

Journal of Pension Benefits - Gucciardi and Ferenczy, 401(K) PLANS, (Oct. 1, 2005)

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This column is not meant to be the latest in a long line of writings differentiating the fine line between the various definitions of [Section 415](#) compensation and the alternate compensation definitions. This column concentrates specifically on the various compensation rules for 401(k) plans, and identifies the rules that apply to particular circumstances.

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Unraveling the Tangled Web of Compensation for 401(k) Plans

One of the more confusing areas of benefit plan law is that of compensation. It is interesting that this engenders so much bafflement, as it is the basic building block of most retirement plans and particularly of 401(k) plans. One reason the analysis of compensation can be so challenging is that a plan may have myriad definitions of compensation for various purposes, giving the word different meanings under different circumstances. Furthermore, the differences between the various compensation definitions may be minor at times. This problem was even worse in the past, when the law mandated that the compensation definition be different for several legal purposes. This problem has been substantially fixed, but practitioner and plan sponsor confusion remains.

To start at the beginning, how is compensation used in a 401(k) plan? It's quite a list:

1. To determine what sources of pay (e.g., bonuses, overtime) can be deferred by the participant to the plan.
2. To determine how much may be deferred by the participant (i.e., deferrals (in addition to other types of contributions) are subject to the [Internal Revenue Code \(IRC\) Section 415](#) limitation of 100 percent of compensation; in addition, the plan may limit participant deferrals to a percentage of compensation).
3. To determine how much may be deferred by the participant as a catch-up contribution (i.e., catchup contributions are also limited to 100 percent of compensation).
4. To determine how much of the deferral to match (i.e., many plans match only deferrals up to a certain percentage of compensation).
5. To calculate the participant's actual deferral ratio for purposes of the nondiscrimination testing.
6. To calculate the participant's actual contribution ratio for purposes of the nondiscrimination testing for the matching or after-tax contributions to the plan.
7. To determine who is highly compensated for purposes of the nondiscrimination testing.
8. If the plan is a safe harbor 401(k) plan, to determine the appropriate safe harbor contribution.
9. To allocate any profit sharing contribution under the 401(k) plan, assuming that compensation is a factor in such an allocation.
10. To calculate the benefit percentage if average benefit testing is being used for coverage or if general testing is being used for nondiscrimination testing of the profit sharing contribution.
11. To determine how much profit sharing and matching contributions may be deducted by the employer (maximizing the deduction at 25 percent of compensation; remembering that the deduction for salary deferrals is now separately calculated).
12. To determine who is a key employee for top-heavy purposes, and to determine the rate of contribution by key employees and the required top-heavy minimum allocation for nonkey employees.

In other words, it is hard to find a function in the administration of a 401(k) plan without bumping into compensation.

In qualified plans, there are generally three types of compensation definitions with which we need to be concerned: [Section 415](#) compensation, [Section 414\(s\)](#) compensation, and a reasonable definition of compensation. One of these definitions will apply for most circumstances; one need only determine which one!

The point of this column is not to be the latest in a long line of pieces that differentiate the fine line between the various definitions of [Section 415](#) compensation and the alternate compensation definitions (does it include this year's Thanksgiving turkey?). For this we refer you to other writings, particularly those that have appeared previously in this Journal. [JPB 11.1, Pratt, "Focus on Compensation Definitions"] This column concentrates specifically on the various compensation rules for 401(k) plans, and identifies which applies to what situation.

Statutory Rules Unrelated to Discrimination Issues

Most statutory rules that relate to compensation require the use of [Section 415](#) compensation. This would include (amazingly enough), the [Section 415](#) limit on allocations in excess of 100 percent of compensation or on benefits in excess of 100 percent of average compensation, as well as the determination of key employees [[IRC § 416\(i\)\(1\)\(D\)](#)], highly compensated employees [[IRC § 414\(q\)\(4\)](#)], topheavy minimum contributions and benefits [[IRC § 416\(c\)\(2\)\(A\)](#)], and the limitations on catch-up contributions to 100 percent of compensation. [[IRC § 414\(v\)\(2\)\(A\)\(ii\)\(I\)](#)]

The law permits the use of one of three different definitions as [Section 415](#) compensation:

1. Currently includible compensation,
2. W-2 compensation ([Section 6041](#), [6051](#), and [6052](#) compensation), and
3. Compensation for income tax withholding ([Section 3401\(a\)](#) compensation). [[Treas. Reg. § 1.415-2\(d\)](#)]

The plan will define which definition is to be used; however, under any of these three definitions, one must add back salary deferrals to [401\(k\)](#) plans, [403\(b\)](#) plans, 457 plans, cafeteria plans under [Code Section 125](#), and qualified transportation fringes under [Code Section 132\(f\)\(4\)](#).

When applying [Section 415](#) compensation for the purposes outlined here, it is important to note that this is full-year compensation, regardless of when the participant actually entered the plan. Therefore, a participant who enters the plan midyear is entitled to a top-heavy minimum contribution based on his or her full year [Section 415](#) compensation, even if the profit sharing allocation is based only on partial year compensation. Furthermore, [Section 415](#) compensation is generally paid during the limitation year, and amounts accrued but not paid are not included. There is a *de minimis* exception to this rule that permits inclusion of amounts earned but not paid during the limitation year because of the way pay periods fall, so long as the amounts are actually paid in the first few weeks of the next year and that the inclusion in the prior year is on a uniform and consistent basis with regard to all similarly situated participants. [[Treas.Reg. § 1.415-2\(d\)\(5\)\(ii\)](#)]

Compensation for Allocation and Nondiscrimination Purposes

The compensation definition used for allocation and nondiscrimination testing purposes is much more flexible, but one must be careful about ensuring that the compensation definition does not create its own set of problems.

401(k) and 401(m) Nondiscrimination Testing (ADP/ACP Tests)

Under Treasury regulations, the ADP and ACP tests are the *exclusive* means of testing nondiscrimination in the amounts of 401(k) deferrals and matching/after-tax contributions. The regulations further require that the definition of compensation that is used for this purpose must be, in and of itself, nondiscriminatory. In other words, it must meet the requirements of [Code Section 414\(s\)](#).

[CodeSection 414\(s\)](#) exists for the sole purpose of defining what a nondiscriminatory definition of compensation is. As with much of the nondiscrimination rules in the Internal Revenue Code, two choices

are open to practitioners: (1) use a safe harbor definition (which, in and of itself, is guaranteed to be nondiscriminatory), or (2) show that one's definition of compensation is nondiscriminatory by testing the compensation under an objective numerical test available in the regulations.

This means that, if one does not use a safe harbor definition of compensation for ADP and ACP testing, the first step must be to test the compensation definition to make sure *it* is not discriminatory. If it fails the test, a different definition of compensation must be used for the ADP and ACP test.

The safe harbor definitions of compensation under [Section 414\(s\)](#) are generally:

1. [Section 415](#) compensation,
2. [Section 415](#) compensation that excludes all the salary deferrals discussed previously that are usually added back, and
3. [Section 415](#) compensation that excludes certain reimbursements, fringe benefits, and the like. [[Treas. Reg. § 1.414\(s\)-1\(c\)](#)]

[Section 414\(s\)](#) compensation used for the ADP or ACP test generally can exclude compensation earned prior to the participant's entry into the plan, which often makes the nondiscrimination testing easier to pass. [[Treas. Reg. § 1.401\(k\)-6, Compensation](#) definition] The compensation used for these tests may be measured by the plan year, which is certainly the most common, or by the calendar year ending within the plan year. [*Id.*] The latter option could produce problems for late-in-the-plan-year entrants: Such individuals could have no compensation at all during the prior calendar year.

If a safe harbor definition is not used, the definition must pass the testing outlined in [Code Section 414\(s\)](#) and the regulations. Under this guidance, the definition must be "reasonable," and it must pass the compensation ratio test—that is, the average of the ratios of the compensation being used to total compensation for the highly compensated employees (HCEs) cannot exceed the average of the ratios for the nonhighly compensated employees (NHCEs) by more than a *de minimis* amount, whatever that is. Rumor has it that a 3-percent differential is acceptable to the IRS. A "reasonable definition" of compensation may exclude all or a portion of certain types of additional or irregular compensation listed in the regulations, such as bonuses, overtime, and premiums for shift differentials. [[Treas. Reg. § 1.414\(s\)-1\(d\)\(2\)](#)] A definition is not reasonable if it credits only a percentage of total compensation, but the definition may limit compensation to a certain dollar amount. [*Id.*]

Compensation in a safe harbor 401(k) plan must also satisfy [Code Section 414\(s\)](#). [[IRC §§ 401\(k\)\(12\)\(B\) or 401\(k\)\(12\)\(C\)](#)]

Compensation for Profit Sharing Allocations

Unlike ADP and ACP testing, there is no "exclusive means" for testing the nondiscrimination of a regular profit sharing contribution. The rules of general testing outlined in [Code Section 401\(a\)\(4\)](#) and the regulations thereto apply. Under those regulations, if a plan is to meet the nondiscrimination safe harbor, it must use a [Section 414\(s\)](#) definition of compensation. Furthermore, if the plan is to be tested generally for nondiscrimination, the compensation for *testing* purposes must fit a [Section 414\(s\)](#) definition. Nothing requires a generally tested allocation to use a [Section 414\(s\)](#) compensation definition for the allocation.

What does this mean in English? It means:

1. *To avoid nondiscrimination testing by using a safe harbor allocation* for the profit sharing contribution, [Section 414\(s\)](#) compensation must be used. This can be a safe harbor compensation or a [Section 414\(s\)](#)-tested compensation (although one has to wonder why one would want to use a safe harbor allocation (which ostensibly makes things easier) and then force oneself into general testing of the compensation definition).
2. *If the compensation used for the allocation meets 414(s) nondiscrimination testing (i.e., the compensation ratio test),* then it may be used for both the allocation and, if necessary, the general nondiscrimination testing of a non-safe harbor allocation formula.
3. *If the compensation used for the allocation does not meet [Section 414\(s\)](#) nondiscrimination testing* it may be used for the contribution allocation, but the resulting allocation must be general tested using a different compensation definition that *does* meet the requirements of [Section 414\(s\)](#). Therefore, the testing compensation would be different from the allocation compensation.

Other Compensation Definitions

What else is left? Can we limit the compensation that we permit to be deferred to certain types of payments? For example, can we exclude tips if we have a restaurant? Tips represent a difficult conundrum for restaurants, because they can be hard to track. Furthermore, cash tips received directly by the server cannot be deferred because the deferral must precede receipt by the employee. [See, JPB 8.4, Cavanaugh, "Evaluating Tips as a Form of Compensation in Qualified Plans".] The answer to this question is "yes": Compensation need not meet the requirements of [Code Section 415](#) or [Section 414\(s\)](#); however, keep in mind that the ADP testing will be performed using a [Section 414\(s\)](#) definition of compensation and the inability to defer on a classification of compensation may reduce the actual deferral ratios of the NHCEs, making the test hard to pass.

Compensation for self-employed individuals is generally earned income, determined at the end of the year. Nonetheless, a 401(k) plan is permitted to accept deferrals made during the year by partners from guaranteed payments or other cash advances made during the year, so long as these payments do not exceed a reasonable estimate of the partner's earned income during the year. [[Treas.Reg. § 1.401\(k\)-1\(a\)\(6\)\(iv\)](#)]

Compensation for deduction purposes is generally the same as [Section 415](#) compensation, although it is based on the taxable year for which the deduction is being taken, rather than the plan or calendar year. [[IRC § 404\(a\)\(12\)](#)]

Severance Payments

The IRS has stated informally several times that compensation for [Code Section 401\(k\)](#) deferral purposes does not include severance pay. This position was based on the fact that severance pay is provided to someone who has terminated employment, and deferrals are permitted only to employees. [[Treas.Reg. § 1.401\(k\)-1\(a\)\(3\)\(i\)](#)] This position is restated and expanded in the recently released proposed regulations to [Code Section 415](#). Under those proposals, post-termination payments are included in [Section 415](#) compensation only if they are made within 2-1/2 months of the severance date and fall into one of the following categories:

1. Payments the employee would have received had he or she continued employment that are regular compensation, bonuses, commissions, overtime, etc.; or
2. Payments for unused sick leave, vacation time, etc., that the employee could have used if employment continued.

Accordingly, severance pay (amounts that would not have been paid to the employee in absence of his or her termination of employment), nonqualified deferred compensation, and parachute payments received after employment termination would never be compensation for [Section 415](#) compensation purposes if these regulations are finalized.

Conclusion

Although the range of definitions of compensation for the various qualified plan purposes has been narrowed considerably in the post-GUST era, there is still room for confusion. Compensation, as with other nondiscrimination issues, can be defined in the plan in a simple manner, or it can be an area of great flexibility—with the attendant complications that this can create. A plan must utilize a definition of compensation that is understandable and manageable for the people who will be administering the plan: the plan sponsor, the sponsor's payroll provider (if any), and the thirdparty administrator. Without this, the information reported by and to all parties is likely to be "garbage in, garbage out," creating significant potential for disqualifying operational failures. As a result, everyone should be wary of complicating the compensation definition unless there is a compelling reason to do so.