

## Episode 2: Definition of Compensation for Retirement Plans

MAY 20, 2019



We encourage you to subscribe via [Apple iTunes](#) or [Google](#), or via the RSS feed [here](#).

### Audio Transcript

**Steve Flores:** Welcome to Winston's Benefits Blast podcast. I'm Steve Flores and I'm joined today by Nancy Gerrie, co-chair of the Employee Benefits & Executive Compensation group here at Winston. During this episode, we will be presenting on the definition of compensation for retirement plans. So, Nancy, tell our listeners; what is the definition of compensation in a retirement plan used for and why does it matter?

**Nancy Gerrie:** Thanks, Steve. Well, we picked this as a topic today because it is an issue that seems so simple, but it's actually very complicated and full of traps for the unwary. So, most retirement plans calculate the benefits that they will pay to participants based on the participants' pay or compensation.

Examples of this are profit sharing plans where the employer contributes a percentage of the employee's pay each year or a defined benefit pension plan, where the employee's benefit is based on their, for example, final average pay or career average pay. Plans are pretty much free to define the components of pay used to calculate those benefits, unless you have a safe harbor 401(k) plan where you have to use an IRS approved definition of compensation. But that's an exception – most plans can pick whatever definition of compensation the employer wants to use.

However, once the employer has decided how to design their plan, those components of pay have to be clearly described in writing in the plan document. And when you consider how many types of pay an employee can get, like salary, wages, overtime, shift differential, long-term bonus, performance bonus, stock grants, etc., you realize how many types of compensation there really are. Just ask any payroll manager if you want to know.

**Steve Flores:** Okay, so that can get pretty complicated. Can you describe for our listeners what can happen if you get it wrong?

**Nancy Gerrie:** Well, if you have a plan where the employer has been contributing on the wrong items of pay, for example, and are not following the plan document, there are two basic worries: an audit by the government or a claim for the benefit by a plan participant, or his or her attorney.

Checking whether a plan has been using the right definition of compensation is an extremely easy task for an IRS or DOL agent to do during a routine plan audit. All they have to do is ask for the employer's payroll records and compare them to the plan's definition of compensation that's in the document. So if the employer is using the wrong definition of pay to calculate benefits from what the plan document says, the IRS could consider the plan to be out of compliance and possibly disqualify it for tax purposes. That is the worst possible result because then the tax-deferred nature of the plan is lost.

Similarly, if the DOL finds the error, it could decide that the plan administrator didn't follow the terms of the plan and therefore committed a breach of fiduciary duty. Plan administrators do not want to be accused of a fiduciary breach.

**Steve Flores:** Right, well, thankfully there are fixes for problems like this but they can be costly for the company and disruptive to the employees. Do you have an example that you can share with our listeners?

**Nancy Gerrie:** Yes, many, and one war story, in particular, stands out for me.

One of my clients many years ago had a large 401(k) plan with an employer match. The company had used what's called a pre-approved plan document that consists of a bunch of boilerplate choices that the plan's record keeper supplied to them. For many years, the plan document stated that employee bonuses were not included in the definition of compensation for purposes of the employer match. Employees could make a 401(k) deferral out of the bonus but it wouldn't be matched.

Not a problem, until the company changed record keepers. The new record keeper had its own plan document they wanted the company to use in place of the old plan document; you can see where this is going. The new record keeper rushed the new plan document through and no one realized that they had failed to exclude bonuses from the matching contribution description. No one realized the error for three years and the company just continued its old practice of not making matching contributions on employee bonuses. By the time the problem was discovered three years later, the company added up all the contributions that should have gone into the plan based on this additional compensation, plus earnings that should have accrued on those missed contributions, and the shortfall totaled \$16 million. Of course, the stock market had been on a tear during those years. It was ugly, the board got involved and they thought there was going to be a hit to the earnings per share if they had to contribute \$16 million into the plan, plus earnings.

And the head of benefits was in tears and was afraid she was going to lose her job, all because of a small mistake in the plan's definition of compensation.

**Steve Flores:** Wow, I think that really shows us what is seemingly a small mistake, can have huge implications. Other than calculating benefits, there are a few other ways the definition of compensation can come into play, can you touch upon those?

**Nancy Gerrie:** Yes, there are two additional ways the definition of compensation comes into play for retirement plans. Number one is, what definition of compensation the employer uses for doing non-discrimination testing? Like figuring out who their highly compensated employees are or doing ADP/ACP testing in a 401(k) plan, etc. That definition of compensation is dictated by certain IRS rules and there's not as much leeway in picking and choosing what elements of pay are counted for that purpose. So for example, you typically wouldn't be able to exclude bonuses when doing non-discrimination testing or determining who qualifies as a highly compensated employee.

The number two way that a plan must be careful about is how it determines the annual limitations on the amount of contributions that can go into a plan under the Tax Code Section 415 regulations. Again, that definition is also dictated by certain IRS rules which may be different from the rules that govern non-discrimination testing, depending on which safe harbor definition of compensation the plan document spells out.

These testing definitions do not necessarily mirror the basic definition of pay that a plan sponsor uses to calculate an employees' benefits. Of course, this causes some confusion. You just have to look very carefully at the various definitions of compensation that are in your particular plan and make sure you are following what is included and excluded extremely carefully.

Also, just to note one more wrinkle, we said at the top of this podcast that employers can pick whatever definition of compensation they want to use. But note, however, that if you do choose a definition of compensation that's not one of these IRS safe harbors, you may have to test the benefits under the plan periodically to make sure the definition of compensation itself is not discriminatory.

Usually, this would only be an issue if your definition of compensation for plan benefits purposes is skewed so that highly compensated employees get contributions on more components of pay than non-highly compensated employees. For example, if you have a lot of hourly employees and a few salaried employees who get bonuses and your definition of compensation in your plan excludes overtime, for example, but includes bonuses, you can see how this would be inherently discriminatory against your non-highly compensated employees.

**Steve Flores:** So, a plan can have multiple definitions of compensation. One definition for calculating benefits, another for non-discrimination testing, another for applying dollar limits. This seems awfully complicated, why don't plan sponsors simply use a single definition for all purposes?

**Nancy Gerrie:** Great question, you could use one of these IRS safe harbor definitions of pay for all purposes under your plan, but buyer beware on that one. It may seem simpler, but it's not always simpler.

**Steve Flores:** Can you give us an example?

**Nancy Gerrie:** Yes and I'll give you an example that is a problem for a lot of employers, especially smaller companies who have matured quickly and maybe are doing very well and want to reward people with equity awards like stock options, etc. So they may not have paid much attention to the definition of compensation that they originally selected in their 401(k) plan when it started.

For example, in those pre-approved plan documents I mentioned earlier, one of the standard choices for the definition of compensation is W-2 compensation. And you could see why an employer would choose this, they think, "Oh yeah, I'll include all my employees' W-2 pay, that covers the waterfront. No problem, I'll pick that!" But, if that company offers any equity compensation or incentive compensation paid in the form of stock, now you've got a really unwieldy definition of compensation for making 401(k) deferrals out of. Are you really going to take 401(k) deferrals out of a stock award? But that's W-2 compensation.

Or how about taxable employee expense reimbursements, how do you take 401(k) deferrals out of a reimbursement? I suppose you could take it out of other pay to make up for it, but that gets complicated and confusing to employees. So the innocent choice of W-2 compensation can actually cause many headaches. And there are other and even more complicated problems that flow out of the wrong choice of compensation. But the W-2 example is so easy to explain and the ramifications of making the wrong choice are so drastic that it really illustrates how important it is to make sure your definition of compensation in your plan is what you think it should be.

**Steve Flores:** Well, Nancy, this would make us all nervous, let's talk about a few Winston takeaways.

Takeaway number one: No matter how long your plan has been around, consider doing a payroll audit every few years or any time you update your plan document or you change your record keepers. This is really an area where you can't just set it and forget it. Many plan administrators never think to revisit the plan's definition of compensation after the original engagement. Yet if you talk to a payroll administrator, they'll tell you that most businesses modify their pay codes all the time. Are there new types of pay that should be captured in your plan that aren't fitting into the old plan document definition? Are there types of pay that should not be included? We recommend that plan administrators do a check of all payroll codes that feed into their plan and compare it to the plans definition of compensation. You should do this on a fairly frequent basis. For large employers we recommend doing this exercise

at least every two years or so. And as Nancy mentioned earlier, this is a very easy exercise for the IRS or DOL auditor during a plan audit. It's low hanging fruit for them. So if they can do it, you should be doing it, too.

Takeaway number two: Don't forget to review your non-qualified plans that are tied to your qualified plans. If you're looking at or changing the definition of pay in your qualified retirement plan, think about looking at it in your non-qualified retirement compensation plan, too. This is particularly important where the definition of compensation in your non-qualified plan is linked to the definition of compensation in your qualified plan. And if they have different definitions, make sure that you understand the differences and are administering them correctly.

So Nancy, going back to your earlier comments, whatever happened to that company with the \$16 million error in their definition of compensation?

**Nancy Gerrie:** Well, we were able to fix it, and all they had to do was pay the IRS a \$25,000 fee, and the benefits administrator didn't lose her job. But that's a story for another podcast. Thank you for joining us and please remember, check your pay codes.

**Steve Flores:** Thank you, Nancy, and thank you for listening to another edition of our Benefits Blast podcast. Stay tuned to future episodes for more insights on the latest legislative, regulatory and practical developments concerning employee benefits and executive compensation. Also, please check out our Benefits Blast blogs for updates on the latest legal developments in the employee benefits area. You can reach it by going to [Winston.com](https://www.winston.com) and clicking on the blogs link at the top of the page.

## Related Locations

Chicago

Washington, DC

## Related Topics

Podcast

Retirement Plans

Executive Compensation

Fiduciary & Investment Issues

## Related Capabilities

Executive Compensation Plans & Agreements

Employee Benefits & Executive Compensation

Health Care

## Related Regions

North America