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A non-technical review of qualified retirement plan legislative and administrative issues **October 2007**

Compensation:

Definitions and Applications

One of the more complicated and confusing parts of qualified plan design and administration is determining the proper definition of compensation. It's complicated for a number of reasons. First, the term is used in many contexts. For example, it is used to determine:

- The maximum contribution for each participant;
- The employer's maximum deductible contribution;
- The participant's contribution or benefit accrual;
- Whether the plan satisfies the nondiscrimination requirements;
- The types of compensation that can be deferred in a 401(k) plan;
- Who is a highly compensated employee; and
- The amount of top heavy contributions required.

Second, there are several statutory definitions that have to be used for different purposes and each of these definitions lets the sponsor choose from several alternatives.

Third, in the important area of determining benefit accruals, the sponsor is not limited to a specific statutory definition, but the choice will have an impact on administration and, more importantly, on the overall cost of providing benefits.

To help the sponsor get a better understanding of this topic, we will first explore the statutory definitions of compensation and then review the key areas in which the definition of compensation comes into play.

Statutory Definitions

Code Section 415(c)(3)

Many statutory rules involving the definition of compensation require the use of Code Section 415(c)(3) compensation. The sponsor can choose from one of three safe-harbor definitions:

- A simplified definition that only includes wages, fees for professional services and other amounts received for personal services to the extent that the amounts are includible in gross income;
- W-2 compensation (Code Sec 6041, 6051 and

6052 compensation); and

- Compensation for income tax withholding (Code Sec 3401(a) compensation).

Also note that under all three definitions, pretax 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) are added back to the definition. Compensation includes all compensation paid during a defined twelve month limitation year.

The 415(c)(3) definition is required for a number of qualified plan rules including:

- The limit on contributions and benefits under Code Section 415 (the 100% limit);
- The highly compensated employee rule (determining who earns $100,000 or more);
- The limit on catch-up contributions to a 401(k) plan; and
- The top heavy rules (determining who is a key employee and required top heavy contributions). Note that since the whole year of compensation must be counted, top heavy contributions must consider the whole year even if the employee was only a participant for part of the year.

Another issue is that compensation generally excludes amounts earned after termination, such as severance pay. However, payment for work that had already been performed and payment for accrued sick or vacation time that is made to the terminated employee within a limited time after termination can be counted as compensation.

Code Section 414(s)

Code Section 414(s) provides a definition of compensation that is required under the nondiscrimination rules. Under this Section, the employer can choose a safe-harbor definition or an alternative. The safe harbors include any of the Section 415 definitions. Also, any of the Section 415 safe-harbor definitions can be altered to exclude salary deferrals.

An employer can elect an alternative definition that does not satisfy one of the safe harbors as long as it is reasonable and does not discriminate in favor of the highly compensated employees (in general, more than 5% owners and employees with compensation in the prior plan year exceeding a specified level ($100,000 in 2006)).

Regulations require that, to satisfy this requirement, the plan must demonstrate that the average percentage of total compensation included under the alternative definition of compensation for an employer's highly compensated employees does not exceed by more than a de minimis amount the average percentage of total compensation for the non-highly compensated employee group.

For example, if the employer uses regular pay as the definition of compensation and only non-highly compensated employees receive additional compensation (overtime), then the definition would be considered discriminatory. On the other hand, if only highly compensated salesmen were receiving additional pay (commission), then the definition would most likely not be discriminatory.

Code Section 404

Under the maximum deductible contribution limits, compensation is essentially the same as Code Section 415 compensation, although it is based on the taxable year for which the deduction is being taken, rather than the limitation year (which is typically the plan or calendar year).

Maximum Compensation Limit

It is important to remember that, for virtually all qualified plan purposes, compensation has an upper limit under Code Section 401(a)(17). For 2007, the maximum compensation amount is $225,000.

Contribution and Benefit Structures

From a plan design perspective, the most important definition of compensation is the one used to determine plan benefits or contributions. How compensation is defined directly affects plan costs and participants' benefits.

The definition chosen has to satisfy the nondiscrimination requirements. For this purpose, the simplest option is to choose one of the safe-harbor alternatives under Code Section 414(s). However, to limit costs and keep them more predictable, some employers will want to choose a definition that only includes base or regular pay and excludes extras such as overtime and bonuses. This is acceptable as long as the plan can satisfy the nondiscrimination requirement that was described above.

401(k) Plans

There are several additional issues that come up for 401(k) plans. For testing whether salary deferrals and matching contributions satisfy the nondiscrimination rules (ADP and ACP tests), the plan has to use a definition that complies with Code Section 414(s). However, the plan can disregard compensation earned before an individual becomes eligible to participate in the plan. This is generally a good election to make since it generally increases the deferral percentage for non-highly compensated employees.

Also, salary deferrals in a 401(k) plan can only be made from Code Section 415(c)(3) compensation. This means, for example, that an individual cannot make a salary deferral on severance pay but could defer a portion of a payment for accrued sick time paid after termination of employment.

In some cases it may be useful to limit the type of compensation that a participant can defer. For example, eliminating irregular pay such as bonus and commission income can simplify administration. However, this could make it more difficult to satisfy the ADP nondiscrimination test since this test requires a more inclusive definition of compensation (Code Section 415(s)).

Other Planning Considerations

Here are a number of additional issues that bear mentioning:

Controlled Groups

An extra layer of "compensation confusion" may occur if you are in a brother/sister or parent subsidiary group. In this case you'll need to coordinate the different definitions of compensation as they apply across businesses. Also, if an employee is employed by two or more entities that are aggregated under Code Section 414(b), (c), (m), or (o), compensation includes compensation from all members of the group, including those employers that do not offer the qualified plan.

Measuring Period

Another consideration is the measuring period that is used to identify compensation. Whether you use plan year, limitation year or another alternative, you'll need to make sure that you are comparing apples with apples.

Self-Employed Persons

For a self-employed person (which includes sole-proprietors and partners in a partnership), compensation is generally earned income, determined at the end of the year, reduced by employer contributions to retirement plans made on behalf of the self-employed individual (other than 401(k) deferrals).

Employee contributions can only be made with respect to earned income derived from the business that sponsors the plan. Even though compensation is not determined until the end of the year, regulations provide that 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.

S Corporations

In S corporations, only income that is distributed to the owner as wages can be used for retirement plan purposes (pass through income reported on Schedule K-1 cannot be included).

Choosing Compensation Definitions

When making decisions about the appropriate definition of compensation, the sponsor and third-party administrator ("TPA") should consider the following factors:

- Choosing compensation definitions should begin by reviewing the types of compensation paid by the employer and the records available for tracking compensation;
- A definition of compensation needs to be understandable and manageable for everyone involved in the administration of the plan, including the sponsor, payroll provider and TPA;
- To simplify administration in a small plan, it may be appropriate to choose a uniform definition of compensation; and
- For larger employers, it may be more cost effective to use a number of compensation definitions. To streamline administration, compensation should be reported to the TPA in its component parts (base compensation, overtime, bonuses, salary deferrals, etc.).

Conclusion

Gaining more appreciation for the complexity of the term compensation should help employers be more sensitive to the TPA's request for compensation data. Similarly, the more the TPA understands about the employer, the more carefully definitions can be chosen that gel with the employer's payroll system and benefit objectives.

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