Defining Compensation in Qualified Plans

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Robert M. Kaplan, CPC, QPA, CFP, APA
VP and National Training Consultant
Voya Financial

Agenda

- Definitions
- Nondiscrimination - §414(s)
- Post Severance and Tips
- Applications
- Common Defects and Corrections
- Self-Employed Income
- Related Employers
- Short Plan Years

Compensation

IRS has a very good write up on their website:

http://www.irs.gov/pub/irs-tege/epchd304.pdf

Note: it is a little outdated but has many good examples that are relevant

Note: IRS has stated in its compliance update for employers that compensation mistakes are one of the most common errors they find upon plan examination

Compensation

Compensation is wages or earnings for ***services rendered***

- Wages
- Salaries
- Fees for Professional Services
- Commissions
- Tips
- Bonuses
- Fringe Benefits
- Etc.

Most Important Takeaway Today

We will discuss the plan options ***but*** you should look at definition selected in the:

- Plan Document
- Summary Plan Description
- Enrollment Material
- Safe Harbor Notice

Owner’s Compensation

In some cases owners may have different definition of compensation based on the type of business:

- Sole proprietor – earned income (to be discussed later)
- Partnerships – earned income
- Corporation – W-2
- S Corp – W-2 (investment earnings or dividends on K-1 are not wages for services rendered)
- LLP – earned income (taxed as partnership)
- LLC – could be earned income or W-2 (depends on way it is taxed)

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Basic Definitions

- §415(c) – has three subsets
  - §3401(a)
  - W – 2 = §§6041 and 6051
  - §415(c)

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Basic Definitions

- Safe Harbor

  § 3401(a) – wage; withholding at source

  Plus taxable fringe benefits – will give examples a few slides from now

  You may want to consider excluding the fringe benefits if document allows

  Think of this as regular pay and/or bonus

Basic Definitions

- Safe Harbor

W–2 or §§ 6041 and 6051 – wages plus taxable portion of insurance premiums and personal use of company car AND other taxable fringe benefits

Basic Definitions

- Safe Harbor

§415(c)(3) – above plus most fringe benefits (basically any income received from company) - always use this definition with self-employed employees

All compensation received from employer

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Fringe Benefits

- Any non-cash benefit
  - Not clearly defined in either the Tax Code or Regulations
  - Some common:
    - Personal use of company car
    - PS 58 for group term insurance
    - Moving expenses paid by employer
    - Gift cards
    - Value of stock options

Fringe Benefits

- Two suggestions:
  - Make sure you get all correct information from client
  - Probably a good idea to exclude all fringe benefits in plan document (then can rely on payroll to calculate benefits)
    - Especially in 401(k)s so the deferral percentage matches the payroll
- FWIW

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Tips: Compensation or Not?

Tips

- If run through payroll or included on W-2 – include
- Problem with deferring though – you can only defer from income not yet received so cannot defer against a cash tip that is taken home

Limits on Compensation

- 2013 = $255,000
- 2014 = $260,000
- 2015 = $265,000
- Short years – pro-rate by months
  - Note: Does not apply to mid-year entry

- Off-calendar year plans – use limit at beginning of PY

Net Compensation

- Prior to application of limit
  - Example: Earn $300,000 and defer $18,000

    $300,000 - $18,000 = $282,000

    Capped at $265,000 for 2015

Post Severance

- Option to include
  - Military continuance payments – see §415 Regulations – this is amount paid by employer when a reservist is activated (usually the difference between company pay and military pay)
    - Employee treated as active so gets TH or SH
    - Do not need to take into account for nondiscrimination tests
  - Disability continuance payments – if paid by employer
    - Watch out for long term disability as it might (probably) is paid by insurance company that issues W- 2
    - Short-term disability usually paid directly by company
    - You may want to discuss in more detail with Plan Administrator

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Post-Severance Compensation

- Do <u>not</u> include "severance pay"
- <u>Include</u> amounts paid within 2½ months after severance or end of PY if later, if the amount would have been paid if the participant continued employment
  - This may include unused vacation and sick days
- Only include if amounts would have been paid if employment continued

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Post-Severance Compensation: Example

- Date of severance = July 1, 2015
- Include comp until December 31, 2015

- Think about those who bill for service and get paid later (doctors, lawyers, etc.)

- Only include if they would have received the amount if they continued working

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Post-Severance Compensation: Example

- Date of severance = November 30, 2015
- Include comp until February 15, 2016

- Only include if they would have received the amount if they continued working

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

First Few Weeks Rule

- Can consider amounts paid after the end of the plan year in that plan year, IF paid within the "first few weeks of the next year…"

- Plan Administrator should be consistent in the approach selected and document, document, document so others know what was done (for future administration and audits)

IRS Q&A Highlights - 2009

- Post-severance compensation (part 1 of 5)
  - Employee terminates in December 2009
  - Final payment of salary made in January 2010
  - Plan allows elective deferrals of post-severance
  - Plan does NOT use the special "first few weeks rule"
  - Participant <u>is</u> included in 2010 testing (ADP)

IRS Q&A Highlights - 2009

- Post-severance compensation (part 2 of 5)
  - Employee terminates in December 2009
  - Final payment of salary made in January 2010
  - Plan allows elective deferrals of post-severance
  - Plan <u>does use</u> the special “first few weeks rule”
  - Participant is included in 2009 testing (ADP)
  - All of the salary payment relates to 2009

IRS Q&A Highlights - 2009

- Post-severance compensation (part 3 of 5)
  - Employee terminates in December 2009
  - Final payment of salary made in January 2010
  - Plan allows elective deferrals of post-severance
  - Plan <u>does NOT use</u> the special “first few weeks rule”
  - Plan is a Safe Harbor plan
  - Participant is entitled to 2010 Safe Harbor
    - Either nonelective or match

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

IRS Q&A Highlights - 2009

- Post-severance compensation (part 4 of 5)
  - Employee terminates in December 2009
  - Final payment of salary made in January 2010
  - Plan does not allow elective deferrals of post-severance
  - Disregarded for 2010 ADP test

  - Note: this would constitute “reasonable compensation”

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

IRS Q&A Highlights - 2009

- Post-severance compensation (part 5 of 5)
  - Employee terminates in December 2009
  - Final payment of salary made in January 2010
  - Plan has Safe Harbor contributions for 2010
  - Plan also has non Safe Harbor nonelective contributions for 2010
  - Participant would not receive any since not employed on last day (assume plan has that provision)
  - Still has to meet gateway for 2010 if cross-testing is used

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Discrimination

- Plans must meet definition of §414(s) in order to demonstrate nondiscrimination
  - Safe Harbor – we discussed already
  - Can exclude the following and still be Safe Harbor:
    - Elective deferrals
    - Fringe benefits
    - $ over a certain threshold (other than 401(a)(17)) limit

Discrimination

- Non-Safe Harbor:

  Common exclusions:

  OT

  Bonuses

  Commissions

  Test for non-discriminatory exclusion (see next slide)

Nondiscrimination Testing

- Similar to ADP
- Calculate inclusion percentage for each employee
- Then average the results for the HCE group and then the NHCE group
- Result must be de minimis (three percent?) – *see note on next slide*

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

De Minimis Three Percent

- This is only a “rule of thumb”
- Does not appear in regulations or official IRS guidance
- IRS has stated that even if you are within the three percent, if the only amounts excluded are for NHCEs, this will probably be deemed to fail nondiscrimination test

Nondiscrimination Testing

- Plan excludes bonuses
- Participant compensation = $50,000 including $6,000 in bonus
- Inclusion: $44,000/$50,000 = 88 percent

Nondiscrimination Testing

- Plan excludes bonuses

HCEs	Total	Bonus	%	Group
1	$200,000	$50,000	75%	
2	$150,000	$ 30,000	80%	
				77.5%
NHCEs				
1	$ 50,000	$6,000	88%	
2	$ 40,000	$4,000	90%	
3	$ 24,000	$3,000	87.5%	
				88.5%

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

What if Test Fails?

- Plan must be amended to pass the test or must pass using a general test

- Bob's caution – be very careful in explaining exclusions to sponsors – they may not remember there is a test and that failure is possible (this could affect budgets for plan contributions if compensation has to add back exclusions)

Pre-Participation

- Check document
- Does employer contribution include pre-participation salary for that year?
- Example – date of hire: January 3, 2015
- Date of entry: October 1, 2015 (first of quarter after six months)
- Plan says use full year's compensation (makes sense if you think about TH)

Pre-Participation: Example

- DOH = January 3, 2015
- Annual Salary = $24,000
- DOE = October 1, 2015
- Participation Salary = $6,000

- But have to consider $24,000 for top-heavy so it may not matter
- Of course, you can never defer against money already received so this only impacts employer contributions

ASPPA | Making Retirement Plans Work
Part of the American Retirement Association

Don’t Forget

- Check Plan Documents for selections
- Might have to gather more than one set of compensation data for each employee
- Work with sponsor to see what they can reasonably supply

- Does your service agreement have a disclaimer that your calculations are based on the data provided (who pays if new data is submitted)

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Applications

- Allocations to participant accounts
  – Any nondiscriminatory definition - §414(s)
    - Safe Harbor 401(k)
    - Permitted disparity safe harbor
    - Uniform allocation safe harbor

Applications

- Limit on Annual Additions
  - Include deferrals
  - Use §415(c)
  - Remember to use “Limitation Year” as defined in document – usually the same as PY

Applications

- §§401(k) and 401(m) testing
  - Either include (gross) or exclude (net) deferrals
  - "Exclude" creates a higher ADR for most employees

  - Example – next slide

Example: Net or Gross

- §§401(k) and 401(m) testing - NHCE
  - $50,000 total salary
  - $5,000 deferrals
  - Percentage if use total = 10 percent
  - Percentage if use net = 11.11 percent

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Applications

- §§401(k) and 401(m) testing – partial year option
  - $50,000 annual salary for 2015
  - Enters 7/1/15
  - Defers $3,000
  - Full-year percentage = $3,000/$50,000 = 6 percent
  - Partial-year percentage = $3,000/$25,000 = 12 percent

Applications

- §§401(k) and 401(m) testing
  - Part of year that employee is eligible
  - Increases ADR for most (remember that most employees this would affect are NHCE)
  - Example – next slide

Example

- §§401(k) and 401(m) testing – HCE
  - $200,000 total salary
  - $17,500 deferrals
  - Percentage if use total = 8.75 percent
  - Percentage if use net = 9.60 percent
  - This result harms testing

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Applications

- HCE and Key
  - – §415(c) – including deferrals
  - – May not use a non-safe harbor definition

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Applications

- Top Heavy
  - Full year (even before participation)
  - §415(c)

Applications

- Deductions
  - Use compensation in employer's tax year
  - Include deferrals
  - 415(c)
  - Include all eligibles (even if they do not defer) – this is on the IRS guidance plan for the upcoming year
    - If you want to be conservative, you would exclude those not deferring or receiving other benefits under the plan

Applications

- Matching contributions
  - May want to consider using a "payroll-by-payroll" matching method so plan does not have to potentially true-up at PYE
    - May be nothing wrong with true-up other than the hassle factor

Common Errors

- How do they occur?
  - Failure to update administrative software if document is amended
  - Employer sends TPA or record keeper incorrect amounts
  - Miscommunication between sponsor, payroll provider and administrator

Corrections for Common Errors

- Failure to adhere to 401(a)(17) limit
  - Treat as forfeiture (excess amounts)
  - Contribute corrective amounts to OTHER employees including corrective earnings - OUCH

Corrections for Common Errors

- Employer contributions – redo allocations
- Employee contributions – if not allowed to defer (compensation understated) – see EPCRS as corrective QNEC may be needed
  - Full matching and earnings regardless of whether a QNEC is needed

Always a good idea to check with ERISA counsel

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Self-Employed

- Use earned income to calculate contribution for the self-employed (Sole Proprietor or Partners)
  - Use net profits
    - Line 31 from Schedule C, or
    - Line 15a of K-1
  - Gross income less expenses (wages and contributions for other employees)
  - Do not reduce for deferral or contributions for SE

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Self-Employed

- Reduce net amount by half of SE self-employment tax - §164f
- Schedule SE calculates one-half of SE tax deduction
- Then reduce by contributions for SE
  - Check definition of compensation in document to see if deferrals reduce the income even further
  - SEE IRS PUB 560 for calculation details and worksheets

Self-Employed

- Suggestion – get software to do this roundabout calculation
  - Need to know SE income to determine allocations to others (if not at annual additions limit)
  - But need employee-contribution amounts to properly determine SE income
  - How do you spell “conundrum?”

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Partnership Issues

- Very similar to SE individual
- But different partners may have different contribution amounts (see partners' distributive share in partnership agreement)

ASPPA | Making Retirement Plans Work
Part of the American Retirement Association

SE Issues

- Compensation deemed earned as of last day of the taxable year
- Use same "net" or "gross" and "partial" year as common law employees
- Salary deferral <u>elections</u> must be made as last day of year (even if not contributed by that time)
  - Many people defer against "draw"

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

More Than One Related Employer

- Total compensation used for annual additions limit
  - Remember one limit for related employers (control group or affiliated service
  - TH uses total also
  - Key and HCE also
  - Contributions/allocations may use only one entity but must test for nondiscrimination

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

More Than One Related Employer

- One area where we need guidance from IRS is when the SE individual has a loss in one entity and profits in another
  - If the loss is greater than the profits – is it considered “zero” or do you need to do a net calculation – not sure!

Short-Plan Years

- Annual additions – pro rate by number of months
- Compensation limit – pro rate limit by months
- HCE – use the prior 12 months regardless if they cross PY
- One watch out – in first PY – may use full calendar year PY or may be short PY – be careful in design

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association

Questions?

ASPPA
Making Retirement Plans Work
Part of the American Retirement Association