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BLOG

Traps for the Unwary: Common Mistakes in Applying Compensation Definitions Under Retirement Plans

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Most retirement plans calculate benefits on the basis of a participant's pay or compensation. For example, in a profit-sharing plan, an employer typically contributes a percentage of the employee's pay each year, or, in a defined benefit pension plan, the employee's benefit will be based on his or her final average pay or career average pay.

Employers are largely free to define the components of pay used to calculate plan benefits as they see fit among the choices permitted. However, once the employer has decided how to design its plan, the components of pay and application of the definition of compensation have to be clearly described in writing in the plan document, and accurately applied in calculating plan benefits, performing nondiscrimination testing, and applying statutory limitations.

Common Mistakes and Misconceptions

Due to complexities involved with tracking pay, errors are often made. Errors in administering the definition of compensation can be very costly to correct, especially if the errors apply to a large number of employees. Below is a shortlist of common mistakes and misconceptions related to calculating compensation for plan purposes.

1) Imprecise Plan Descriptions of Compensation and Misclassifications of Certain Types of Pay

There are many types of pay an employee might receive, such as salary, wages, fringe benefits, overtime shift differential, long-term bonus, performance bonus, stock grants, etc. Compensation types also may shift over time, as needed to meet an employer's recruitment and retention goals. The plan document might describe pension-eligible pay in broad terms that do not clearly cover specific or special compensation types provided by the employer. When the plan document is imprecise, there is an opportunity for mistakes in interpretation that could result in items of compensation being misclassified as plan-eligible or plan-ineligible. These misclassifications become wired into the payroll system once payroll codes are established, and result in repeated erroneous inclusion or exclusion of items of pay for determining plan benefits.

2) Misapplication of Multiple Compensation Definitions

Plans do not always apply a single definition of compensation for all plan purposes. For example, the definition of compensation used in performing nondiscrimination testing is limited by certain IRS rules, and there is not as much leeway in choosing which elements of pay are counted for testing as there is for designing the plan's benefit formula. As a result, the plan will often apply a different definition of compensation for testing purposes than it applies for calculating benefits. Similarly, the definition of compensation used for applying annual limitations on the amount of plan benefits or contributions during a plan year may utilize yet another definition. This definition for applying annual limitations is also dictated by certain IRS rules that may differ from those that govern nondiscrimination testing, depending on which safe-harbor definition of compensation the plan document applies. Applying the wrong definition of compensation for the wrong purpose could result in skewed discrimination testing results or benefit calculations that exceed annual benefit limitations.

3) Misunderstandings Related to the Application of Code-Based Definitions

To avoid the issues described in Items 1 and 2 above, employers sometimes opt to apply a "safe harbor" definition of compensation for all purposes under the plan. However, the safe-harbor options themselves have different components, such as W-2 wages, or wages subject to withholding, or compensation described in the general *Internal Revenue Code* Section 415 definition. (For a more detailed description of the safe-harbor compensation definitions, see the IRS publication on compensation.) The application of these statute-based compensation definitions seems to present a simple solution to pay-tracking problems but can, in application, be difficult to administer. To start, the references to the definitions can be misleading. For example, the W-2 definition of compensation does not necessarily result in a participant's Box 1 wages on his or her Form W-2 being included in plan compensation. The safe-harbor definition instead starts with W-2 wages, but then adds and subtracts certain additional components of compensation, such as employee deferrals. In addition, depending upon the types of compensation offered to employees, the application of the safe-harbor compensation definitions can have complicated results. For example, certain types of non-cash compensation are included in the safe-harbor definitions of compensation. Under a defined contribution plan using that definition for employee deferrals, this would mean that a participant may make elective deferrals on non-cash compensation, which is usually not the intended result and is difficult to administer. Furthermore, the problems described in Item 1 can arise when the safe-harbor definitions are not tailored to all of the employer's unique pay codes. Though seemingly simpler, the safe-harbor compensation definitions are often misapplied.

Winston Takeaway

Each compensation calculation mistake results in a failure to follow the terms of the plan document, which could result in a participant claim or, alternatively, present problems for the employer upon IRS or DOL audit. In order to minimize compliance issues resulting from the misapplication of compensation definitions, we suggest employers take the following steps:

- **Understand how your plan uses the term "compensation," and for which plan purposes.**

  It is important for employers to understand which types of compensation are included in their plan's definition, how many separate compensation definitions should be tracked, and what the differences are with respect to each of those definitions. With an understanding of what should be included in compensation for various plan purposes, an employer should review the plan document and summary plan description to ensure that each document contains an accurate description of the employer's practices.

- **Consider performing payroll audits every few years and following any update to your plan document or change in payroll provider or plan record-keeper.**

  Compensation and benefits are ever-evolving. Payroll codes are added and changed frequently. Furthermore, tax law changes can affect the payroll codes; e.g., moving expense reimbursements are now all taxable. As a result, it is important to continue to revisit your plan's definition of compensation and ensure that payroll practices continue to align with the plan document and related communications.

- **Consider how the compensation definition in your qualified plan interacts with other plans.**

Changes to the definition of compensation in your qualified retirement plan also may impact your nonqualified executive compensation plan if, as is often the case, the compensation definition in your non-qualified plan is linked to the definition of compensation in your qualified plan. Even if you apply different definitions under the two plans, make sure that you understand the differences between the compensation definitions and that you are administering each correctly. Failure to do so in the non-qualified plan could result in a 20% penalty tax in addition to other adverse tax consequences to the participants.

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