White Paper

The Kaleidoscope of Compensation in Qualified Retirement Plans

Compensation is something everyone thinks they understand. You work. You get paid. Right? Actually, it can be a very complex area in qualified retirement plans and is the one area where IRS auditors find the most errors.

Every employer offers a base pay either as a set amount per pay period or an hourly amount based on the hours worked during the pay period and may include a shift differential. Base pay tends to be set by job class and is applied the same for everyone in that job class. But all employees do not have the same level of competence, diligence, or capabilities. Some hourly paid employees work more than the standard work week and are paid for those additional hours. Employers want to recognize diligence and productivity without committing themselves to a base pay level that may not be appropriate in the next fiscal year or that might be applied to another less diligent employee. So how do they reward some employees and not others?

Enter the fringe benefits! They solve the employer's problems (YAY) but may increase the complexity of qualified retirement plan administration (Not so YAY). Fringe benefits are what make it possible to adjust the picture of compensation to be used for the various purposes in a plan.

For most fringe benefits, the employer determines who shares in them and how much an employee will get. Fringe benefits can be in the form of property, services, cash, or cash equivalents. Also, there are required fringe benefits, such as workers' compensation and unemployment insurance, which the employer must provide for everyone and are not included for plan purposes. Then there are those fringe benefits that are NOT taxable to the employees and are not reported as income on the Form W-2 such as medical flexible spending accounts, dependent care accounts, transportation to and from work, or group term life insurance **up to** $50,000. Because these amounts are not taxable to the employee, they are not included in any plan calculations.

The fringe benefits that impact qualified plans are taxable to employees and considered as §415 compensation include:

- Bonuses
- Overtime
- Vacation and sick time
- Athletic club membership, or health resort expenses
- Value of the personal use of an employer provided vehicle
- Amounts paid to employees for moving in excess of actual expenses
- Business frequent-flyer miles converted to cash
- Group term life insurance provided to employees in excess of $50,000

There are regulations explaining how the value of noncash fringe benefits is calculated for inclusion in the employee taxable income.

The plan document will define the compensation to be used for allocations of contributions. For example, a 401(k) document may (should?) ***exclude*** non-cash fringe benefits from the compensation definition for deferrals as it is not possible for the employer to apply the participant's deferral election to non-cash compensation. Non-cash fringe benefits examples would be personal use of the company car, moving

expenses and tips not run through payroll. To allow deferrals on non-cash benefits increases the likelihood what is actually withheld will not match the participant's election.

The definition of compensation for allocation purposes can exclude or include any or all of the fringe benefits listed above for plan allocation purposes. As long as the §417 compensation limit is not exceeded, there are no regulatory limitations on compensation that can be included for plan compensation providing the definition meets §415 and can pass IRC §414(s) if the allocation is a safe harbor allocation. Interestingly enough, compensation for discretionary match allocation purposes does not have to pass §414(s) but it does for Safe Harbor Match allocation purposes.

What is the §414(s) test and what does it take to pass it? The test is performed to ensure the compensation used for plan purposes does not discriminate in favor of Highly Compensated Employees (HCEs) and is performed including all participants without breaking out the 'otherwise excludable employees' . This is determined by calculating the amount of each participant's excluded compensation to their total compensation and then averaging the percentages of compensation excluded for the HCEs and for the Non-Highly Compensated Employees (NHCEs). While there are no hard and fast rules in the regulations as to what passes and what does not pass, a general rule of thumb used by TPAs that has passed IRS auditor review is that provided the difference between the NHCEs exclusion percentage is within 3% of the exclusion for the HCEs, the exclusion is not considered to be discriminatory, and the definition passes §414(s).

Example:

	Base Compensation	Bonuses	Overtime	Personal Use of Company Car	Total Taxable Compensation
Highly Compensated Employees					
Steven Shareholder	200,000	175,000	0	5,000	380,000
Sylvester Sales	70,000	75,000	0	3,500	148,500
HCE Sub-Total	$270,000	$250,000	$0	$8,500	$528,500
Non-Highly Compensated Employees					
Sam Supervisor	85,000	10,000	20,000	0	115,000
Amanda Assistant	65,000	0	1,000	0	66,000
Wally Workerbee	40,000	0	10,000	0	50,000
Mark Mailroom	30,000	0	5,000	0	35,000
NHCE Sub-Total	$220,000	$10,000	$36,000	$0	$266,000

Often, Employers will feel that because overtime pay is time and a half of the employee's base compensation, excluding overtime from allocation compensation is appropriate. But how does that fare under §414(s)?

	Overtime	Total Taxable Compensation	% Excluded Overtime	Average Exclusion
Highly Compensated Employees				
Steven Shareholder	0	380,000	0	
Sylvester Sales	0	148,500	0	
HCE Sub-Total	$0	$528,500	0%	0.00%
Non-Highly Compensated Employees				

Sam Supervisor	20,000	115,000	17.39%	
Amanda Assistant	1,000	66,000	1.52%	
Wally Workerbee	10,000	50,000	20.00%	
Mark Mailroom	5,000	35,000	14.29%	
NHCE Sub-Total	$36,000	$266,000	53.19%	13.30%
				Fails

Because only the NHCEs earn overtime, excluding overtime pay is discriminatory, so it is not viable compensation to use for testing, or for safe harbor allocation methods.

In an attempt to restrict plan contributions, an Employer may decide to exclude bonuses.

	Bonuses	Total Taxable Compensation	% Excluded Overtime	Average Exclusion
Highly Compensated Employees				
Steven Shareholder	175,000	380,000	46.05%	
Sylvester Sales	75,000	148,500	50.51%	
HCE Sub-Total	$250,000	%528,500	96.56%	48.28%
Non-Highly Compensated Employees				
Sam Supervisor	10,000	115,000	8.70%	
Amanda Assistant	0	66,000	0.00%	
Wally Workerbee	0	50,000	0.00%	
Mark Mailroom	0	35,000	0.00%	
NHCE Sub-Total	$10,000	$266,000	8.70%	2.18%
				Passes

Under ERISA, it is possible to take more away from HCEs. However, as company practices could change each year and NHCEs may begin to receive bonuses, it is important to re-test every plan year to ensure the exclusion percentage for NHCEs is within 3% of that for the HCEs.

Testing compensation may differ from the allocation compensation defined in the plan. If the plan does not provide safe harbor allocations, it can use any compensation definition within §415. Section 415 compensation includes any or all of the fringe benefits listed above. However, when it gets to the testing phase, all compensation used in testing the allocations must pass §414(s).

The service provider has the opportunity to use their expertise to adjust the compensation used in testing for the advantage of the HCEs who would face reductions in benefits or deferrals if the testing fails. This is the kaleidoscope of compensation, focusing the base compensation to include or exclude fringe benefits to help ensure the plan passes all testing. The only fly in the ointment is that compensation used for one test must be used in all testing.

Regardless of what the plan document states, §415 compensation is used to determine:

- Who the HCEs are

    - §410(b) coverage testing looks at the percentage of HCEs who are participating in the plan versus the percentage of NHCEs who are participating
    - Nondiscrimination testing for a qualified plan compares amounts the HCEs receive in the plan in relation to what the NHCEs receive. Nondiscrimination testing is used to determine whether HCEs receive more of the non-elective contributions (IRC 401(a)(5)), the percentage of deferrals made to the plan for the HCEs vs NHCEs (ADP Test) and the percentage of matching contributions made for HCEs vs NHCEs (ACP Test)
- Who the Key Employees are
    - Key employees form the basis of the top-heavy test. The top-heavy test is performed to determine if a 3% minimum contribution is due for any non-key employees for a plan year. A Key Employee is:
    - A more than 5% owner, regardless of compensation earned;
    - A more than 1% owner earning more than $150,000;
    - An employee earning more than $200,000 (indexed) in 2022
    - Any lineal ascendant or descendant of a more than 5% owner or a more than 1% owner earning more than $150,000
- Compensation used to allocate a required top-heavy contribution in the case of a top-heavy plan
    - While the plan may exclude some types of compensation for determining the allocation of contributions or deferrals to be made, a top-heavy plan must always use IRC Section 415 compensation to calculate the top-heavy minimum contributions.
- IRC §415 limits for annual additions regardless of the plan definition
    - A participant's maximum annual allocation for 2022 is the lesser of $61,000 or their IRC §415 compensation
- The 5% minimum gateway allocation.
    - If the plan is 'cross tested', meaning converting a defined contribution allocation to defined benefit values, it must first pass the minimum gateway by providing an allocation of 5% of the IRC §415 compensation for each NHCEs.

But wait! There's more! For testing purposes, the service provider can pick and choose among the fringe benefits to be excluded. Just as exclusion of compensation for allocation purposes may have to meet IRC §414(s) testing, plans which decide to exclude certain types of compensation for testing purposes must ensure the compensation they use complies with IRC §414(s). Any inclusion or exclusion of fringe benefits is acceptable as long as the compensation used is in compliance with IRC §414(s).

IRC §414(s) compensation rules apply to:

- ADP/ACP testing;
- IRC 401(a)(4) testing (cross-testing);
- Average Benefits Testing;
- Safe Harbor contributions for ADP/ACP purposes;
- Contribution calculations to a plan with an integrated formula;
- Determining that the minimum gateway allocation has been satisfied for cross tested plans

What does all of this mean? It means that as long as the compensation modified for testing meets the requirements of IRC section 414(s), it can be used for testing that the benefits provided by the plan do not discriminate in favor of HCEs. This provides the service provider with flexibility as to what to include or exclude in order to preserve as much of the allocations for the HCEs as possible without penalizing the NHCEs.

To accomplish this the service provider must receive as much detail on the compensation paid to participants as possible. It is the bits and pieces of the compensation picture which allow the service provider to turn the kaleidoscope to change the picture just enough to pass testing and stay within the regulations.