

# Definitions of Compensation for Retirement Plans

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BVY5C-Q-00002-1 2-0
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# Agenda

- The basics (W-2, Withholding and 415 safe harbor compensation)
- The add-ons/take-aways (post severance comp, post year-end comp, etc.)
- Compensation for allocations – 414(s)
- 414(s) compensation testing
- ADP/ACP testing compensation – 414(s)
- Safe harbor 401(k) plan compensation
- 415 Testing compensation
- Self-employed persons compensation
- Other places compensation is used – which definition?



# The Basics



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# 3 Main Definitions Used

All 3 base definitions are used for 415 and 414(s)/non-discrimination purposes

- W-2
- Withholding
- 415 safe harbor



# W-2 Compensation

W-2 comp = Information reported in Box 1

er	<b>For Official Use Only ▶</b> OMB No. 1545-0008	
	<b>1 Wages, tips, other compensation</b>	<b>2 Federal income t</b>
	<b>3 Social security wages</b>	<b>4 Social security ta</b>
	<b>5 Medicare wages and tips</b>	<b>6 Medicare tax wit</b>
	<b>7 Social security tips</b>	<b>8 Allocated tips</b>

# Withholding

- Code Section 3401(a) compensation subject to federal income tax withholding:
  - wages, bonuses, and commissions
- Same as W-2 except excludes:
  - taxable cost of group-term life insurance
  - employer's vehicle that is includible in wages if
    - (1) notify the employee, and
    - (2) include on W-2 and withhold social security and Medicare tax
  - [http://www.irs.gov/pub/irs-tege/fringe\\_benefit\\_fslg.pdf](http://www.irs.gov/pub/irs-tege/fringe_benefit_fslg.pdf)
- Presumably available from payroll provider



# 415 Safe Harbor: 1.415(c)-2(d)

- Wages, salaries, commission, bonuses
- Includes tips under \$20 (W-2 and withholding exclude)
- Includes pre-tax elections under section 125(a), 132(f)(4), 402(e)(3), 457(b), 402(h)(1)(B) and 402(k)

# 415 Safe Harbor Optional Inclusions

- Other optional inclusions (1.415(c)-2(b)(3)-(7)):
  - Non-deductible moving expenses reasonable belief not deductible by the employee under section 217,
  - Amounts includible under 105(a)/(h) or 104(a)(3),
  - value of a nonstatutory stock option to the extent includible in income when granted
  - Amounts includible due to property received for services upon election (Code section 83(b))
  - Amounts includible under 409A/457(f) due to constructive receipt

# 415 SH Cont'd – Exclusions 1

- Employer contributions to a plan deferred compensation to the extent not includible in income
- Distributions from a plan of deferred compensation (whether or not qualified) - *regardless of whether such amounts are includible in the gross income of the employee when distributed.*
- Amounts realized from the sale, exchange, or other disposition of stock acquired under a statutory stock option



# 415 SH Cont'd – Exclusions 2

- Amounts realized from the exercise of a nonstatutory stock option
- When restricted stock or other property held by an employee either becomes freely transferable or is no longer subject to a substantial risk of forfeiture
- Other amounts that receive special tax benefits:
  - premiums for group-term life insurance (to the extent not includible in gross income and not 125 salary reductions).
- Other similar items

# What are the Main Differences?

- W-2 vs Withholding:
  - Withholding can be less – excludes taxable cost of group-term life insurance and possibly company car use
- 415:
  - Pre-tax deferrals are included
  - Includes non-cash tips and tips less than \$20
  - Nonqualified stock options excluded when exercised
  - Nonqualified, funded plan distributions excluded (unfunded are excluded)
  - Longer, much more complicated definition – not used for taxation (less practical)

# Which of the 3 Should I Use?

- All 3 are "safe harbor" definitions for 414(s)/415
  - All 3 include bonuses and commissions
- What are employers providing/capable of providing?
- Suggestion:
  - Use W-2 as a default and modify for particular employer situations/exclusions/additions
  - If company cars, consider withholding
  - When to use 415? - ?



# Common Add-ons and Take-Aways

# Post Severance - Required

- Required under 415
- Regular compensation, commissions, bonuses
- Paid by later of:
  - 2.5 months after severance
  - End of limitation year that includes the date of severance



# Post Severance - Optional

- Accrued bona fide sick/vacation/other leave that could be used if continued in employment or
- Payment from nonqualified, unfunded deferred compensation plan not includible in income if paid at same time if employment continued
- Paid by later of:
  - 2.5 months after severance
  - End of limitation year that includes the date of severance



# Post Year-End Compensation

- Amounts earned during a year but not paid until the next solely due to timing of pay periods can be included for the plan in the year earned if:
  - Amounts are paid during first few weeks of the next year,
  - Amounts are included uniform basis for all employees, and
  - No compensation is counted twice

# Post Severance and Year-End

- Difference between two types Post Severance compensation is the **TYPE** of compensation.
- Post Year-End compensation is concerned with **WHEN** the compensation is **counted** in the plan.
- NOTE: Severance pay is never included in the definition of compensation
- For more examples/details:

<http://www.ftwilliam.com/articles/415Comp20080811.html>

# Example

- Plan has elected to use Post Year-End comp
- Plan includes required Post Severance comp
- Plan does not include optional Post Severance comp
- Plan/limitation year is the calendar year
- 12/31 = date of severance
- **Regular compensation** and **unused vacation** is paid out in the 'final paycheck' in the first week of January
- **Commissions** are paid out 2 full months after severance

Will the compensation be counted? In the current plan year or the next?



# Example - Answers

## ■ Commissions

- will be counted as required post-severance compensation
- will be counted in the next plan/limitation year – paid out more than a few weeks into the next year
- Employee is a participant in the plan for another year – could be eligible for contributions/deferrals.

## ■ 'Final paycheck'

- **Unused vacation** is not counted (optional post sev)
- **Regular comp** is counted in current year (req'd post sev comp and post-yr end applies)

# Recommendations

- Do employers report comp when actually paid?  
If so, do not use Post Year-End Comp
- Required Post Severance Comp – include as a default to simplify administration – is this communicated to employers?
- Optional Post Severance Comp – unknown how this impacts 414(s), assume it may be simpler for employers to include

# Deemed 125 Compensation

- Common option in retirement plans
- Often confused with 125 deferrals – not the same
- Plain language definition:

If employer does not request information regarding participant's other health coverage (no program to offer cash in exchange for not taking health insurance), then the employer can include the value of the health insurance as compensation under the plan for those that do not take the health insurance offered by the employer.

- See Rev. Rul. 2002-27 for more details



# Differential Military Pay

- Code section 3401(h)(2)
  - made by an employer while on active duty w/ uniformed services for a period of more than 30 days, and
  - represents all/portion of the wages the individual would have received if the individual were performing service for the employer
  - treated as wages for tax purposes
- Entirely optional to provide the differential military pay and/or to provide allocations based upon the military pay

# Compensation for Allocations



# Allocation Comp - 414(s)

- 401(a)(5)(B) allows allocations to be tied to compensation if compensation meets 414(s)
- 414(s) safe harbor compensation
  - W-2
  - Withholding
  - 415 'simplified' (no optional inclusions)
- May include all of the following even if not taxable:
  - Elective contributions 125, 402(e)(3), 402(h), 403(b), 457(b) and gov't pick-up contributions under 414(h)(2)
  - Deferrals always included in comp for deferrals



# 414(s) Safe Harbor Continued

- Can choose to exclude all of the following even if taxable:
  - reimbursements or other expense allowances,
  - fringe benefits (cash and noncash),
  - moving expenses,
  - deferred compensation, and
  - welfare benefits
- May exclude any portion of some or all HCE compensation
- Notice 2010-15: plan 'will not fail to meet 414(s)' if it excludes differential wage payments

# 414(s) Non-Safe Harbor

- Exclude/include only part of safe harbor 414(s) comp
- May exclude irregular/additional compensation (bonuses, overtime, etc.)
- May limit compensation above a dollar amount (but not max percent)
- Non-safe harbor 414(s) comp must be tested

# Allocation Compensation Limited by 401(a)(17)

- \$245,000 (2011)
- \$250,000 for 2012



# 414(s) Compensation Test

- Average percent of total compensation for NHCEs cannot be less than HCEs
  - Total comp = W-2, withholding or 415, limited by 401(a)(17)
  - Deferrals can be included or excluded in total comp
  - If exclusion applies only to some HCEs, that must be added back for the test
  - May aggregate all plans of the employer for the test
  - Self-employed are disregarded

# 414(s) Test Example (2011)

## Highly Compensated Employees:

Participant Name	Match Comp	Test Comp	Match Comp %
Fonda, Henry	175,000.00	175,000.00	100
Gable, Clark	245,000.00	245,000.00	100
Hepburn, Audrey	150,001.00	150,001.00	100
Hepburn, Katharine	45,000.00	45,000.00	100
Total:			400.00%
Count:			4
Average:			100

## Non Highly Compensated Employees:

Participant Name	Match Comp	Test Comp	Match Comp %
Bacall, Lauren	106,000.00	106,000.00	100
<b>McQueen, Butterfly</b>	<b>25,000.00</b>	<b>45,000.00</b>	<b>55.56</b>
Monroe, Marilyn	25,000.00	25,000.00	100
Tracy, Spencer	45,000.00	45,000.00	100
Wood, Natalie	15,000.00	15,000.00	100
Total:			455.56%
Count:			5
Average:			91

Test Result: FAIL

	Non Highly Compensated	Highly Compensated
Average:	91	100

# 414(s) Non-Safe Harbor

- In general, stay away from excluding overtime (tends to apply to NHCEs more than HCEs)
- If excluding bonuses tends reduce HCE's pay more than NHCE, OK to exclude
- What happens if you fail?
  - Make up the difference in contributions using a Section 414(s) definition of compensation plus earnings for all affected years.



# 414(s) Unknowns

- HCEs average percent of total comp permitted to be higher than NHCE by "de minimus" amount -- what is 'de minimus'?
- Timing/post-severance comp/post-year end comp are not discussed in 414(s)
- Deemed 125 compensation also not discussed

# 414(s) Non-Safe Harbor Special Rules

- Types of Special Pay
  - Rate of compensation (\$10/hour instead of actual pay) – cannot apply to elective deferrals and/or match
  - Prior employer compensation
  - Imputed compensation (reduced work schedule or work for another employer)
- Cannot exceed total compensation
- See 1.414(s)-1 for detailed rules



# Compensation for ADP/ACP Tests



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# ADP/ACP comp is 414(s)

- Basic test is the average of:  
employee contributions [QNECs] / match [QMACs]  
Compensation
- Compensation = 414(s) compensation limited by 401(a)(17)
- Can use the plan year or calendar year ending within the plan year to determine compensation
- Pre-approved plans typically will not define ADP/ACP testing compensation.
  - Add in/take away deferrals to see which definition passes

# 401(k) Safe Harbor Plan

- Safe harbor nonelective
  - Safe harbor plan uses 414(s) compensation (pass testing if applicable) but...
  - cannot exclude compensation over dollar amount for NHCEs
- Compensation for electives/match in a safe harbor plan
  - Must be 'reasonable' w/in meaning of 1.414(s)-1(d)(2)
    - May exclude irregular/additional compensation (bonuses, overtime, etc.)
    - May limit compensation above a dollar amount (but not max percent)
  - Not required to meet nondiscrimination rules of 1.414(s)-1(d)(3)

# Adding Safe Harbor Plan Mid-Year

- Plan may add 401(k) and SH during plan year provided at least 3 mos before end of plan year
- May exclude Compensation before 401(k) established for safe harbor contributions
- Prorate 401(a)(17) limit
  - 1.401(a)(17)-1(b)(iii) "... no proration is required merely because an employee is covered under a plan for less than a full plan year, provided that allocations or benefit accruals are otherwise determined using compensation for a period of at least 12 months..."



# 415 Limit Compensation

# 415 Limit

The lesser of:

- \$50,000 (2012), as adjusted or
- 100 percent of compensation



# 415 Compensation

- W-2 – all payments to an employee by the employer reported in W-2
  - plus amounts elected under 125(a), 132(f)(4), 402(e)(3), 457(b), 402(h)(1)(B) and 402(k).
  - May exclude moving expenses (if reas to believe deduct 217)
- Withholding
  - plus amounts elected under 125(a), 132(f)(4), 402(e)(3), 457(b), 402(h)(1)(B) and 402(k).
- 1.415(c)-2
  - 'safe harbor'
  - Anything else in 1.415(c)-2

All definitions limited by 401(a)(17)



# Related Employers

- Related employers are aggregated for 415 compensation:
  - Employee's compensation equals compensation earned by that employee from all related employers
- Contributions under all plans of the employer are also aggregated for 415 test

# Section 415 and Controlled Groups

- A parent-subsubsidiary controlled group generally exists if one company owns at least 80% of a subsidiary
- For Section 415 purposes, a parent-subsubsidiary controlled group exists if a company owns more than 50% of a subsidiary

# Foreign Compensation

- 415 includes foreign compensation
  - earned for services performed outside of the United States, and
  - not included in gross income because of the location of services performed under Code sections 872, 893, 911, 931, and 933
- Typical non-resident alien exclusion:
  - Employee who is a non-resident alien (e.g. French citizen living in France) and
  - who received *no earned income* ... which constitutes income from services performed within the United States...



# Back Pay

- Pursuant to administrative agency/court order, or bona fide agreement
- Counted in the limitation year to which the back pay relates
- Only if payments represent wages/compensation that otherwise would be included as section 415 compensation
- Even if they are paid after severance, not treated as post-severance comp

# Compensation for Self-Employed



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# Earned Income

- Net earnings from self-employment for the plan's trade or business if services are a material income-producing factor
- Determined without regard to items not included in gross income



# Earned Income continued

- Reduced by contributions to a qualified plan (employer contributions for employees plus contributions for self-employed person)
- Determined with the deduction allowed to the taxpayer by Code section 164(f) (one half of self-employment taxes)

# Steps to Adjust Earned Income

- Total earnings, then adjust for:
  - half of the deduction for the self-employment tax as determined on line 6 of Schedule SE
  - contributions to the plan (elective deferrals, match and/or nonelective contributions)
- If nonelectives (or other plan provisions) are based on compensation, the calculation is inter-related. (ftw admin software performs iterations to find result)

# Example

- Total earnings = \$50,000.00
  - Nonelectives for employees\* -\$7,500.00
  - line 6 of Schedule SE -\$3,531.85
  - elective deferrals -\$5,000.00
- Total = \$33,968.15
- Nonelectives 3% of compensation  
 $33,968.15 \times 3\% = \$1,019.045$
- But now comp is \$32,949.102...



# Example

- Nonelectives for employees\* - \$7,500

\*subject to limit of 25% of compensation paid (or accrued) during the year to eligible employees participating in the plan

# Total Earnings

- For Partners, See Schedule K-1
  - <http://www.irs.gov/pub/irs-pdf/f1065sk1.pdf>
- For Sole Proprietors, See Schedule C (or Schedule C-EZ, if applicable)
  - <http://www.irs.gov/pub/irs-pdf/f1040sc.pdf>
  - <http://www.irs.gov/pub/irs-pdf/f1040sce.pdf>

# Self Employed Contributions

- If there is a match, things get even more complicated...
- Generally need software to calculate
- See publication 560 for more details (tables at end in particular)



# Compensation of LLC Members/Owners?

- Are LLC members/owners treated as self-employed individuals or common law employees for compensation purposes?
  - If the LLC has elected to be taxed as a partnership, then its members/owners will be treated as self-employed
  - If the LLC has elected to be taxed as a corporation, then its members/owners will be treated as common law employees

# Other Uses of Compensation



# HCE Determination

HCE (basic definition):

- Def 1:
  - More than 5% owner or
  - Comp over \$115,000 (2012)
- Def 2: Top 20 percent of employees ranked on the basis of compensation paid during such year

Comp = 415 compensation



# Key Employee

- More than 5% Owner, or
- 1% owner with comp over \$150,000, or
- Officer with comp over \$165,000 (2012)

Comp = 415 compensation

Thank You!



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