



Employing the Proper Definition of Compensation

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The U.S. Department of Labor (“DOL”) and the Internal Revenue Service (“IRS”) routinely report common operational failures that such agencies detect in the context of retirement plan audits and investigations. One of the operational failures that is always at or near the top of that list concerns plan sponsors failing to employ the correct definition of compensation for purposes of performing necessary compliance testing and/or determining benefit allocations. The following article is intended to briefly highlight some of the issues that can occur when the incorrect definition of compensation is employed as well as to provide an explanation of some of the differences between the most commonly employed definitions of compensation.

Impact of Employing the Incorrect Definition of Compensation

As suggested above, utilizing the correct compensation for each retirement plan participant is very important. This is because compensation is a critical data point which is necessary in order to accurately calculate many different plan limits and make proper benefit calculations. Sometimes problems occur if a plan sponsor fails to limit compensation to the maximum amount which may be considered for tax-qualified retirement plan purposes under the Internal Revenue Code. In other situations, a plan sponsor may not understand what types of income are included within the definition of compensation. In still other circumstances, a plan sponsor may not realize that different definitions of compensation are employed for different plan purposes. When mistakes such as these occur, tax-qualification defects often result.

As a more specific example, compensation is employed to calculate the Average Deferral Percentage (“ADP”) and Actual Contribution Percentage (“ACP”) tests (the tests that limit the amount of “elective deferrals” and “employer matching” contribution that can be received by plan participants during a plan year). If such tests are not performed accurately, a failing test may appear to be passing or an incorrect distributable amount may be calculated to “correct” a failing test. Inaccurate compensation data would also result in the inaccurate calculation of salary deferral, employer matching and employer profit sharing contribution amounts.

As a result of these concerns, plan sponsors should be familiar with the terms of the plan document to ensure that they use the proper definition of compensation for nondiscrimination testing, deferral and contribution calculations and limitation purposes. It is important to recognize whether: 1) certain types of compensation are excluded for specific plan purposes; 2) compensation is limited for specific plan purposes; and/or 3) compensation is determined using different computation periods (i.e., plan year vs. calendar year).

Failure to follow the terms of the plan document, properly limit the maximum considerable compensation under the Code or satisfy the ADP and/or ACP tests are problematic and, if possible, should be corrected as soon as possible under the “Employee Plans Compliance Resolution System” (“EPCRS”) as sponsored by the IRS. Failure to do so can result in severe consequences which, in



extreme circumstances, can lead to significant penalties up to and including plan “disqualification” (the immediate taxation of the trust of the plan at issue, the immediate taxation of the participants on their assets held by such plan and the loss of the employer’s tax deduction on contributions to such plan for all “open” plan years).

Differences Between Commonly Employed Definitions of Compensation

In order to assist in illustrating some of the differences between commonly employed definitions of compensation, we have created the following chart. However, please be aware that this chart is only a brief summary of some of the differences between the most commonly employed definitions of compensation and is by no means complete.

Item of compensation	415 Simplified Comp	W-2 comp	Section 3401(a) Wages
Salary	Included	Included	Included
Overtime	Included	Included	Included
Bonuses	Included	Included	Included
Commissions	Included	Included	Included
Tips	Included but allocated tips are excepted	Exclude allocated tips, noncash tips, tips under \$20 per month	Same as W-2
Elective deferrals	Included	Included	Included
Differential wage payments to individuals in the military	Included	Included	Included
"Nonqualified" moving expense reimbursements	Excluded	Included	Included
Nontaxable fringe benefits	Excluded	Excluded	Excluded
Taxable fringe benefits	Included	Included	Included
"Excess" group term life insurance	Included	Included	Excluded
Taxable medical or disability benefits	Excluded	Included	Included
Nonqualified plan distributions	Excluded unless plan provides otherwise	Included	Included



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As much as we hope this article helped you to better understand this topic, it is not to be construed as financial, tax or legal advice. Therefore, if you believe that the issues discussed herein may apply to your (or your client's) company, be sure to further discuss it with a qualified retirement plan professional; more specifically, your tax and/or accounting professional. For more information about this topic, please contact our marketing department at 484-483-1044 or your administrator at Legacy.



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