

# December Newsletter: Plan Compensation

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**When** it comes to operating your retirement plan, determining the compensation that should be used for each participant can be really confusing. It seems like it should be simple, but the reality is quite different. In fact, the rules can be so confusing that using an incorrect definition of compensation is on the top ten list of mistakes the IRS sees in voluntary correction filings.

Since compensation is used not only to calculate contributions but also to apply limits, conduct nondiscrimination testing and determine tax deductions, the IRS is especially concerned that it be correct. While an exhaustive discussion of all the rules and exceptions would take up far more space than we have here, this article will cover some of the more common points of confusion.

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## Overview

For starters, no matter how a given plan determines compensation, the IRS sets a cap on the maximum pay that can be counted each year. The limit for 2016 is \$265,000, and the IRS adjusts this maximum each year based on the rate of inflation.

The more standard definitions of compensation cast a wide net in terms of what they include. There are four general definitions that serve as starting points:

1. W-2 compensation;
2. Withholding wages;
3. Current includible compensation; and
4. Simplified compensation.



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There are more similarities than differences among these definitions, and the differences involve certain specific types of pay. For example, non-cash tips are excluded in #1 and #2 but are included in #3 and #4. Distributions from non-qualified plans are just the opposite—in for #1 and #2 but out for #3 and #4.

Examples of other differences include the value of group term life insurance in excess of \$50,000 as well as certain stock options. Because the differences are so limited, all four definitions will yield an identical result for the "average" employee.

If you want to disregard a certain form of pay that isn't already excluded under one of the above definitions, it must be clearly identified and specifically excluded in the plan document. The trick is that if certain types of compensation are excluded, it can trigger additional nondiscrimination testing to ensure that non-highly compensated employees are not disproportionately affected.

The so-called compensation ratio test divides included compensation by total compensation to arrive at a ratio for each participant. The average ratio for the highly compensated employees (HCEs) cannot exceed that of the non-HCEs (NHCEs) by more than a de minimus amount. What does de minimus mean? Good question. It's not defined, but based on anecdotal information from IRS representatives, a spread of three percentage points or less is usually deemed acceptable.

## Pre-Participation Compensation

Most plans have some sort of waiting period before new employees become participants. Under all of the above definitions, that pay is counted for testing as well as for calculating benefits. If the goal is to disregard pre-participation compensation, the exclusion must be noted in the plan document.

This particular exclusion does not trigger the compensation ratio test; however, there is an important point to note. If a plan is top-heavy (more than 60% of the plan benefits are for certain owners and officers), any minimum required company contribution must be calculated using full compensation even if the plan otherwise excludes pre-participation pay.

## Bonuses, Commissions and Overtime

Although not uncommon, these types of pay are also not necessarily regularly recurring. As a result, some companies prefer to exclude them for plan purposes. Again, the default under the four definitions is that all of these are included unless otherwise noted in the plan document. This is where being specific can be important.

Let's use bonuses as an example. Assume that White Ocean, Inc. pays performance bonuses, holiday bonuses and ad hoc merit bonuses. They want to include performance bonuses but disregard the other two. If White Ocean sticks with one of the standard definitions of pay, all bonus payments are in; however, if they simply exclude "bonuses," all three types are out. To



accomplish its goal, White Ocean would have to note in the plan document that holiday and ad hoc merit bonuses are excluded.

In addition to the need for specificity, all three of these types of pay, if excluded, trigger additional testing, and it is important to monitor changing conditions from year to year. Consider this example:

The Lost Penguin 401(k) Plan excludes bonuses and overtime from its definition of pay. The company has several strong years in which it hires new employees and pays bonuses of 5% to 10% depending on position. Because they are well-staffed, very few of the hourly employees put in much overtime. Since the HCEs receive larger bonuses than the NHCEs, the plan easily passes the compensation ratio test since bonuses are excluded.

Fast forward a couple of years when difficult economic times require Lost Penguin to cut its staff. The employees that are left put in a lot of overtime to get the work done, and company losses mean no bonuses are paid. Now, the exclusion of overtime means the plan's definition of pay disproportionately impacts the NHCEs, and the compensation ratio test fails.

## Taxable Fringe Benefits

This type of pay includes items that might not be in the form of cash but still provides something of value to an employee and must, therefore, be reported as taxable income. One example might be allowing employees to use company cars for their own personal business. Although included by default, a plan can exclude taxable fringe benefits from its compensation definition. If the plan excludes all taxable fringe benefits (and not just some), then the compensation ratio test is not required.

## Reimbursements and Allowances

The distinction between reimbursements and allowances can sometimes be a tricky one and is more easily explained via an example. Wonderland, LLC provides its CEO, Alice, with a monthly amount to cover automobile expenses. Alice receives that amount regardless of the actual expenses she incurs, and she is not required to provide any documentation. Lewis is a salesman for the company. He tracks his mileage each month, submits documentation to the company and receives a payment for each mile to cover the related expenses. Alice's payment is an allowance and Lewis' is a reimbursement.

The difference is important, because a reimbursement is not taxable (and, therefore, not included as plan compensation), while an allowance is taxable and is included for plan purposes. An allowance is generally considered to be a taxable fringe benefit, so it follows the rules noted above.



## Post-Severance Compensation

Post-severance compensation is any amount paid to an employee following his or her severance from employment. It generally falls into four categories:

1. Amounts earned but not yet paid at time of termination (bonuses, commissions, etc.);
2. Payments for unused leave (sick leave, vacation, etc.);
3. Distributions from deferred compensation plans; and
4. Traditional severance pay.

The first three are amounts the employee would have been entitled to receive even if he or she remained employed. The fourth is not...the employee is essentially being paid to leave.

The default provision in most plans is that the first three types are counted if they are paid before the later of:

- The last day of the plan year in which the employee terminated; or
- Two and a half months following the employee's date of termination.

The fourth type can never be treated as plan compensation, so it is important not to promise departing employees that they will receive retirement benefits based on traditional severance payments.

## Self-Employed Individuals

So far, we've focused on amounts paid to employees, but there are some important nuances that apply to owners and self-employed people. Owners of corporations receive W-2 compensation, and any distribution of profits (either dividends in a C corporation or S corporation distributions) is disregarded for plan purposes.

Self-employed individuals, such as sole proprietors and partners in a partnership, on the other hand, receive earned income which is counted. The calculation used to determine the exact dollar amount of earned income for each self-employed individual is very complex and includes some circular calculations and adjustments.



## Employees vs. Independent Contractors

While somewhat beyond the scope of this article, this topic is worth mentioning at least in passing. The IRS, DOL and most states have strict rules for defining who is an employee and who is an independent contractor. Most of those requirements revolve around who controls the work and have very little to do with how the worker is paid.

In other words, simply reporting payments on a Form 1099 instead of a Form W-2 does not make someone a contractor. This is important because if it is determined a worker is an employee, the amount of payments reported on the Form 1099 must actually be recharacterized as compensation that must be considered for plan purposes.

## Conclusion

As you can see, something as seemingly simple as determining compensation can become quite complicated, and this article has only scratched the surface. Payroll is often a company's most significant expense, so it is no surprise that many companies devote a lot of time and energy to developing their compensation strategies to attract and retain employees. Retirement benefits are an important part of that strategy.

No matter how simple your pay structure may appear, the retirement plan rules are complex enough that you can't go wrong by consulting an expert to make sure your plan defines compensation exactly as you intend and that all necessary parties—from HR to finance to outside service providers—are on the same page.



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## IRS and Social Security Annual Limits

Each year the U.S. government adjusts the limits for qualified plans and Social Security to reflect cost of living adjustments and changes in the law. However, the 2015 limits will remain unchanged for 2016 because the increase in the cost-of-living index did not meet the statutory thresholds that trigger their adjustment. Many of these limits are based on the "plan year." The elective deferral and catch-up limits are always based on the calendar year. Here are the 2015/2016 limits as well as the 2014 limits for comparative purposes:

	2015/2016	2014
Maximum compensation limit	\$265,000	\$260,000
Defined contribution plan maximum contribution	\$53,000	\$52,000
Defined benefit plan maximum benefit	\$210,000	\$210,000
401(k), 403(b) and 457 plan elective maximum elective deferrals	\$18,000	\$17,500
Catch-up contributions	\$6,000	\$5,500
SIMPLE plan elective deferrals	\$12,500	\$12,000
Catch-up contributions	\$3,000	\$2,500
IRA	\$5,500	\$5,500
Catch-up contributions	\$1,000	\$1,000
"Highly Compensated" employee threshold	\$120,000	\$115,000
"Key Employee" (officer) threshold	\$170,000	\$170,000
Social Security taxable wage base	\$118,500	\$117,000

