



Diane Boleyn, CRSP
Compliance Specialist



AT Bancorp

Compensation Under Your Retirement Plan

Employers that sponsor qualified retirement plans are responsible for a number of administrative duties. One of the most important and sometimes complex of these duties includes determining each employee's compensation as defined under the plan document. It is critical that compensation determined by the employer is accurate as it is used in:

- Calculating how much will be deducted from each employee's paycheck and submitted to the 401(k) plan on their behalf
- Determining how much an employee will receive in employer contributions, whether it be matching contributions and/or profit sharing contributions
- Performing compliance testing as required by the Internal Revenue Code

There are generally three definitions of compensation available to an employer in a qualified retirement plan. Under the American Trust & Savings Bank Defined Contribution Volume Submitter Plan & Trust, the three definitions are:

- W-2 wages
- IRS Code §3401(a) wages (income tax withholding)
- IRS Code §415 compensation (current income definition/simplified compensation)

About the Definitions

All three definitions include wages, salaries (including overtime), fees for professional services, and "other amounts received" (cash or noncash) for personal services rendered in the course of employment *to the extent includible in income*, including commissions on sales and insurance premiums, bonuses, fringe benefits and reimbursements (or expense allowances) under a non-accountable plan.

For an average employee earning only wages, salaries, overtime, bonuses, and commissions, all three definitions produce the same result. However, when additional forms of compensation are paid to employees, different definitions can produce different results.

Most employers use W-2 Wages as the definition of compensation under their plan. Many employers prefer this definition because it is the information most easily obtained through their payroll service providers. W-2 Wages and IRS Code §3401(a) Wages are similar with some exceptions. For instance, group term life insurance in excess of \$50,000 is included in W-2 Wages (because it is reported in Box 1), but is not subject to federal income tax withholding; therefore, it is not included under IRS

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§3401(a) Wages. As for IRS Code §415 Compensation, an employer may want to use this definition over say, W-2 Wages, because there is some type of payment that they want to treat differently than is treated under W-2 Wages.

We are focusing on W-2 Wages in our newsletter since it is the most commonly used definition. W-2 Wages generally include wages reported in Box 1 on Form W-2. We say “generally” because Box 1 **does not** include elective deferrals, **so they must be added back.**¹ Elective deferrals include deferrals to a 401(k) plan, 403(b) plan, 457(b) plan, salary reduction SEPs, SIMPLE IRAs, 125 cafeteria plans (aka flexible spending arrangements) and qualified transportation fringe benefit arrangements. Please note that Roth deferrals are already included in Box 1 and do not need to be added back. Also note that Box 5 should not be used instead of Box 1 as there are a number of differences between Box 1 and Box 5.

Important: Similar to W-2 Wages, IRS Code §3401(a) Wages **does not** include elective deferrals. Any pre-tax elective deferrals would have to be added back into compensation for the affected individual. *However*, IRS Code §415 Compensation **does** include elective deferrals.

In the case of a **self-employed** individual (sole proprietor, partner under a partnership, or an entity taxed as a partnership), compensation means Earned Income, which is net earnings from self-employment in the trade or business with respect to which the employer has established the plan.

Severance from Employment

The IRS issued updated regulations under Code §415 which affect the treatment of compensation paid after an employee’s severance from employment. The updated rules, which generally took effect in 2008, require that certain types of post-severance compensation paid **within the later of 2 ½ months following the employee’s severance, or the last day of the plan year in which the**

employee severed employment, be included as eligible compensation.

The post-severance compensation that is *required* to be included and reported as compensation includes:

Regular Pay which includes overtime, shift differentials, commissions, or bonuses for services performed prior to severance.

Some *optional* forms of post-severance compensation include:

Leave Cash Outs: payments for accrued bona fide sick, vacation, or other leave the employee would have been entitled to if employment had continued. Your plan document will determine whether you include leave cash outs as part of plan compensation.

Other forms of post-severance compensation that *plan sponsors have the option* to include based on elections in the plan document include:

Deferred Compensation: payment from a nonqualified unfunded deferred compensation plan.

Military Service Payments: payments made to an individual who is currently in military service and no longer performs service for the employer.

Disability Compensation: pay to a permanently and totally disabled participant.

Severance Pay should never be included in compensation.

This would include any pay an individual receives after severance of employment which is paid as a result of the severance of employment.

Financial Impact

Failure to use the definition of compensation specified in an employer's plan document is considered an operational failure by IRS standards. This type of error can be costly for the employer to resolve. Depending on the error, IRS self-correction method may require make-up contributions (and earnings) to be made to the affected participant's account.

Considerations

Please be aware that non-cash forms of benefits (e.g., use of company car) may be included in your plan's definition of compensation and therefore would require that (in the case of a 401(k) plan) salary deferrals be deducted from said amounts. In addition, these amounts would need to be included in calculating any matching or profit sharing contribution made under your plan, as well as in the compensation reported to American Trust for purposes of year-end compliance testing.

Determining compensation for each employee is a function of looking at all the items that make-up your company's payroll and identifying those things that should be included. There can be many items that make up yours or any company's payroll (too many to list). Some IRS publications that you or your accountant are probably familiar with may help you in the process of determining what benefits/payments are included in compensation are:

- Publication 15 (Circular E), Employer's Tax Guide
- Publication 15-A Employer's Supplemental Tax Guide (Supplement to Publication 15, Circular E), Employer's Tax Guide
- Publication 15-B Employer's Tax Guide to Fringe Benefits
- Publication 525 Taxable and Nontaxable Income
- General Instructions for Forms W-2 and W-3

Publications can be found at www.irs.gov/publications/index.html.

Should you decide to add any items to your employees' benefits package, we suggest you contact your accountant or payroll provider to see if it will be considered compensation under the plan, so as to administer the plan properly.

The content of this newsletter is for informational purposes only. It should not be used as a substitute for specific tax, legal and/or financial advice. Your accountant, tax advisor, or payroll provider is your best resource for determining compensation for each of your employees.

¹Box 1 plus pre-tax elective deferrals will equal W-2 Wages, with two possible exceptions: 1. An employer must disregard any rules that limit the payments included in wages based on the nature or location of the employment or services performed. Therefore, even if a foreign subsidiary pays an individual for work outside the United States and is not required to give the individual a Form W-2, the employer must count the compensation which would have been reportable on a W-2. 2. An employer should include amounts the employer paid or reimbursed an employee for moving expenses, if at the time of payment, it is reasonable to believe that the employee can deduct the amounts under Code §217. If however, the employer made an election in their plan document to exclude these amounts, the employer should not include them in compensation.