**
- **When is earned income earned?**
 - 401(k) regulations – earned income becomes “currently available” as of the last day of the partnership’s taxable year
- **Arguments for and against proration**
 - Against -- earned on the last day of year = similar to bonus for a common law employee
 - For -- discrimination issue = SEI put in a more favorable position
- **IRS guidance needed**

Questions?