



Compensation – Getting It Right

August 6, 2020

Presented by:
John P. Griffin, J.D., LL.M.
ASC Institute, LLC
www.asc-net.com

1

Agenda

- Different definitions of compensation under qualified plans
- Code §415 compensation – starting point
- Nondiscrimination testing – Code §414(s) compensation
- Compensation limit – Code §401(a)(17)
- Compensation for self-employed individuals and partners
- Matching contribution issues
- Related employer issues
- Other common issues and violations



2

2

Compensation Definitions



3

3

Types of Employers

- Corporation
- S-Corporation
- Partnership
- Limited Liability Company (LLC)
- Sole Proprietor
- Tax-Exempt Entity
- Governmental Entity



4

4

Types of Compensation

- Corporation - Form W-2 compensation
- S-Corporation - Form W-2 compensation
 - “Pass through” income reported on Form 1120S (Sch. K-1) is NOT self-employment income and NOT plan compensation
- Partnership, including LLP
 - If taxed as partnership - earned income
 - If taxed as corporation - Form W-2 compensation
- LLC
 - If taxed as partnership - earned income
 - If taxed as corporation - Form W-2 compensation
- Sole Proprietor - earned income
 - Single member LLC



5

5

Compensation Definitions

- Code §415 - Code §415 compensation
- Top-heavy - Code §415 compensation
- HCEs - Code §415 compensation
- Deductions - Code §415 compensation
- Compensation for allocations/accruals
 - Must be defined in Plan
 - Full year or period of participation
- Testing compensation
 - Any Code §414(s) definition of compensation
 - Full year or period of participation



6

6

Code §415 Compensation

- Three main definitions of compensation
 - W-2 compensation
 - Wages for income tax withholding (Code §3401(a))
 - Current includible compensation
 - Can use simplified definition that excludes certain types of “unusual” compensation
- For self-employed individuals - use earned income
 - Sole proprietor - Schedule C
 - Partners - Form 1065 (Sch. K-1)
 - Independent contractors - generally self-employed



7

7

Compensation Definitions

Type of Comp	W-2 Comp	Federal withholding wages	Current Includible Comp (415 Comp)	Simplified 415 Comp
Wages/Salary	Included	Included	Included	Included
Overtime	Included	Included	Included	Included
Bonuses	Included	Included	Included	Included
Commissions	Included	Included	Included	Included
Tips	Noncash tips and tips under \$20 per month are excluded	Same as W-2	Generally included	Generally included



8

8

Compensation Definitions

Type of Comp	W-2 Comp	Federal withholding wages	Current Includible Comp (415 Comp)	Simplified 415 Comp
Contributions to qualified plan (other than elective deferrals)	Excluded	Excluded	Excluded	Excluded
Elective deferrals	Included	Included	Included	Included
Expense reimbursement accountable plan	Excluded	Excluded	Excluded	Excluded
Expense reimbursement nonaccountable plan	Included	Included	Included	Included

9



9

Compensation Definitions

Type of Comp	W-2 Comp	Federal withholding wages	Current Includible Comp (415 Comp)	Simplified 415 Comp
"Qualified" moving expenses	Included (TCJA)	Included (TCJA)	Included (TCJA)	Excluded
"Nonqualified" moving expenses	Included	Included	Included	Excluded
Nontaxable fringe benefits	Excluded	Excluded	Excluded	Excluded
Taxable fringe benefits	Included	Included	Included	Included
Taxable medical or disability benefits	Included	Included	Included	Excluded


10



10

Compensation Definitions

Type of Comp	W-2 Comp	Federal withholding wages	Current Includible Comp (415 Comp)	Simplified 415 Comp
Group term life insurance > \$50,000	Included	Excluded	Included	Included
Statutory stock options - grant or exercise	Excluded	Excluded	Excluded	Excluded
Nonstatutory stock option includible in year granted	Included	Included	Included	Excluded
Nonstatutory stock option includible in year of exercise	Included	Included	Excluded	Excluded




11
Actuarial Systems Corporation

11

Compensation Definitions

Type of Comp	W-2 Comp	Federal withholding wages	Current Includible Comp (415 Comp)	Simplified 415 Comp
Nonqualified plan contributions	Excluded	Excluded	Excluded	Excluded
Nonqualified plan distributions	Included	Included	Excluded unless plan provides otherwise	Excluded unless plan provides otherwise
Differential wage payments	Included	Included	Included	Included



12
Actuarial Systems Corporation

12

Code §415 Compensation

- Difficulty of care payments
 - SECURE Act adds Code §415(c)(8) applicable to defined contribution plans
 - Treats difficulty of care payments, which are non-taxable, as Code §415 compensation
 - Difficulty of care payments – compensation for providing certain additional care needed for “qualified foster individuals”
 - Plan contributions allocable to difficulty of care payments are treated as after-tax contributions

13



13

Code §415 Compensation

- Definition used for Code §415 limitation, HCE determination, top heavy purposes and deductions
- Code §415 compensation is grossed up for pre-tax deferrals
 - Cannot simply use Box 1 of Form W-2 since Box 1 does not include pre-tax deferrals
 - Must add back pre-tax deferrals from Box 12 of Form W-2
 - Be careful of Roth contributions since those amounts are included in Box 1 and Box 12 of Form W-2
- Must use 12-month measuring period
- May not use compensation while a participant

14



14

Code §415 Compensation

- Measuring period is based on purpose for which compensation is being used
 - Code §415 - limitation year
 - HCE - lookback year
 - Top-heavy - plan year
 - Deductions - employer's tax year
- Cannot use accrued compensation
 - "First few weeks" rule - may include amounts earned during year but not paid until first few weeks of next limitation year
 - Election must be included in plan document

15



15

Post-Severance Compensation

- Post-severance compensation
 - General rule – post-severance compensation is NOT included in Code §415 compensation
 - Exception – Code §415 compensation includes payments made after severance of employment if:
 - Compensation is regular compensation or payment for unused sick, vacation or other leave
 - Payment is made by the later of (i) 2½ months after severance from employment or (ii) the last day of the limitation year in which the severance occurs, and
 - The amounts would have been included in 415 compensation if paid prior to severance from employment

16



16

Post-Severance Compensation

- Severance pay not included in compensation and may not be used for deferrals
- Plan can exclude all post-severance compensation for plan allocation purposes
 - Requires 414(s) testing

17



17

Differential Pay

- Differential pay is included as Code §415 compensation
 - Employer need not provide differential pay but if does it is included as 415 compensation
 - Employee treated as employed so must receive top-heavy contribution
 - Can exclude differential pay from Plan compensation
 - Not subject to 414(s) testing
 - Any contributions made on differential pay need not be taken into account for nondiscrimination testing

18



18

Plan Allocation Compensation

- Generally, may use any definition of compensation for allocations
- Must use nondiscriminatory compensation for:
 - Uniform allocation safe harbor
 - Permitted disparity safe harbor
 - Safe harbor 401(k) contributions
- Must use nondiscriminatory definition of compensation when testing plan contributions
 - To be nondiscriminatory, must meet definition under Code §414(s)

19



19

Code §414(s) Compensation

- For nondiscrimination testing (e.g., ADP/ACP testing), must use nondiscriminatory definition of compensation under Code §414(s)
 - Plan need not define compensation used for testing purposes
 - If plan does define testing compensation, then must follow definition under plan otherwise operational error
- Start with Code §415 compensation and may exclude any of the following:
 - All elective deferrals (including Roth contributions)
 - All fringe benefits, reimbursements, moving expenses, deferred compensation and welfare benefits
 - Amounts payable only to HCE

20



20

Compensation Ratio Test

- If exclude compensation other than safe harbor exclusions, must pass “compensation ratio test”
 - Determine compensation % for each employee
 - Compensation % = $\frac{\text{plan comp}}{\text{total comp}}$
 - Compare average for HCEs and NHCEs
 - HCE average cannot exceed NHCE average by more than a “de minimis” amount
 - 3% difference is generally considered de minimis

21



21

Example of Compensation Ratio Test

- Plan excludes bonuses for purposes of calculating ER contributions

EE	Total Comp	Plan Comp	Comp Ratio	Comp Ratio %	Avg %
HCE1	\$285,000	\$285,000	285/285	100%	
HCE2	\$285,000	\$285,000	285/285	100%	
HCE3	\$200,000	\$200,000	200/200	100%	100%
NHCE 1	\$80,000	\$76,000	76/80	95%	
NHCE 2	\$65,000	\$63,000	63/65	96.92%	
NHCE 3	\$47,000	\$45,000	45/47	95.74%	
NHCE 4	\$42,000	\$40,000	40/42	95.24%	
NHCE 5	\$42,000	\$41,000	41/42	97.62%	
NHCE 6	\$39,000	\$39,000	39/39	100%	96.75%
Does compensation definition satisfy Code §414(s)?					

22



22

Example of Compensation Ratio Test

- Plan excludes bonuses for purposes of calculating ER contributions

EE	Total Comp	Plan Comp	Comp Ratio	Comp Ratio %	Avg %
HCE1	\$285,000	\$285,000	285/285	100%	
HCE2	\$285,000	\$285,000	285/285	100%	
HCE3	\$200,000	\$190,000	190/200	95%	98.33%
NHCE 1	\$80,000	\$76,000	76/80	95%	
NHCE 2	\$65,000	\$63,000	63/65	96.92%	
NHCE 3	\$47,000	\$45,000	45/47	95.74%	
NHCE 4	\$42,000	\$40,000	40/42	95.24%	
NHCE 5	\$42,000	\$41,000	42/42	97.62%	
NHCE 6	\$39,000	\$39,000	39/39	100%	96.75%

Does compensation definition satisfy Code §414(s)?

23



23

Effect of Failure to Satisfy of §414(s)

- XYZ Corp maintains a 401(k) plan with a uniform 3% of Plan compensation PS contribution. For all purposes, Plan compensation is defined to exclude bonuses. The Plan fails the compensation ratio test. Jack earns \$50,000 and receives a \$5,000 bonus.
 - If Jack defers 5% of compensation, how much should he defer?
 - Must the Plan be amended to modify the definition of compensation under the Plan?
 - May the Plan use the Plan's definition of compensation for ADP/ACP testing?

24



24

Flexibility in Code §414(s) Compensation

- When performing ADP/ACP testing, can have flexibility in type of compensation used in test
 - Net compensation v. gross compensation
 - Full year compensation v. compensation while a participant
 - Can exclude types of compensation (e.g., bonuses) if compensation definition satisfies Code §414(s)
- Make sure plan document does not define compensation for testing purposes

25



25

Compensation Dollar Limit

Year	Maximum Plan Compensation
2015	\$265,000
2016	\$265,000
2017	\$270,000
2018	\$275,000
2019	\$280,000
2020	\$285,000

- Code §401(a)(17)
- The compensation dollar limit in effect for a plan year is the limit in effect at the beginning of that plan year

26



26

Compensation Dollar Limit

- Compensation dollar limit applies:
 - In determining an employee's allocation under the plan
 - For purposes of nondiscrimination testing - e.g., ADP/ACP tests
 - For purposes of compensation ratio test - both numerator and denominator limited by compensation limit
 - Example – In 2020, Joe earns \$350,000 but \$25,000 is excluded as bonus. How is Joe's compensation ratio determined?
 - Joe's compensation ratio is $\$285,000/\$285,000$

27



27

Compensation Dollar Limit

- How does compensation dollar limit apply to deferral elections?
- Example - Julie's compensation for 2020 is \$300,000. Julie elects to defer 5% of compensation. How much has Julie deferred for 2020?
 - \$15,000 [5% x \$300,000]*
 - \$14,250 [5% x \$285,000]
- Would answer change if plan contained 5% of compensation deferral limit?

28



28

Compensation Dollar Limit

- Short plan year issue
- The compensation limit for a short plan year is determined by multiplying the applicable annual compensation dollar limit for the calendar year in which the short year begins by a fraction:

Number of months in the short plan year

12

- What may create a short plan year?
 - Amendment changing plan year
 - Initial plan year
 - Plan termination
- Not prorated for participants who join or leave during the plan year
- Not prorated if plan states it uses calendar year compensation

29



29

Earned Income



30



30

Who is a Self-Employed Individual?

- Any individual who has “earned income”
 - Sole proprietors
 - Partners
 - Members of LLC treated as a partnership
 - Independent contractors may be self-employed
- Sole proprietor is the employer for qualified plan purposes
- Partnership / LLC is the employer for qualified plan purposes
- Shareholder of S-Corp is NOT self-employed

31



31

What is Earned Income?

- Earned income is used for qualified plan purposes, including:
 - Compensation under Code §415
 - Compensation used to determine allocations or benefits
 - Compensation for deduction under Code §404
 - Compensation for nondiscrimination testing
- Earned income is net earnings from self-employment, with modifications described in Code §401(c)(2)
- Earned income only includes earnings from a trade or business in which the individual’s personal services are a material income-producing factor

32



32

Earned Income for Sole Proprietor

- Sole proprietor – Start with Form 1040, Sch. C, Line 31 – Net profit or (loss)
 - Expenses already deducted, including contributions to qualified plan for employees, elective deferrals of employees and employee wages
 - Contributions and deferrals on behalf of self-employed individual are NOT expenses in determining net profit
 - Reductions to net earnings from self-employment to determine Earned Income
 - Deduction allowed under Code §164(f) for one-half of self-employment tax – Schedule SE, line 6 (also Form 1040, line 27)
 - Deduction allowed to individual under Code §404 for contributions to qualified plan (See Deduction Worksheet for Self-Employed – IRS Publication 560)

33



33

Earned Income for Sole Proprietor

- Net earnings from self-employment (NESE)
 - $\$107,602 - \$7,602 = \$100,000$
- So how much can be contributed to qualified plan?
 - Maximum deduction - 25% of earned income
 - To get earned income - must reduce NESE by plan contribution for SEI
 - $.25 (\$100,000 - x) = x$
 - $\$25,000 = 1.25x$
 - $\$20,000 = x$
 - $\$100,000 - \$20,000 = \$80,000$ - earned income

34



34

IRS Deduction Worksheet - IRS Pub 560

- Step 1
 - Enter your net profit from Schedule C (Form 1040); line 3 Schedule C-EZ (Form 1040); Schedule F (Form 1040); or box 14, code A**, Schedule K-1 (Form 1065)
- Step 2
 - Enter your deduction for self-employment tax from Schedule 1
- Step 3
 - Net earnings from self-employment. Subtract step 2 from step 1
- Step 4
 - Enter your rate from the Rate Table for Self-Employed or Rate Worksheet For Self-Employed

35



35

IRS Deduction Worksheet - IRS Pub 560

Contribution %	% of NESE	Contribution %	% of NESE
2%	1.9608%	14%	12.2807%
3%	2.9126%	15%	13.0435%
4%	3.8462%	16%	13.7931%
5%	4.7619%	17%	14.5299%
6%	5.6604%	18%	15.2542%
7%	6.5421%	19%	15.9664%
8%	7.4074%	20%	16.6667%
9%	8.2569%	21%	17.3554%
10%	9.0909%	22%	18.0328%
11%	9.9099%	23%	18.6992%
12%	10.7143%	24%	19.3548%
13%	11.5044%	25%	20%

36



36

IRS Deduction Worksheet - IRS Pub 560

- Step 5
 - Multiply step 3 by step 4
- Step 6
 - Multiply \$280,000 by your plan contribution rate (not the reduced rate)
- Step 7
 - Enter the smaller of step 5 or step 6
- Step 8
 - Contribution dollar limit - \$56,000
 - If you made any elective deferrals to your self-employed plan, go to step 9
 - Otherwise, skip steps 9 through 20 and enter the smaller of step 7 or step 8 on step 21

37



37

IRS Deduction Worksheet - IRS Pub 560

- Step 9
 - Enter your allowable elective deferrals (including designated Roth Contributions) made to your self-employed plan during 2019
 - Do not enter more than \$19,000
- Step 10
 - Subtract step 9 from step 8
- Step 11
 - Subtract step 9 from step 3
- Step 12
 - Enter one-half of step 11
- Step 13
 - Enter the smallest of step 7, 10 or 12

38



38

IRS Deduction Worksheet - IRS Pub 560

- Step 14
 - Subtract step 13 from step 3
- Step 15
 - Enter the smaller of step 9 or step 14
 - If you made catch-up contributions, go to step 16.
 - Otherwise, skip steps 16 through 18 and go to step 19.
- Step 16
 - Subtract step 15 from step 14
- Step 17
 - Enter your catch-up contributions (including Roth contributions, if any).
 - Do not enter more than \$6,000

39



39

IRS Deduction Worksheet - IRS Pub 560

- Step 18
 - Enter the smaller of step 16 or step 17
- Step 19
 - Add steps 13, 15 and 18
- Step 20
 - Enter the amount of designated Roth contributions included on lines 9 and 17
- Step 21
 - Subtract step 20 from step 19. This is your maximum deductible contribution.

Next: Enter your actual contribution, not to exceed your maximum deductible contribution, on Schedule 1, Form 1040

40



40

Sole Proprietor with Employees

- Difficulties arise when plan determines allocation
- Cannot determine allocation to employees until SEI's earned income is known
- Cannot determine earned income until allocation for employees is known
- Computer software can perform calculations to determine appropriate allocation



41

41

Partnerships Plans

- Plan must be maintained by partnership for partners
- Partners deemed to earn compensation on last day of partnership year
- Must enter into salary deferral election before end of plan year
 - Any deferrals will be allocated for plan year which includes last day of partnership year
 - Must have performed services for which deferrals are being made



42

42

Partnerships Plans

- Flo and Joe Partnership maintains a 401(k) plan for its employees. Flo and Joe each expect to earn over \$285,000 for 2020. Flo would like to begin deferring into the plan on January 1, 2020. May she do so?
 - Yes, Flo may take “draws” from the partnership and defer on those amounts
 - No problem as long as income justifies deferrals
 - What if no earned income at end of year?
- Joe does not elect to defer until 12/20/20. May Joe make a full \$19,500 deferral?
 - Yes, as long as enters into deferral election before end of partnership tax year

43



43

Partnerships Plans

- Would answer change if Joe enters into deferral election on January 15, 2021?
 - Yes, too late! Compensation already currently available
- By what date must Joe’s deferrals be deposited into the plan’s trust?
 - As soon as can be reasonably segregated from general assets – when distributive share determined

44



44

Other Issues for SEIs

- Change in status - employee becomes partner
 - Compensation is the SUM of the individual's compensation as employee (Form W-2) plus earned income as partner
- Contributions for SEI with two businesses - one has profits and one has losses
- Form W-2 wages for partners?
- Compensation for S-corporation shareholders
 - Medical premiums

45



45

Matching Contribution Issues

- Make sure matching contribution is consistent with plan document
- Make sure to provide true-up contribution if plan is using plan year compensation
 - Can avoid true-up contributions by basing deferrals on payroll compensation
 - Can employer have discretion whether to make true-up contribution?
 - Is employee entitled to earnings on true-up contribution?
- Additional testing may be required if different levels of match apply to different employees
 - Benefits, rights and features testing

46



46

Related Employer Issues

- Plan aggregates compensation of “related employers” for Code §415 compensation purposes
 - Get single Code §415 limit for related employers
 - Be careful if plan is top-heavy
 - Also must aggregate for HCE determination
- Plan compensation issues
 - Definition of plan compensation may include compensation of related employers for determining contribution under plan
 - May exclude compensation of related employers, but will be subject to 414(s) testing

47



47

Related Employer Issues

- Parent Corp and Sub Corp are related employers. Parent maintains 401(k) plan for its employees. Sub does not maintain a plan and does not participate in Parent’s plan. Parent’s plan excludes all compensation with Sub Corp for Plan purposes. Sarah earns \$80,000 with Parent and \$65,000 with Sub in 2019 and 2020.
 - Is Sarah an HCE under Parent plan for 2019?
 - Yes! All compensation with a related employer must be included for purposes of calculating 415 compensation
 - HCE determination is based on 415 compensation - Sarah earned \$145,000 in lookback year (\$125,000 dollar threshold for 2019)

48



48

Related Employer Issues

- Parent's plan excludes all compensation with Sub Corp for Plan purposes. Sarah earns \$80,000 with Parent and \$65,000 with Sub.
 - Is Sarah entitled to a contribution with respect to Sub compensation?
 - No! Plan may exclude compensation of related ERs for allocation purposes
 - Would answer change if Parent's plan is top-heavy?
 - Top-heavy contribution is based on 415 compensation so would have to aggregate compensation
 - Should Parent include Sub compensation for ADP/ACP testing?
 - Use any definition that satisfies Code §414(s)

49



49

Other Common Issues and Violations

- IRS examination guidelines and IRS CPE material concentrate on compensation and common problems
- IRS has identified numerous common problems it has found with compensation definitions during examinations
 - A plan amendment changes the definition of compensation from the plan's initial terms
 - A box on the plan's adoption agreement is marked incorrectly
 - The plan document was not carefully reviewed before it was signed

50



50

Other Common Issues and Violations

- Failure to follow plan terms
 - Operational error
- Coordination of plan terms and salary reduction agreements
 - Expiration of deferral elections
- Deferrals on bonus compensation

51



51

Other Common Issues and Violations

- Failure to use correct definition of compensation relating to taxable fringe benefits
 - Example - Plan includes fringe benefits in the definition of plan compensation and such amounts are not included in calculating deferral and matching contributions
- What are fringe benefits?
 - No definition in Code / regulations (IRS Pub 15-B, Employer's Tax Guide to Fringe Benefits)
 - Any "unusual" type of compensation
 - Car allowance
 - Moving expenses
 - Holiday bonus/gifts

52



52

Other Common Issues and Violations

- Failure to use proper definition of compensation for deferral and allocation purposes
 - Correction methods
 - Distribution of excess deferrals
 - Additional contributions
 - QNEC contributions
 - Missed deferral opportunity contributions
 - Forfeiture of employer contributions
 - Forfeiture of matching contributions attributable to excess deferrals

53



53

Missed Deferral Opportunity

- If missed deferrals begin within 3 months from date of failure - no corrective QNEC required
- If after 3 months (but before end of 2nd PY) - corrective QNEC equal to 25% (instead of 50%) of missed deferrals
- Employer must make contribution for missed match, plus earnings, by end of second plan year following failure
- Employer must send 45-day notice to affected Employees
- Automatic enrollment plans have special correction method

54



54

Other Common Issues and Violations

- Failure to apply Code §401(a)(17) compensation limit
 - Reduction of account balance correction method
 - Contribution correction method
 - Requires plan amendment

55



55

Other Common Issues and Violations

- Compensation definition in a safe harbor 401(k) plan
 - Contributions must be based on a nondiscriminatory definition of compensation within the meaning of Code §414(s)
 - Start with Code §415 compensation and may exclude any of the following:
 - All elective deferrals (including Roth contributions)
 - All fringe benefits, reimbursements, moving expenses, deferred compensation and welfare benefits
 - Amounts payable only to HCE
 - Compensation may be limited to period of eligibility
 - Compensation ratio test available
 - Compensation of NHCE may not be limited (capped)

56



56

Other Common Issues and Violations

- Using accrued compensation
- Top-heavy contribution for participants who enter plan mid-year
- Cross-testing when all participants are in own group, but all get a uniform percentage of compensation
- Eligible HCE with no compensation – included in ADP test?
- 403(b) plan definitions of compensation
- Basing contributions on distributions of nonqualified deferred compensation

57



57

IRS Correction Programs

- Self-Correction Program (SCP)
 - Plan must have practices and procedures
 - No IRS fees
 - Determination of “significant” or “insignificant” errors
 - 2 years to correct significant error
- Voluntary Correction Program (VCP)
 - Submission to IRS with user fee
 - Proposed/negotiated correction
- Audit Closing Agreement Program
 - SCP correction with negotiated sanction

58



58

THANKS FOR ATTENDING!



59