Q&As from Definitions of Compensation for Retirement Plans Webinar

June 20, 2012

Questions are arranged by topic and are reproduced as submitted.
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CE Credits

CE-1: Am assuming this will also qualify for cpe for cpa?

A1: I'm afraid it depends upon the state. CPAs, attorneys, and others licensed by state boards/organizations should check with their respective boards/organizations to determine if credit applies toward their continuing education requirements.

CE-2: I thought you mentioned there was going to be a spot to enter the PTIN? Where do we enter our PTIN for ERPA credit?

A2: Attendees should have been prompted to view a survey upon leaving the webinar. If you did not provide us with your PTIN and want us to report your attendance to the IRS, please send an email to support@ftwilliam.com with your PTIN and contact information.

CE-3: We had five of us registrants in a conference room participating on the webcast. Only I was logged into the webcast for the presentation and thus only I received the survey for continuing education credit.

A3: IRS requires that we have a way to track attendance in order to provide web-based seminars. We can track/confirm that one user from your office was logged in to the website and viewing the webinar. Will the IRS prevent others in the room from claiming credit? I don't think the guidelines are all that clear. You may want to contact the IRS for clarification.

General

G-1: What is the difference between W2 box 1 and W2 box 5? If you use W2+deferals, can't you just use box 5 of the W2?

A1: It is not recommended to use Box 5.

Box 1 "Wages, tips, other compensation" is an employee's taxable compensation. Deferrals are not included in Box 1.

Box 5 "Medicare wages and tips" (the 2nd half of FICA) includes any deferred compensation, 401(k) contributions, or other fringe benefits that are normally excluded from the regular income tax. This will ***not*** include most employee contributions to a cafeteria/125 plan.[1] This will also not include qualified

[1] Note that Code section 125 adoption benefits are added back to box 5 (and not reported in box 1). Also note that since W-2s are a federal tax filing this will not vary by state.

transportation fringe under Code section 132(f). Note that items reported in box 5 may change with health care reform as well.

In short, *there is no box on the W-2 that will always equal a 415 safe harbor definition of compensation. Box 1, however, is a 414(s) safe harbor definition of compensation.* If you use box 1 as the base definition of compensation for allocations and 415 testing, you would then specifically ask the employer for amounts elected under 125(a) (Cafeteria plan) and 132(f)(4) (qualified transportation fringe). Presumably you would already have amounts under 402(e)(3) (401(k) and 403(b) pre-tax contributions), 457(b) pre-tax contributions, 402(h)(1)(B) (simplified employee pensions) and 402(k) (simple retirement account). All these amounts should be added back for 415 testing/HCE determinations, etc.

G-2: The Health Insurance for a 2% SH SCorp is included in W-2 Box 1 so is included in W-2 plan compensation. Is it included in 415 safe harbor compensation as well?

A2: This is an optional inclusion in 415 compensation (this is an amount includible under 105(a)). If you are using the 'simplified' 415 definition, it would not be included.

G-3: How to use W2 and withholding comp for a fiscal year compensation year.

A3: The issues that arise for fiscal year plans really are not unique to any definition of the three base definitions of compensation. I would assume employers can ask payroll providers to provide reports of compensation for a specific 12 month period.

You can use the plan year or calendar year ending within the plan year to determine compensation for ADP/ACP testing and HCE determinations; and 415 limits are determined according to the limitation year but allocations are typically determined based upon plan year compensation.

G-4: If don't elect to use Post Year-End Comp, is an additional contribution due in the following year on residual post severance compensation if the plan is a 3% SH plan? Concern is the participant has usually been paid out and will be due additional distribution.

A4: Using post-year end compensation will typically not fix the problem of having compensation counted into the next plan/limitation year for a terminated participant (or any participant). Life tends not to neatly split into plan years and employees can be terminated/leave just a few days into a new plan year. The complications Post Year-End Compensation typically cause in getting the correct information from employers would tend to outweigh the possibility that it may save a few contributions from going into the next plan year.

G-5: How would you handle severance package? Included or not included in compensation for plan purposes? Example - 3 months of pay.

A5: True severance pay is never included in the definition of compensation for 415 purposes.

G-6: Wouldn't you also need to look at the plan's allocation rule for the next year? So even if you count it as comp, the allocation rules may require allocations go only to active employees.

A6: That's correct. Last day and service rules on employer contributions would help limit needing to carry terminated participants over into the next plan year. Last day/service rules cannot apply to safe harbor plans.

G-7: How does sole proprietor or partnership net income fit into these definitions?

A7: It doesn't. Both 414(s) and 415 have the same required definition of compensation for participants with self-employment income - earned income must be used.

414(s) Testing

414-1: If a plan fails the 414s test with a 95%:91% HCE:NHCE comp ratio, what compensation must be used for corrections for NHCE allocations? If, in the example, the HCE rate was 95%, would the NHCE allocation still have to be based on 100% (414) compensation? or 95%?

A1: It depends... Compensation that brings the NHCE compensation up to at least the same ratio as HCE compensation - or amending to a safe harbor definition of compensation would work (as long as a safe harbor definition doesn't decrease contributions). The amendment is typically a corrective amendment under Treas. Reg. section 1.401(a)(4)-11(g) (since most test failures are caught after the end of the plan year). Adding back in elements of compensation for NHCEs is likely to make HCE compensation ratios increase as well so the final percentage can be a bit of a moving target.

You need to amend to use whatever compensation will allow the plan to meet 414(s). You do not need to bring everyone up to 100% - rather you need to bring up NHCEs' ratios to the HCE ratio (or within a 'de minimus' amount).

414-2: Does Butterfly get a 44.44% matching contribution?

A2: In the example, Butterfly's compensation for matching was $25,000 and total comp was $45,000 - making it his/her ratio to total comp 55.56%. To fix the example, whatever exclusion was applied would no longer apply and total compensation would be used to allocate the match (Butterfly was the only participant with compensation less than total compensation).

414-3: If you fail the 414(s) test, could you run a rate group test on total compensation to prove you are not being discriminatory? Isn't true that if you have discriminatory definition of compensation but the allocation passes the 401(a)(4) general test, you are O.K?

A3: Yes. However, if you are going through the hassle of a general test, why not just have a new comparability allocation formula that has no connection to compensation?

414-4: How do you calculate the contributions due upon 414(s) failure? Is it a matching / profit sharing / QNEC / QMAC?

A4: It would be whatever contributions are affected. After modifying the definition of compensation to a safe harbor definition or to some other definition that passes testing, you would allocate whatever allocations apply according to the new definition of compensation.

414-5: Slide 32 indicates that if the plan fails the 414(s) comp test you would make up the difference in contributions using a §414(s) definition of comp plus earnings. What are we calculating earnings on?

A5: Whatever contributions are made as a make-up. If the contributions would have been made during the plan year - or for prior years - then earnings would apply to those make-up contributions. If the error is found before allocations no earnings would be required.

414-6: Wouldn't you have to retest using a different definition of 414(s) comp if the 414(s) test fails and then retest your allocations? Wouldn't you have to use a different definition of 414(s) compensation if your test fails and redo your testing?

A6: Yes.

414-7: Would you use your example of the 414(s) failure to show how to correct it, please? I'd like to see how you calculate the matching contribution due and to which participant. In that example, I presume it's the one participant with excluded compensation.

A7: My example was incredibly simplistic. We might assume that facts are that only the one NHCE received a very large bonus that year that made the plan fail testing (all other participants/HCEs had compensation equal to 100% of total compensation). So adding bonuses back into the definition of compensation would bring his/her compensation up to total compensation (45,000 instead of 25,000).[2]

With this large of a difference in compensation, the employee may have missed out on opportunities to make elective deferrals (this is a facts and circumstances type of decision). You should use Rev Proc 2008-50 correction principles to sort it out -- unfortunately, there's not a heck of a lot of detailed guidance out there to guide each scenario -- it's always simplest to just use a safe harbor definition of compensation and not deal with failed tests....

414(s) Compensation and Safe Harbor Plans

SH-1: How do you correct a plan that uses safe harbor nonelective and fails 414(s) comp ratio test? Is the correction the same if a non-safe harbor definition is used, and the test fails, and the contribution is a Safe Harbor Non-elective (3%) contribution?

A1: A corrective amendment under Treas. Reg. section 1.401(a)(4)-11(g) can be used to fix the failed compensation test.

SH-2: If you are using SH to satisfy top heavy can you exclude any compensation under 414S? if you have a mid-year entrant and exclude comp prior to participation for ADP safe harbor contributions, so that the 3% SHNEC doesn't meet top-heavy, does that change your answer about comp definition? Can you use compensation from plan entry for the safe harbor 3% if you have no other employer contributions?

[2] Had other employees received bonuses their compensation would also increase by the amount of their bonuses.

A2: In order to use safe harbor to satisfy top heavy, the safe harbor contribution must be the only employer contribution to the plan (IRC section 416(g)(3)(h), Rev. Rul. 2004-13). In order to satisfy the safe harbor rules, you would need to use a definition of compensation that will satisfy the applicable safe harbor rule. This means you certainly could use some exclusions - but of course, you will want to carefully analyze whether this makes sense for the plan/employer. For safe harbor nonelectives, that means you must pass 414(s) and any applicable testing. For match, it means a reasonable definition of compensation under 414(s) and testing is not required.

If the plan is not utilizing the safe harbor exception from top heavy, then the 3% top heavy contribution must be based upon full year compensation.

SH-3: On the SH Match what if the bonuses are primarily to the NHCE? So, if a Safe Harbor Matching plan chooses to exclude bonuses for purposes of the safe harbor match, do you have to apply the compensation ratio testing?

A3: If you have a safe harbor matching plan and choose to exclude bonuses you do not need to apply compensation ratio testing.

If the bonuses only/primarily apply to NHCEs then you would certainly want to proceed with caution as that would likely raise alarm bells for any examiner. *Any definition of comp that would clearly not satisfy 414(s) ratio testing would likely not be considered "reasonable" on audit.* I have excerpts from the safe harbor regulation and 414(s) to put the rule into context. Note that a reasonable definition of compensation can exclude irregular compensation (like bonuses) but that whether something is truly irregular is, of course, a facts and circumstances test.

1.401(k)-3(c)(6) provides:

> (iv)Restrictions on types of compensation that may be deferred.—
>
> A plan may limit the types of compensation that may be deferred by an eligible employee under a plan, provided that each eligible NHCE is permitted to make elective contributions under a definition of compensation that would be a reasonable definition of compensation within the meaning of §1.414(s)-1(d)(2). Thus, the definition of compensation from which elective contributions may be made is not required to satisfy the nondiscrimination requirement of §1.414(s)-1(d)(3).

1.414(s)-1(d)(2) provides:

> (ii)Items that may be excluded.— A reasonable definition of compensation is permitted to exclude, on a consistent basis, all or any portion of irregular or additional compensation, including (but not limited to) one or more of the following: any type of additional compensation for employees working outside their regularly scheduled tour of duty (such as overtime pay, premiums for shift differential, and call-in premiums), bonuses, or any one or more of the types of

compensation excluded under the safe harbor alternative definition in paragraph (c)(3) of this section. Whether a type of compensation is irregular or additional is determined based on all the relevant facts and circumstances. ...

Self Employment Compensation

SE-1: Can you use the W-2 definition in the plan document for sole proprietors since the owner is not issued an actual W-2?

A1: No. Both 414(s) and 415 have the same required definition of compensation for participants with self-employment income - earned income must be used. Even if there are no common law employees, the document must still specify one of the three definitions (W-2, withholding or 415) and it will make no operational difference if there are no common law employees.

SE-2: Does the number you have for 1/2 the self-employment include the fact that the non-elective contributions for the employees get deducted on the Schedule C? Your calculation of the 1/2 social security deduction on slide 50 does NOT take into account the fact that the nonelectives for employees is deducted on Schedule C. That deduction has to be done first, before you calculate the social security deduction!

A2: In my example, total earnings would be the owner's compensation before any non-elective contributions are deducted... I was coming at the calculation more from the perspective of administration software than from tax forms/reporting.

Code sections 415/414(s) define a self-employed person's compensation minus nonelectives made on behalf of that self-employed person. If the nonelective contributions for the self-employed person depend upon knowing the owner's earned income (pro rata), you have a situation where the two values are interrelated. You can't know one without knowing the other. This conundrum occurs whether you are using a schedule C, K-1 or anything else to report self-employment earnings.

Put in a more specific way --- You can complete line 19 of the schedule C (nonelectives for W-2 employees) and know line 31 of Schedule C minus line 6 of the SE. However, to calculate a self-employed person's compensation (for Code section 415/414(s)), you must first subtract out line 28 of the 1040 (the self-employed person's nonelective contribution). (Our admin software is calculating the W-2 employee nonelective contributions and so it also calculates line 31 of the schedule C and line 6 of the schedule SE.)

SE-3: How are PS 58 costs treated in adjusting self-employment earnings? Added or deducted?

A3: PS 58 is not counted in W-2 nor is it counted for self-employed persons.

SE-4: Can you talk a little more about earned income? Can you talk a little more about earned income - what is the difference between using publication 560 and doing the iterations with software?

A4: We could talk all day about earned income. After discussing with others at ftwilliam.com, we think it would make sense to offer a webinar entirely on this topic alone. My presentation was meant to really just introduce the concept of how it works and alert folks that if you are simply adding and subtracting for self-employment compensation, you are very likely missing something.

I think publication 560 is a great place to start when evaluating your admin software and to understand how this all works. Try out some calculations using publication 560 and compare to what you get out of your admin software. If they do not agree, call/email your software provider and see if they can help explain why.

If you are a ftwilliam.com admin software user and not sure how to code a participant as self-employed, please contact us.

SE-5: How do you handle a mid-year entrant who is self-employed (plan excludes pre-entry comp)? Do you pro-rate comp? If so, what do you pro-rate?

A5: Good question. No solid guidance. 404(k) regs say all self-employed income is "earned" on the last day of the year. Both 414(s) and 415 do not contemplate adding or removing compensation for self-employed persons and I don't think it's clear whether you could or should apply the exclusion of pre-entry compensation to a self-employed person. I would assume most administrators use full-year compensation - and you may want to draft plans that have self-employed persons so that full year compensation is included for all participants to help avoid any potential nondiscrimination issues.

SE-6: If a self-employed individual has a DB and a DC plan, is there any particular order for determining the net amount. That is, is the DB subtracted first, or the DC?

A6: Taking this only from the perspective of the DC plan, the order does not matter.

SE-7: If LLC is taxed as partnership, but members are also receiving a W-2 from LLC should we do SE Calc from K-1 and add W-2 comp? Don't think they should have W-2 also but some do. What should be plan compensation?

A7: There are really a few scenarios that could be coming up here. Perhaps the self-employed is changing to an employee in the middle of the year or performs service as a SE for one entity and as a common law for a corporation. During the program some participants mentioned it could be so that the self-employed person could make elective deferrals during the plan year ("Sometimes owners take W2 in order to make 401(k) contribs during the year via payroll." -- I'm not familiar with this practice) ...

I would want to know why and what the facts are before proceeding (is the work with respect to a trade or business in which personal services of the taxpayer are a material income-producing factor? etc....) and, obviously, you should have an accountant's blessing on mixing types of compensation for a participant for work at the same entity.

SE-8: Is there a regulation cite for taking out the deferrals for self-employeds? The deferrals were subtracted out in your self-employed calculation....is that correct? Why did you deduct the elective

deferrals from earnings? For the self employed calculation, if the plan adds back in deferrals, would you add them back in for the self employed person when determining his or her compensation?

A8: For the self-employed calculation example, I was assuming that elective deferrals are not included in the definition of compensation for allocation purposes. If the plan had included elective deferrals (and other pre-tax contributions) for the nonelective contribution, the $5,000 deferral would not have been subtracted out. I'll summarize the rules for the different approaches below:

The 415 regulations clearly require that deferrals for all types of compensation (W-2, withholding, '415' and self-employed persons) get added back to compensation for 415 testing. 1.415(c)-2(b)(2) provides: "In the case of an employee who is an employee within the meaning of section 401(c)(1) ... the employee's earned income... plus amounts deferred at the election of the employee that would be includible in gross income but for the rules of section 402(e)(3), 402(h)(1)(B), 402(k), or 457(b)." This is essentially identical to how W-2 and withholding are treated under 415 -- both are W-2/withholding plus "amounts deferred at the election of the employee that would be includible in gross income but for the rules of section 402(e)(3), 402(h)(1)(B), 402(k), or 457(b)"

As was described during the webinar, the 414(s) regulations have not been updated for the final 415 regulations except to update a cross-reference. The 414(s) approach is generally to assume the base definition of compensation is taxable compensation and pre-tax deferrals can be added back, while taxed compensation items can be taken out. We therefore assume it is permissible to take deferrals out of a self-employed persons compensation for purposes of allocations. The 414(s) regs refer back to the 415 regulations for the definition of self-employment compensation.

In case it is helpful, Code section 401(c)(2)(A) defines earned income for both 414(s) and 415, it provides that elective deferrals would be excluded from earned income. It provides as follows:

> The term “earned income” means the net earnings from self-employment (as defined in section 1402(a)), but such net earnings shall be determined—
>
> (i) only with respect to a trade or business in which personal services of the taxpayer are a material income-producing factor,
>
> (ii) without regard to paragraphs (4) and (5) of section 1402(c),
>
> (iii) in the case of any individual who is treated as an employee under sections 3121(d)(3)(A), (C), or (D), without regard to paragraph (2) of section 1402(c),
>
> (iv) without regard to items which are not included in gross income for purposes of this chapter, and the deductions properly allocable to or chargeable against such items,

(v) with regard to the deductions allowed by section 404 to the taxpayer, and

(vi) with regard to the deduction allowed to the taxpayer by section 164(f).

SE-9: line 6 on schedule sse has changed slightly from last year - how does that affect the earned income calculation

A9: The 2011 instructions state: "[f]or 2011, the SE tax deduction is revised to reflect an employer's equivalent portion of tax. Previously, the deduction was equal to one-half of self-employment tax. "

This means line 6 will not always be 50% of self-employment tax. In 2011, it is sometimes 57.51%.

SE-10: Will you cover how to calculate compensation when the controlled group includes both unincorporate and incorporated entities?

A10: This is probably best left for the webinar that only covers self-employment compensation.

Miscellaneous/Typos

M-1: Top 20 percent still includes employees earning over HCE threshold, correct?

A1: Yes - the top 20% paid over the threshold. A more than 5% owner, regardless of compensation, would still be included as an HCE.

M-2: Will you address the different compensation definitions for the two cross-tested allocation gateways? The 1/3rd versus the 5%?

A2: A defined contribution plan can test on a benefits basis if it passes a gateway requiring allocation rates for nonhighly compensated employees to be "at least 5% of the NHCE's compensation within the meaning of section 415(c)(3)" or at least 1/3 of the highest allocation rate for highly compensated employees (1.401(a)(4)-8(b)(1)(vi)). Allocation rates are determined under §1.401(a)(4)-2(c)(2), but without taking into account the imputation of permitted disparity under §1.401(a)(4)-7. 1.401(a)(4)-2(c)(2) uses 414(s) compensation.

For either test you can use participation compensation (under the final regulations).

M-3: HCE is $110,000 I believe. I think your comp limit is the key definition. Isn't the comp limit for HCEs for 2012 $115,000? HCE more than $150,000? Isn't the HCE limit for 2012 $115,000, not $150,000? One of the last slides showed HCE comp as $150,000 for 2012 - should that be $115,000?

A3: Yes. The slides have been updated/corrected.

M-4:Didn't the slide say the commissions are paid 2 mos after SEVERENCE, not the next year? Wait. Was the termination date DECEMBER 31? The slide says "2/31" February 31 ;)

A4: termination date was meant to be 12/31 - the 1 was inadvertently deleted. The slides have been updated/corrected.

M5: What information do you need to include in FTW to determine SEI for the software to find results?

A5: Generally, the key is to code the self-employed person as self-employed. For details, please contact support and we'd be happy to walk you through it.