



Professional Perspective

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Regular Review of Compensation Definition in Plans Can Forestall Mistakes

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As an employee benefits attorney, one of the recurring plan failures that I see are mistakes related to the definition of “compensation for contribution purposes.” And by recurring I do not just mean this mistake happens with many plans, but also that it can happen repeatedly for the same plan! Keep in mind that this type of mistake can be very, very expensive to fix. But the good news is that plan administrators can set procedures in place to catch these mistakes before they get too significant and painful.

Definition of Compensation for Contribution Purposes

First of all, we need to understand what is meant by the “definition of compensation for contribution purposes.” At its most simplistic, it means the description in the plan document that says what will be included in compensation for purposes of contributions. Note that there are generally two definitions of compensation described in the plan document, one that is used for testing and one that is used for contributions. The definitions that are used for testing are prescribed by statute and regulations under Internal Revenue Code (I.R.C. § 415 and 414. See **I.R.C. §§ 415(c)(3)** and **414(s)**). Technically, plans may use any definition they want for purposes of determining contributions and accruals, but practically speaking, plans will usually use a base definition that is the same as the one used for testing, with adjustments. This keeps data gathering and administration more efficient.

The definition that is used for contribution purposes falls into two parts: the base definition and the selected adjustments that are chosen by the plan sponsor when establishing the plan. In an individually-designed plan or a pre-approved single document plan, the structure and options may be different. In a two document pre-approved plan, the definitions of compensation will literally be found in different places: the base definition will be in the base plan document, and the adjustments in the adoption agreement. For purposes of this discussion, we will be assuming that the plan is established on a pre-approved plan document with an adoption agreement and base plan document (a pre-approved two document plan).

The Base Definitions

As mentioned above, the base definition will generally be the same as the testing definition. A detailed discussion of compensation definitions is outside the scope of this article, but it should be understood that I.R.C. §§ **415** (c)(3) and **414(s)** provide certain safe harbor options for the compensation definition used in testing. In order to simplify this discussion, we will assume that the base definition of compensation is W-2 compensation, by far the most prevalent base definition. This includes in compensation for contribution purposes any item of compensation required to be reported on the employee's **Form W-2**. For example, W-2 compensation includes non-cash compensation such as gifts and awards, fringe benefits, gift cards, and gift certificates.

Inclusions and Exclusions

Each plan sponsor may choose what items of compensation it wants to add to the base definition, and what items it wants to exclude from the base definition. (Note that the definition of compensation may not be discriminatory under Treas. Reg. § **1.414(s)-1(d)(2)** and may require special testing if too “outside the box.”) For example, an employer may want to exclude bonuses (because their employees would be unhappy with a reduced bonus) or non-cash compensation (from which it can be difficult to defer the compensation to a subsequent tax year). Another decision is whether to exclude compensation earned during the plan year prior to the employee entering the plan. Obviously that compensation is W-2 Income, but does the employer want to include it, say when calculating a limit on matching contributions? Or in determining the employee's pro rata share of a profit sharing contribution?

There is no “one size fits all” definition of compensation, each employer may want to make special adjustments to even the most basic of definitions.

How Mistakes Happen

Mistakes in the definition of compensation for contributions can happen in several ways, such as:

- The payroll system is initially set up for reporting (**Form W-2**) and withholding (**I.R.C. § 3401(a)**) purposes, but not consistent with the plan definition.
- Changes in types of compensation are added over time, but they are not verified against the plan definition and updated in the payroll system.
- Amendments affecting the plan's definition of compensation are adopted, but the payroll system is not updated accordingly.

The theme here is payroll system hygiene. All the mistakes find their way to the payroll system.

Expensive Corrections

Because using the incorrect definition of compensation for contributions is a tax-disqualifying failure to follow the terms of the plan, the plan sponsor is required to correct under the Employee Plans Compliance Resolution System (EPCRS) (currently provided under **Revenue Procedure 2021-30**), the IRS program for plan qualification failure corrections. Not correcting under these guidelines could jeopardize the tax qualified status of the plan. But these types of mistakes can result in painful corrections because they may affect many, even all, plan participants, and they may start small, but go on for many years before being identified and corrected. Time is not your friend in this case, as not only do the principal correction amounts add up, but earnings on the corrections must be paid, and then if not caught in time to self-correct (generally 3 years following the year of the failure), the costs of a voluntary correction program filing, or if identified during an audit, the costs of sanctions, will rack up the financial consequences. For example, let's assume the following:

- Good Heart, Inc. sponsors a 401(k) plan for its eligible employees. When the plan was originally started, Good Heart was a new company and didn't pay bonuses. The plan provides for W-2 compensation for plan contributions. A few years later, Good Heart began paying bonuses to certain employees as an incentive and reward. However, the payroll department, when adding bonuses to the payroll system, did not code it to be included in plan compensation.
- Good Heart's plan provides for deferrals with no limits and a 100% match up to 6% of compensation. The plan also provides for a discretionary non-elective contribution, allocated pro-rata based on compensation. Good Heart made non-elective contributions in 2018 and 2020 equal to 2% of compensation.
- Brenda, an eligible employee of Good Heart participating in the plan, elected to have 5% of her compensation deferred into the plan, beginning in 2014.
- Brenda began receiving \$1,000 bonuses each quarter for her hard work in 2016. Because of the payroll coding, no deferrals were made from her bonuses.
- In 2024, the plan became subject to the audit requirement for **Form 5500** filing. During the audit, the auditors discovered the mistake and reported it to Good Heart.
- Because the failure went on for eight years, the correction was not eligible for self-correction, or for the reduced correction percentage for deferrals.
- The correction amount for Brenda would be 50% of the missed deferrals on the bonus compensation, plus 100% of the match and the non-elective contribution:
 - **Missed Compensation.** \$4,000 in bonus compensation times 8 years equals \$32,000.
 - **Missed Deferrals.** \$32,000 times 5% (Brenda's deferral rate) equals \$1,600 in missed deferrals
 - **Missed Deferral Opportunity.** 50% of the missed deferrals (the required corrective contribution under EPCRS for the missed deferral opportunity) equals \$800.
 - **Missed Matching Contribution.** 100% of the missed matching contribution is \$1,600 (equal to 100% of the missed deferrals up to 6% of compensation, which was \$1,600)

- **Missed Non-elective Contributions.** 100% of the missed non-elective contribution is \$160 (2% of compensation in two years when the non-elective contribution was made).
- **Total Principal Correction Amount.** The total corrective contribution for Brenda would equal \$2,560 (\$800 in missed deferrals, \$1,600 in missed matching contribution, and \$160 in missed non-elective contribution)
- **Plus Earnings.** On top of that, earnings would need to be paid on the missing amounts. Brenda's actual rate of return should generally be used, but for illustration, earnings calculated using the Department of Labor's VFCP Lost Earnings Calculator would be approximately \$600, for an approximate total of \$3,160. Not too bad, but ...
- **Plus All the Other Affected Participants.** There are 40 other employees who received approximately the same bonuses over the same years, meaning that the final correction cost to Good Heart will be more than \$120,000, plus the costs to file the correction under the Voluntary Correction Program, including a \$3,000 filing fee.

How to Mitigate or Eliminate Mistakes Through Internal Audits

In order to reduce or prevent compensation mistakes, the first thing to do is make sure that the payroll system was set up correctly to reflect the plan's definition of compensation for contribution purposes. All compensation recordkeeping is run through an employer's payroll system: what compensation is earned and when, what type it is, what types of taxes apply, what benefits are affected, etc. An experienced payroll administrator, in conjunction with a reasonably sophisticated payroll system, will know how to set up a payroll to account for various types of income and how they must be taxed and reported. However, the administrator may not be aware of customized provisions for plan compensation purposes, so it is imperative that the employer makes sure that someone is looking at this issue when the plan administration is set in place.

Next, it is important that changes to compensation in the payroll system are properly updated consistent with the definition of compensation in the plan. The best practice is that every time a new item of compensation is created, it should be assessed for its inclusion or exclusion from income for plan purposes. Let's assume the following for illustration:

- A plan has a basic definition of **W-2** Income.
- The plan document does not exclude bonuses, but does exclude fringe benefits.
- The payroll system is set up correctly when the plan was originally effective.
- About 3 years later, the employer decides to give "service awards" to incentivize employee retention.
- The next year, the employer wants to compensate employees who have to move into the area to perform their job duties, and begins giving "moving bonuses" to eligible employees.

Will the payroll department know that a "service award" is a bonus and code that category to be included in plan compensation? Will they know whether a moving bonus is a bonus or a fringe benefit? Maybe. But if there is no procedure in place that requires them to verify how this new type of compensation is to be treated for plan purposes, it may just get lost in the shuffle and be coded properly for tax withholding but not for plan contribution purposes.

Also note that anytime an amendment to the plan affects the definition of compensation, the payroll system coding will need to be assessed for consistency with the new definition.

It is a good idea to include in the plan's procedures that payroll records be reviewed internally at least once each year. Even if a plan is a large plan that is reviewed by an outside auditor each year for Form 5500 purposes, employers can't depend on the auditor to catch this. It is the employer's responsibility as the plan administrator to ensure that the plan is being operated in compliance with plan terms, and that participants are receiving the correct contributions under the plan. This will likely entail a collaboration between benefits and payroll personnel, possibly in conjunction with assistance from the third-party administrator and even benefits counsel, especially if errors are found.

Correct Swiftly

Correcting any qualification failure swiftly is important, but it is particularly crucial in the case where there is a mistake in plan compensation when determining plan contributions. As illustrated above, even a small error can have significant ramifications if left unchecked, including the amount of the correction, the earnings that will apply to the correction, and whether it can be self-corrected. Having tight procedures in place, and following those procedures, can reduce, or even eliminate this type of costly failure.