

# Chapter 3

## Compensation

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## Overview

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### Introduction

Often when the word compensation is spoken, a vision of dollar signs flash inside your head and a smile creeps onto your face. There are not many things that could create this effect with just a simple word. You would think that this word presents a simple idea, but just the opposite is true. The term compensation plays a significant role in retirement plan development.

The definition of compensation in retirement plans could be the difference between getting a hundred dollars more in your employer contribution, allowing you to contribute more to your 401(k) arrangement, or increasing the opportunity for growth with your retirement funds.

Important areas where compensation is used within a plan document include top-heavy minimum contributions, the limitations under section 415, highly compensated employees, key employees, leased employees, allocations of plan contributions, nondiscrimination testing and deductions.

In this chapter, we will discuss the different types of compensation, provide an understanding of the safe harbor rules, calculate and evaluate the compensation test (Demo 9), look at compensation limitations, and explain which definition of compensation is needed for the worksheet questions.

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**Overview, Continued**

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## **Section 415 Compensation**

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### **Overview of compensation**

Compensation must be defined in a plan for many purposes. Each plan component can use a different definition of “compensation.” Therefore, a single plan may define compensation several ways.

Compensation may be used to determine the amount of benefits accrued in a defined benefit plan or the amount of contributions allocated to accounts for a defined contribution plan.

In addition to calculating the amount of benefits, Section 415 compensation also places limits on the amount of benefits or allocations. When a mandatory top heavy benefit arises, compensation is used to determine the amount of the top heavy benefit. Compensation is also a factor when testing the plan for non-discrimination.

Finally, compensation is used by the employer when figuring out the deduction limits under IRC Section 404.

Because the definition of compensation has so many plan applications, it is important to be able to define and distinguish the requirements for compensation for various plan purposes.

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### **Four Section 415 Compensation Definitions**

In order to comply with the Compensation limits specified under Section 415 of the Internal Revenue Code, it is necessary for a qualified plan to accurately describe which definition of Compensation the plan will be using to adhere to these limits.

Generally, there are four viable definitions of Compensation used to determine Section 415 Compensation. Under the regulations for IRC 415, there is the statutory definition and three safe harbor definitions.

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## Section 415 Compensation, Continued

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### **Incorporation by Reference**

When a plan uses a definition of compensation that is intended to satisfy Section 415(c)(3), the definition must clearly state which acceptable definition is being used to avoid ambiguity. For example, a reference to Section 415(c)(3) is not acceptable because there are four definitions which may be used, and the reference would be unclear as to which definition is meant.

When a plan incorporates the Section 415 definitions contained in the regulations, the plan may use specific regulation sections. However, the plan must then also modify the definition to add in the deferrals under Section 415(c)(3)(D). At the time of this writing, the deferrals must be listed out.

The definition of compensation used for the safe harbor plan associated with the safe harbor plan must be incorporated by reference.

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### **Statutory Definition Under Section 415 Compensation**

Treas. Reg. Section 1.415-2(d)(2) provides a detailed definition of IRC 415(c)(3) compensation which includes all wages, salaries and other amounts received that are includible in the employee's gross income.

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### **Recent Law Changes that Require Additions to the Statutory Definition of Compensation**

The regulations under IRC 415 have not been updated since the passage of SBJPA. Therefore, each definition of compensation under IRC 415 must include the following two categories of items from IRC 415(c)(3)(D):

1. Effective for years beginning after December 31, 1997,
    - elective contributions to a Section 457(b) eligible deferred compensation plan or to a cafeteria plan (Section 125 plan), and
    - elective deferrals as described under IRC Section 402(g)(3). This includes elective deferrals to a 401(k) plan, a Section 403(b) tax shelter annuity plan, a SIMPLE IRA, or a SARSEP, including catch-up contributions
  2. For plan and limitation years beginning on and after January 1, 2001 (or, if earlier the date the plan complied in operation, but no earlier than January 1, 1998), compensation paid or made available during such plan and limitation years shall include elective amounts for qualified transportation fringe benefits that are not includable in the gross income of the employee by reason of IRC section 132(f)(4).
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## **Section 415 Compensation, Continued**

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**Other  
Acceptable  
Definitions of  
Compensation**

The other three definitions of compensation under IRC 415 are safe harbor definitions addressed later in this chapter.

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**Items Included  
in Treas. Regs.  
1.415-2(d)(2)  
Definition of  
Compensation**

Items which are included in compensation for purposes of IRC Section 415 under Treas. Reg. 1.415-2(d)(2) are as follows:

- In the case of a self-employed individual treated as an employee under IRC 401(c)(1), the employee's earned income as described in section 401(c)(2) and the regulations there under. Treas. Reg. 1.415-2(d)(2)(ii)
- Medical or disability benefits as described in IRC Sections 104(a)(3), 105(a) and 105(h), but only to the extent that these amounts are includible in the gross income of the employee. Treas. Reg. 1.415-2(d)(2)(iii)
- Amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are not deductible by the employee under IRC Section 217. Treas. Reg. 1.415-2(d)(2)(iv)
- The value of a non-qualified stock option granted to an employee by the employer, but only to the extent that the value of the option is includible in the gross income of the employee for the taxable year in which granted. Treas. Reg. 1.415-2(d)(2)(v)
- The amount includible in the gross income of an employee upon making the election described in IRC Section 83(b) with respect to property received for services rendered. Treas. Reg. 1.415-2(d)(2)(vi)

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**Section 415 Compensation, Continued**

**Items  
Excluded from  
Treas. Regs.  
1.415-2(d)(3)  
Definition of  
Compensation**

Items which are always required to be excluded from compensation for purposes of IRC Section 415 limitations under Treas. Reg. 1.415-2(d)(3) are as follows:

- Contributions made by the employer to deferred compensation plans to the extent that the contributions are not includible in the employee's gross income.
  
- Distributions from deferred compensation plans. However, any amounts received by an employee pursuant to an unfunded non-qualified plan are permitted to be considered as compensation for IRC Section 415 purposes in the year the amounts are includible in the gross income of the employee. Treas. Regs. Section 1.415-2(d)(3)(i).
  
- Amounts realized from the exercise of nonqualified stock options
  
- Amounts realized from the sale or exchange of stock acquired under a qualified stock option
  
- Certain premiums for group-term life insurance.

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## Statutory Safe Harbor Rules under Section 415

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### Introduction

There are three safe harbor definitions. The “statutory safe harbor” and two alternative safe harbors (below).

The “statutory safe harbor” or “traditional safe harbor” is the safe harbor contained in Treas. Regs. 1.415-2(d)(10). Under this rule, any definition of compensation which **includes** the various types of remuneration listed in Treas. Regs. 1.415-2(d)(2)(i). Other types of income that are not included (but are included in other definitions) are 1.415-2(d)(2)(ii-vi) (see below). In addition, this definition **excludes** all of the forms of remuneration listed in Treas. Reg. 1.415-2(d)(3) will automatically meet the requirements of IRC 415(c)(3).

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### Included Items in Safe Harbor Compensation Definition

Treas. Regs. 1.415-2(d)(2)(i) requires the following items to be included in the definition of compensation:

- All wages
  - Salaries
  - Other amounts received that are includible in the employee’s gross income, including overtime
  - Other items include commissions, fees for professional services, tips, bonuses, fringe benefits and reimbursements or other expense allowances under a non-accountable plan as described in Treas. Reg. Section 1.62-2(c)
  - Compensation also includes foreign earned income without regard to the exclusions under IRC sections 911, 931 and 933
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## **Statutory Safe Harbor Rules under Section 415, Continued**

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**Items Excluded from Statutory Definition to satisfy safe harbor**

Items listed under Treas. Reg. 1.415-2(d)(2)(ii)-(vi) which would normally be included in the definition of compensation may be excluded from the safe harbor definition of compensation. The plan must exclude the entire list or none at all. These items include:

- In the case of self-employed individual considered an employee within the meaning of IRC 401(c)(1), the employee's earned income (as described in section 401(c)(2) and the regulations thereunder). Treas. Reg. 1.415-2(d)(2)(ii)
- Medical or disability benefits as described in IRC Sections 104(a)(3), 105(a) and 105(h), but only to the extent that these amounts are includible in the gross income of the employee. Treas. Reg. 1.415-2(d)(2)(iii)
- Amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are not deductible by the employee under IRC Section 217. Treas. Reg. 1.415-2(d)(2)(iv)
- The value of a non-qualified stock option granted to an employee by the employer, but only to the extent that the value of the option is includible in the gross income of the employee for the taxable year in which granted. Treas. Reg. 1.415-2(d)(2)(v)
- The amount includible in the gross income of an employee upon making the election described in IRC Section 83(b) with respect to property received for services rendered. Treas. Reg. 1.415-2(d)(2)(vi)

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**Statutory Safe Harbor Rules under Section 415, Continued**

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**Statutory changes to 415 compensation are excluded**

1. Effective for years beginning after December 31, 1997, elective contributions to a Section 457(b) eligible deferred compensation plan or to a cafeteria plan (Section 125 plan) and elective deferrals as described under IRC Section 402(g)(3). This includes elective deferrals to a 401(k) plan, a Section 403(b) tax shelter annuity plan, a SIMPLE IRA, or a SARSEP, including catch-up contributions
  2. For plan and limitation years beginning on and after January 1, 2001 (or, if earlier the date the plan complied in operation, but no earlier than January 1, 1998), compensation paid or made available during such plan and limitation years shall include elective amounts for qualified transportation fringe benefits that are not includable in the gross income of the employee by reason of IRC section 132(f)(4).
- 

**Items Excluded from Safe Harbor Compensation Definition**

Items listed under Treas. Reg. 1.415-2(d)(3) which are not includable in the definition of compensation are:

- Employer 401(k) and SEP 408(k) contributions
  - 401(k) plan distributions
  - amounts realized from the exercise of stock options
  - amounts realized from the disposition of stock or the lifting of restrictions on the sale of stock acquired under stock options
  - other amounts which receive special tax benefits such as the purchase of premiums for group-term life insurance or annuity contracts
-

## Alternative safe harbor definitions under 1.415-2(d)(11)

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### Overview

Treas. Reg. section 1.415-2(d)(11) provides two alternative safe harbor provisions.

The safe harbor definition contained in Treas. Regs. section 1.415-2(d)(11)(i) generally allows a plan to use a wage withholding or "W-2 - Box 1", definition for purposes of IRC 415 and accordingly, IRC 414(s). Box 1 compensation is information required to be **reported** under sections 6041 and 6051, which includes items of compensation in addition to those subject to withholding. It is currently shown as "Wages, tips, other compensation" in Box 1 of Form W-2.

The safe harbor definition contained in section 1.415-2(d)(11)(ii) includes wages subject to **withholding** under IRC section 3401. Code Section 3401(a) wages are defined as compensation that is subject to federal income tax withholding at the source of the compensation. This is a less inclusive definition of compensation than the other two definitions, because it is based on the information contained in an average employee's pay stub. It starts with an individual's wages, bonuses, and commissions, and includes stock options taxable at time of grant, but excludes all taxable reimbursements and the taxable cost of group-term life insurance coverage

### Regulations Not Updated to Current Law for All Safe Harbors

The regulations under IRC 415 have not been updated since the passage of SBJPA. Therefore, each definition of compensation under IRC 415 must include the following two items from IRC 415(c)(3)(D):

- Effective for years beginning after December 31, 1997, elective contributions to a Section 457(b) eligible deferred compensation plan or to a cafeteria plan (Section 125 plan) and elective deferrals as described under IRC Section 402(g)(3). This includes elective deferrals to a 401(k) plan, a Section 403(b) tax shelter annuity plan, a SIMPLE IRA, or a SARSEP, including catch-up contributions
  
- For plan and limitation years beginning on and after January 1, 2001 (or, if earlier the date the plan complied in operation, but no earlier than January 1, 1998), compensation paid or made available during such plan and limitation years shall include elective amounts for qualified transportation fringe benefits that are not includable in the gross income of the employee by reason of IRC section 132(f)(4).

## W-2 safe harbor (1.415-2(d)(11)(i))

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**W-2 Definition-not allowed by self employed**

Pursuant to Reg. Section 1.415-2(d)(11)(i), self employed individuals are not permitted to use this definition of compensation.

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**Items Included in W-2 Definition of Compensation**

Items which are included in W-2 compensation are as follows:

- Wages as defined in IRC 3401
  - The cash value of payments made in a medium other than cash. Treas. Reg. section 1.6041-2(a)(1)
- 

**Items Excluded in W-2 Definition of Compensation**

- Reimbursements, when paid under an accountable plan. Treas. Reg. section 1.62-2. An example of this would be if an individual lived in Chicago and had a temporary job assignment in Cincinnati. Under an accountable plan, the individual's employer reimbursed him for the actual round-trip traveling expenses from Chicago to Cincinnati and the cost of meals and lodging in Cincinnati.
- Tips of less than \$20 per month and non-cash tips IRC 3401(a)(16)
- Moving expenses paid by the employer to a third party or furnished in kind by the employer

## Withholding safe harbor (section 1.415-2(d)(11)(ii))

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**Items Included in Section 3401 Wages**

- Wages as defined by Section 3401 including cash tips of \$20 or more per month. IRC 3401(a)(16).
  - Vacation pay under Treas. Reg. section 31.3401(a)-1(b)(3)
  - Severance pay under Treas. Reg. section 31.3401(a)-1(b)(4)
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## Withholding safe harbor (section 1.415-2(d)(11)(ii), Continued

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**Items Included  
in Section 3401  
Wages  
(continued)**

- Sick pay under Treas. Reg. section 31.3401(a)-1(b)(8). This would also include disability payments attributable to contributions from the employer to accident or health plans.
- Taxable Fringe Benefits such as a company car or certain tuition reimbursements.

Payments from unfunded nonqualified deferred compensation plans

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**Items Excluded  
in  
Section 3401  
Wages**

- Reimbursements under an accountable plan as defined in IRC 274(d). Foreign Earned Income related to IRC 911
  - Payments made under a worker's compensation law as a result of a work related sickness or injury. IRC 104(a)
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## Safe Harbor Examples under Section 415

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**Example 1**

ABC Corp. Money Purchase Plan defines compensation as “current includible income excluding bonuses, commissions and overtime. Does this meet the IRC 415 safe harbor definition?

No. Bonuses, commissions and overtime must be included under all three safe harbor definitions of compensation.

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**Example 2**

QRS Corp. Profit Sharing Plan defines compensation as “Total compensation which is actually paid to the Participant by the Employer during the 12 applicable month period and includes all information required to be reported under sections 6041, 6051 and 6052 of the Code. Compensation shall not include any amount which is contributed by the Employer as severance pay to terminated employees. Does this meet the IRC 415 safe harbor definition?

No. Severance pay is included in the W-2 wages safe harbor.

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## Key Similarities between the 415 Definitions

**Key Similarities  
Between the  
Three Safe  
Harbor  
Definitions of  
Compensation**

For an average employee, earning only wages, salaries, overtime, bonuses and commissions, all three definitions produce the same result.

For plan years after 1997, Compensation under all three definitions must be increased, or “grossed up”, to the extent elective deferrals were made under IRC 402(g)(3), IRC 125, IRC 457 and IRC 132(f)(4). See Notice 99-44, Q-9.

	<u>Treas. Regs. 1.415-2(d)(3)</u>	<u>W-2 Definition</u>	<u>3401(a) Definition</u>
<b>Tips</b>	Included	Included when cash tips are \$20 or more per month	Included when cash tips are \$20 or more per month
<b>Medical Benefits from Employer-provided Contributions</b>	May be Excluded	Included	Included
<b>Taxable portion of Premiums for Group Term Life Insurance</b>	Included	Included	Excluded
<b>Non-Qualified Stock Options</b>	Included when granted Excluded when exercised	Included	Included
<b>Amounts from the Sale or Disposition of Qualified Stock Options</b>	Excluded	Excluded	Excluded
<b>Non-Qualified Plan Distributions</b>	Excluded, unless distributed from unfunded non-qualified plan	Included	Included

## **Important Areas 415 Compensation Must Be Used**

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**Important  
Areas 415  
Compensation  
Must Be Used**

– Highly Compensated Employee (HCE)

Under IRC 414(q), a “highly compensated employee” is an employee who:

- i. at any time during the year or the preceding year was a 5% owner, or
- ii. for the preceding year had compensation in excess of \$80,000 and, if the employer elects, was in the top paid group (the top 20 percent of the employees when ranked on the basis of compensation paid during such year)

– Top Heavy Contributions

IRC § 416(c)(2) requires that for a defined contribution plan, the top heavy minimum contribution shall be no less than 3 percent of participant’s compensation and stipulates that compensation is defined under IRC § 415

– Key Employee

Must use the same definition of compensation as is used for the top heavy minimum

– IRC § 415 Limitations

Both the defined benefit accruals and defined contribution allocations are limited based on the plan participant’s compensation. For defined benefit plans, the limit is the lesser of \$160,000 (as adjusted) or 100% of average high-three years of compensation. For defined contribution plans, the limit is the lesser of \$40,000 (as adjusted) or 100% of participant’s compensation

– Self-Employed Individuals

According to Regs. § 1.415-2(d)(2)(ii), self employed individuals must use earned income” (as defined by § 401(c)(2)) to determine 415 compensation

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**Important Areas 415 Compensation Must Be Used, Continued**

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**Important  
Areas 415  
Compensation  
Must Be Used  
(continued)**

– Leased Employees

The safe harbor contained in IRC 414(n)(5) exempts the employer from including leased employees in the definition of “employee” if the leased employee works for a leasing organization which maintains a money purchase plan with a minimum 10% of compensation (nonintegrated) contribution formula.

The leasing organization’s plan must define “compensation” using one of the acceptable definitions under IRC 415(c)(3). To ensure that the leasing organization’s plan is using the correct definition of compensation, the safe harbor language for leased employee in the employer’s plan must incorporate IRC 415(c)(3) by reference. This is an EXCEPTION to the incorporation of IRC 415(c)(3) by reference rules.

– Deductions for Defined Contribution plans.

EGTRRA raised the IRC 404(a) deduction limit through the year 2010 for profit sharing plans from 15% to 25% of compensation. Prior to EGTRRA, money purchase plans could effectively (when IRC 404 is applied in conjunction with the IRC 415 limitations) contribute up to 25% as a single plan or up to 10% when combined with a profit sharing plan using the maximum contribution of 15% to have a combined limit of 25%.

IRC 404(a)(12) defines compensation to include amounts treated as participant’s compensation under subparagraph (C) or (D) of IRC 415(c)(3).

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## Miscellaneous Items for Section 415 Compensation

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**Gateway Test** The Gateway test uses compensation in its testing formula.

In the event that the 5% minimum allocation gateway method is specified in the plan document then compensation must be defined as one of the four 415(c)(3) methods. Treas. Reg. 1.401(a)(4)-8(b)(1)(vi)

In the event that the 1/3 minimum allocation gateway method is specified in the plan document, then, in addition to the four methods utilized under 415(c)(3), compensation can also be defined in a manner that satisfies the 414(s) definition of compensation. Treas. Reg. 1.401(a)(4)-8

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**Deductions for Defined Benefit Plans** Defined Benefit plans may deduct benefits funded up to the IRC 415 limit. When calculating projected benefits, Rev. Rul. 2001-51 states that defined benefit plans will use the EGTRRA IRC 415 limits without regard to the 2010 sunset provision of EGTRRA.

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**Other Miscellaneous Items of Interest**

- Accrued compensation earned but not paid during the year is not included in compensation. Treas. Reg. § 1.415-2(d)(5)(i). However, the “First few weeks” rule under Treas. Reg. § 1.415-2(d)(5)(ii) allows a de minimus exception where wages are accrued at the end of the year in question but are actually paid in the first few weeks of the following year
  - Aggregation of all related employers – if an employer is part of an affiliated service group or a controlled group of corporations, all defined contribution plans are aggregated in order to determine the participant’s IRC 415 limits. Similarly, if a single employer utilizes more than one defined contribution plan, then a participant’s annual additions under all such plans are aggregated in order to determine whether or not the IRC 415 limits have been exceeded. Treas. Regs. 1.415-8.
  - Compensation paid by a third party such as leased employees and independent contractors, Treas. Regs. 31.3402(g)-3
  - Common Paymasters such as a controlled group of businesses, IRC 3121(s)
  - Measurement year for Section 415 compensation, Treas. Regs. 1.415-2(b)
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## IRC Section 414(s) Compensation

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### Overview

As the numbers are being called out slowly one by one, you are at the edge of your seat waiting and anticipating for once that luck finds you. Your mind becomes focused on the task at hand. Your heart is pumping an erratic beat. As the last number gets announced, you feel faint about to happen. The odds tipped in your favor; you won the largest state lottery of the century! Early the next day, you waltz into the lottery commission office with thoughts of only sand, surf, and margaritas...lazy days are just a moment away. One lottery official indicates that there were a total of two winners and the distribution of the lottery prize will be seventy five percent to the other winner and twenty five percent to you. Is this division of the prize fair?

The above example provides the basic idea behind Section 414(s) Compensation. Section 414(s) Compensation is often referred to as a nondiscrimination definition. This idea is formed from the concept that having a uniform definition of compensation among the participants provides no discrimination between the highly compensated employees (HCEs) and non-highly compensated employees (NHCEs).

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### Example illustrating a discriminatory definition of compensation

Plan A provides a definition of compensation that includes bonuses and excludes overtime. The plan provides an allocation of 3% of compensation.

Two employees earn the same dollar amount, \$100,000. Employee A earns \$100,000, \$40,000 of which is overtime, and is allocated \$1,800 (3% x \$60,000). The plan excluded A's overtime pay.

Employee B earns \$100,000, \$40,000 of which is bonuses and is allocated \$3,000 (3% x \$100,000). Since bonuses are included, B's compensation under the plan is \$40,000 higher than A's compensation under the plan, resulting in a higher allocation for B.

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## **IRC Section 414(s) Compensation, Continued**

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**Importance of compensation**

Although some may think Section 414(s) Compensation is a simple concept, it plays some important roles in plan document development. Generally, the main purposes of Section 414(s) Compensation include nondiscrimination testing of employer contributions and benefits under Section 401(a)(4), ADP testing of elective deferrals under Section 401(k), ACP testing of matching and after tax contributions under Section 401(m), and calculation of permitted disparity formulas under Section 401(l).

In this section of the chapter, we will discuss the different definitions and uses of Section 414(s) Compensation, show how a Demo 9 is calculated, and review the compensation questions in the workbooks. This will assist you in reviewing plan documents.

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**414(s):  
What Is It?**

IRC 414(s) is a definition of compensation utilized in nondiscrimination testing.

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**When Is 414(s)  
Used for Plan  
Purposes?**

The definition of total compensation is defined as compensation under IRC 415(c)(3), either including or excluding elective deferrals (as discussed above in 415 compensation section). There are many areas in the plan where Section 414(s) compensation may be used.

- ADP or ACP testing
  - 401(a)(4) testing for discrimination purposes
  - Section 410(b) testing for coverage purposes
  - Permitted disparity under Section 401(l)
  - 1/3 rule for gateway testing
  - Design based and non-design based safe harbor formulas
- 

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## **IRC Section 414(s) Compensation, Continued**

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**When Must  
414(S) Be Used  
In The Plan  
Document?**

A plan is never required to use a 414(s) safe harbor definition of compensation. However, many areas require a definition of compensation that satisfies 414(s). If a plan uses a 414(s) safe harbor definition to allocate contributions or determine benefits, many discrimination testing issues are eliminated or simplified. The following is a list of plan features that require that a 414(s) acceptable definition of compensation must be written into the plan document.

- ADP and ACP safe harbor
  - Permitted disparity under Section 401(l)
  - If the plan document contains the minimum allocation gateway in either the allocation formula or the 401(a)(4) fail safe language
  - If the plan document specifies IRC 410(b) fail safe language that utilizes the average benefit test
  - Design based safe harbor formulas
- 

**The Different  
Definitions of  
Section 414(s)  
Compensation**

Section 414(s) Compensation is somewhat unique because several different definitions can be used that satisfy the Internal Revenue Code. The following is a list of acceptable definitions:

- One of the four IRC 415(c)(3) definitions of compensation under Treas. Regs. 1.415-2(d)(2), 1.415-2(d)(10), or 1.415-2(d)(11)
  - The alternative safe harbor definition of Section 414(s)
  - Any reasonable definition of compensation that does not favor highly compensated employees (submission of a Demo 9 required)
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**IRC Section 414(s) Compensation, Continued**

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**Starting with the Basics**

Given that the four different definitions of compensation under Treas. Regs. 1.415-2(d)(2), 1.415-2(d)(10), and 1.415-2(d)(11)(i)&(ii) have been discussed previously in this chapter, we will jump right into the alternative safe harbor definition of 414(s) compensation.

When one thinks of the phrase “safe harbor” what idea often comes to mind? (Unfortunately, it does not reference the place a ship ports.) In employer plans, the words “safe harbor” indicates that the plan is intended to satisfy the discrimination requirements by design.

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**When is a Demo 9 Needed?**

The following chart demonstrates the relationship between defined contribution safe harbors and the 414(s) definition of compensation. See Regs. sections 1.401(a)(4)-2(b)(2) and (3) and 1.401(a)(4)-12 “plan year compensation.”

<b>ALLOCATION FORMULA (DC PLAN*)</b>	<b>DEFINITION OF COMPENSATION</b>	<b>SAFE HARBOR SATISFIED?</b>
SAFE HARBOR	SAFE HARBOR	YES
SAFE HARBOR	NON-SAFE HARBOR	NO (DEMO 9 REQ'D)
NON-SAFE HARBOR	SAFE HARBOR	NO (DEMO 6 REQ'D)
NON-SAFE HARBOR	NON-SAFE HARBOR	NO (DEMO 6 & 9 REQ'D)

\* DB plans have more complex safe harbor requirements.

When reviewing a plan, if the application requests a ruling on nondiscrimination, the employee plans specialists need to verify that all elements of the safe harbor requirements are met. If the allocation formula is a safe harbor formula but the definition of compensation is not a safe harbor definition, then the plan does not pass the safe harbor requirements. In that case, the Employer must provide a Demo 9, amend the definition of compensation to be a safe harbor definition or submit a corrected application.

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## Alternative Safe Harbor 414(s) Definition

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**Alternative  
Safe Harbor  
Definition of  
Section 414(s)**

Several companies have different benefit packages that they offer their employees and inclusion and exclusion of these various items in the definition of compensation is often time consuming and difficult. Therefore, an alternative safe harbor definition of section 414(s) compensation has been established.

To obtain the safe harbor definition, start with one of the four definitions of compensation under Treas. Regs. 1.415-2(d)(2), 1.415-2(d)(10), or 1.415-2(d)(11) and adjust the definition by one or more of any of the three modifications listed below.

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**Modification  
Number One:  
Excluding  
Certain  
Benefits**

The first modification is the elimination of certain benefits under Treas. Regs. 1.414(s)-1(c)(3). However, if you are going to use this modification to the definition of compensation, you must exclude ALL of the following:

- a) Cash and/or non-cash fringe benefits-*these are any taxable “extras” such as the personal use of a company car, educational assistance, etc.*
- b) Reimbursements or other expense allowances-*your company pays you back for expenditures for childcare, traveling expenses, etc.*
- c) Moving expenses-*expenses associated with relocation from one location to another*
- d) Deferred compensation-*any income earned at the present date but will be provided to the employee at a later date*
- e) Welfare benefits-*certain benefits provided by the employer such as disability insurance, college scholarship funds, prepaid legal services, or unemployment benefits*

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*Continued on next page*

## Alternative Safe Harbor 414(s) Definition, Continued

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**Modification  
Number Two:  
Elective  
Deferrals**

The second modification to the definition of compensation is the handling of elective deferrals under Treas. Regs. 1.414(s)-1(c)(4).

What are elective deferrals? Elective deferrals include amounts contributed or deferred by the employer at the election of an employee and is not included in the gross income of the employee under a 401(k) arrangement or a 403(b) plan, contributions to a cafeteria plan under IRC 125, a nonqualified salary deferral under IRC 457, or any qualified transportation fringes under IRC 132(f)(4).

The use of elective deferrals in the compensation definition of section 414 is the opposite of the rules for section 415. Let us first begin to explain how it worked under section 415 compensation. Prior to 1998, elective deferrals were disregarded from the definition. However, under the Small Business Job Protection Act of 1996 (SBJPA), this changed effective after 1997 to include elective deferrals in the definition of section 415 compensation. Conversely, for section 414 purposes, in the pre-1998 years, elective deferrals could be added into the definition of 414(s) compensation and in the post-1997 years, elective deferrals could be eliminated from the definition of 414(s) compensation.\*\*

\*\*Notice the words “could be” in the above paragraph. Regardless of either including or excluding elective deferrals from the section 414(s) definition of compensation, it will still provide you with a safe harbor definition of compensation.

\*\*\*Very important—If the employer chooses to include or exclude elective deferrals in the definition of 414(s) compensation, then he must include or exclude ALL of the elective deferrals to remain a safe harbor definition.

For instance, say an employer has decided to include elective deferrals under a salary reduction 401(k) arrangement and exclude the §132(f)(4) qualified transportation fringe benefits in the definition of section 414(s) compensation. This definition would fail the safe-harbor requirements. The key here is to remember that all elective deferrals are to be treated the same. Therefore, to remain under a safe harbor definition, the employer will need to either include or exclude both types of deferrals in the definition.

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*Continued on next page*

**Alternative Safe Harbor 414(s) Definition, Continued**

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**Elective  
Deferrals**  
(continued)

REMINDER - The effective date of the inclusion of qualified transportation fringes under IRC 132(f)(4) in the compensation definition [per the Community Renewal Tax Relief Act of 2000 (CRA '00)], depends on the chosen effective date. This change could be made retroactively effective for plan years beginning 1/1/98 or later to comply with the operation of the plan. However, it must be in plan documents for plan years beginning after 12/31/2000.. Therefore, to determine if the definition of compensation in the plan is considered a safe harbor may depend on when the employer has this provision effective in his plans.

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**Modification  
Number  
Three:  
Elimination  
of Items Only  
to HCEs**

The last safe harbor modification may exclude any portion of the compensation to some or all of the highly compensated employees (HCEs) under Treas. Regs. 1.414(s)-1(c)(5).  
  
For example, say an employer wanted to include commissions to the NHCEs, but exclude commissions to all of the HCEs. This modification would still produce a safe harbor definition since there is no discrimination in favor of the HCEs.

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## Reasonable Definition of Compensation

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**An  
Example**

ABC company provides the following benefits to all of their employees: relocation expenses to their Detroit plant, disability insurance, salary deferrals in the 401(k) plan up to 15% of pay, use of the company car while traveling, and childcare reimbursements.

The plan document defines the 414(s) compensation as defined in Treas. regs. § 1.415-2(d)(2), but excludes welfare benefits, reimbursement or other expense allowances, deferred compensation, fringe benefits, elective deferrals, and moving expenses.

Would this be acceptable as an alternative safe harbor definition under IRC section 414(s)?

Yes, it would be considered an alternative safe harbor definition since the only exclusions were modifications under the Treas. regs. § 1.414(s)-1(c)(3) (modification number one above) and § 1.414(s)-1(c)(4) (modification number two above).

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**Any  
Reasonable  
Definition of  
Compensation**

The last acceptable definition that can be used to satisfy section 414(s) is a non-safe harbor definition of compensation that:

- is reasonable,
  - does not favor HCEs, and
  - passes the compensation test (Demo 9)
- 

*Continued on next page*



## Reasonable Definition of Compensation, Continued

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**What Does  
“Reasonable”  
Mean?**

Under Treas. Regs. 1.414(s)-1(d)(2), a reasonable definition of compensation can exclude items that are not provided to an employee on a consistent basis. Additionally, the definition cannot discriminate in favor of one person over another. Furthermore, the definition cannot discriminate in favor of HCEs.

Some frequent exclusions in the compensation definition which are deemed by 1.414(s)-1(d)(2) to be “reasonable” include but are not limited to:

- Overtime
- Bonuses
- Premiums for shift differential
- Call-in premiums
- Commissions

Additionally, if the plan document states that it will disregard compensation over a specified dollar amount such as the compensation limitation under IRC section 401(a)(17), this elimination would be considered reasonable.

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**Not Acceptable  
“Reasonable”  
Definitions**

There are two specific exclusions that are not permitted under Treas. Regs. 1.414(s)-1(d)(2)(iii).

The first unacceptable exclusion is the 414(s) definition of compensation is stated as a percentage of another definition of compensation within the plan document. For example, 414(s) compensation is defined as 50% of 1.415-2(d)(10).

The second unacceptable exclusion is a definition that states an employee’s compensation for the limitation year as a one-month period. For instance, 414(s) compensation is defined as the participant’s compensation earned in the month of June of the limitation year.

---

**“Reasonable”  
Example**

DEF Company employees work 40 hours a week with occasional overtime during the Christmas season. The definition of section 414(s) compensation is defined in the plan as compensation defined in Treas. Regs. 1.415-2(d)(2) but excludes overtime and bonuses.

Would this definition be considered reasonable? Yes, because the exclusion of overtime is not provided on a regular basis to all of the employees. However, it still must pass the compensation test (Demo 9).

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## Reasonable Definition of Compensation-Demo 9

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**Same Example Different Circumstances** GHI Company employees work 48 hours a week which includes overtime on the weekend of 8 hours during the company's fiscal year. The definition of section 414(s) compensation is defined in the plan as compensation defined in Treas. Regs. 1.415-2(d)(2) but excludes overtime and bonuses.

Would this definition be considered reasonable? No, because the exclusion of overtime is provided on a weekly basis to all of the employees.

---

**Compensation Test (a.k.a. Demo 9)** If the plan document uses a non-safe harbor definition of compensation it must pass the compensation test (which is also known as the Demo 9).

In a nutshell, the compensation test (Demo 9) is simply a measure of compensation between HCEs and NHCEs. The demonstration must show that the average percentage of total compensation for the HCEs does not exceed the average percentage of total compensation for the NHCEs by more than a de minimis amount.

---

**Total Compensation Definition** Total compensation is defined as compensation under IRC 415(c)(3) and either including or excluding elective deferrals (as discussed in modification number two above).

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**Demo 9 Factors** Some of the factors that are taken into account when completing the compensation test (Demo 9) are:

- Which employees are included?
  - Is there a dollar limitation?
-

## **Calculation of the Demo 9**

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**Included Employees**

Under Treas. Regs. 1.414(s)-1(d)(3)(iii), in the compensation test, you must include all employees taken into account in satisfying the requirements of the applicable provision for the determination period.

For instance, if the plan's compensation definition used in providing the employer's profit sharing contribution is nondiscriminatory under IRC section 401(a)(4), then only employees who received an contribution would be included.

\*\*Certain employees that are not included in the compensation test include the self-employed individuals and anyone who did not make any compensation for the year in question.

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**Compensation Limit**

The total amount of compensation that a participant can use in the compensation test is always capped at the dollar limitation under IRC section 401(a)(17).

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**How is a Demo 9 Calculated?**

To simplify, the calculation of Demo 9 has been put into three steps for better understanding. Additionally, at each step in the process, an example will be provided for further clarification.

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## Calculation of the Demo 9, Continued

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**Demo 9  
Example Basic  
Information**

JKL Business, Inc. provides for a pro-rata employer contribution for plan year 2003 based on their 414(s) compensation definition.

The employees normally work a 40 hour work week.

The 414(s) compensation definition is defined as Treas. Regs. 1.415-2(d)(2), but excludes bonuses.

Employee information is as follows:

Employee	Basic Compensation	Bonuses	Total Compensation
HCE-Adam	225,000	25,000	250,000
HCE-Beth	136,600	13,400	150,000
HCE-Carol	93,250	6,750	100,000
NHCE-Dee	72,700	2,300	75,000
NHCE-Ethan	60,000	0	60,000
HHCE-Freddy	29,175	825	30,000

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**Step One:  
Obtaining the  
Individual  
Compensation  
Percentages  
(ICP)**

In Step One, to obtain an individual's compensation percentage; you will need to divide the basic definition of compensation by total compensation. For you mathematical folks who like to visualize, here is the formula:

$$\frac{\text{Basic Definition of Compensation}}{\text{Total Compensation}}$$

If you have a situation where a participant was only eligible for a portion of a plan year, then the formula would look like this:

$$\frac{\text{Basic Definition of Compensation for Partial Year}}{\text{Total Compensation for Partial Year}}$$

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*Continued on next page*

## Calculation of the Demo 9, Continued

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**Step One:** Calculating the Individual Compensation Percentages (ICP)

**Obtaining the Individual Compensation Percentages (ICP)**

**Example**

Employee	Basic Comp	Total Comp	ICP Calculations
HCE-Adam	225,000	250,000	$200,000 / 200,000 = 100\%$
HCE-Beth	136,600	150,000	$136,600 / 150,000 = 91.07\%$
HCE-Carol	93,250	100,000	$93,250 / 100,000 = 93.25\%$
NHCE-Dee	72,700	75,000	$72,700 / 75,000 = 96.93\%$
NHCE-Ethan	60,000	60,000	$60,000 / 60,000 = 100\%$
NHCE-Freddy	29,175	30,000	$29,175 / 30,000 = 97.25\%$

You may be questioning why the ICP is 100% for HCE-Adam. Remember, there is a cap on the amount of compensation taken into account under IRC 401(a)(17). In this example, the plan year is 2003 and the dollar limitation in 2003 is \$200,000; therefore, we can disregard compensation above this amount.

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*Continued on next page*

## Calculation of the Demo 9, Continued

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**Step Two:** In Step Two, you will take the individual compensation percentages (ICP) from Step One for each group and add them up to get a group total percentage. Next, you will take the total percentage of the group and divide it by the number of employees in each group to reach the average of the individual compensation percentages (ICP). Here are the two formulas:

**Average of the Individual Compensation Percentages (ICP)**

*Formula One: To get the Group Total Percentage*

$$\begin{aligned} & \text{Individual Compensation Percentage(ICP)} \\ & \text{Individual Compensation Percentage(ICP)} \\ & \text{Individual Compensation Percentage(ICP)} \\ & + \underline{\text{Individual Compensation Percentage(ICP)}} \\ & \text{Total Percentage of Group} \end{aligned}$$

*Formula Two: To get the Average of the ICP*

$$\frac{\underline{\text{Total Percentage of Group}}}{\text{Number of Employees in Group}}$$

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**Step Two Example:** For the HCE group:

The total percentage is:  $100\% + 91.07\% + 93.25\% = 284.32\%$

The ICP average is:  $284.32\% / 3 = 94.77\%$

For the NHCE group:

The total percentage is:  $96.93\% + 100\% + 97.25\% = 294.18\%$

The ICP average is:  $294.18\% / 3 = 98.06\%$

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*Continued on next page*

## **Calculation of the Demo 9, Continued**

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**Step Three:** The third and final step in the Demo 9 is evaluating the results from the calculations. Remember, the whole concept behind the Demo 9 is to make sure that discrimination does not occur between the HCEs and the NHCEs.

**Evaluating the Results** Therefore, if the difference between the ICP averages is less than a de minimis amount, the non safe harbor definition of compensation would be considered nondiscriminatory.

NOTE -when calculating the compensation test (Demo 9), if the ICP average of the NHCEs group is ***higher*** than the HCEs group, the definition of compensation used for section 414(s) compensation test is generally considered non-discriminatory.

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**What is De Minimis?** The question of the century among various practitioners is what the Internal Revenue Service views as de minimis.

In view of the fact that there is no published guidance out regarding this issue, taking a conservative approach would be the best advice. Whether or not the definition of compensation is discriminatory should be based on the facts and circumstances of the individual case.

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*Continued on next page*

## Calculation of the Demo 9, Continued

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**Step Three Example:** Based upon the calculations it was determined that the ICP average for the HCEs is 94.77% and the ICP average for the NHCEs is 98.06%. The difference between the two groups is 3.29% in favor of the NHCEs.

**Evaluating the Results Example**

Based upon the above facts, the compensation test is satisfied because the NHCE's have a higher ICP average than the HCEs for the year.

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**Same Example, but Different Outcome**

What if the facts in the above example produced a different result? For argument sake, let us change the facts around and say the HCE group had an ICP average of 98.06% and the NHCE group had an ICP average of 94.77%. The difference would still be 3.29%, but now in favor of the HCEs. Would this be considered a de minimis value in order to pass the test?

Hmm...it is decision time. First, you should look to the facts and circumstances in this example to form your conclusion. For example, instead of looking just at one year in question, you may have to obtain information from the employer indicating that in the past several years the HCEs were not being favored over the NHCEs. Bottom line...sometimes making a determination about a de minimus value may not be so cut and dry.

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**Failing The Compensation Test When The Demo 9 Is Not Associated With A General Or Average Benefit Test.**

What does it mean if the compensation test (Demo 9) fails? Generally, it means that the employer's definition of 414(s) compensation is discriminatory.

However, if the Demo 9 was run to satisfy a design based safe harbor, there are two solutions the employer can make to remedy this issue. The employer can either:

1. Amend the 414(s) compensation definition in the plan document (as long as doing so would not violate the Code or regulations regarding the anti-cutback rules or retroactive plan amendments) and recalculate the compensation test to see if it will pass, or
  2. Perform the general test under IRC section 401(a)(4) by submitting a Demo 6. The Demo 6 must use a 414(s) safe harbor definition of compensation in the test. (Reminder: If the employer does elect to do this, you may have to secure an additional user fee)
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*Continued on next page*



## Calculation of the Demo 9, Continued

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**Failing the Compensation Test When the Demo 9 Is Associated With a General Or Average Benefit Test**

However, if the Demo 9 was run to show that the compensation used in a general or coverage test satisfies 414(s), there are two solutions to this problem the employer can make to remedy this issue. The employer can either:

1. Revise the Demo 5 or 6 using a 414(s) safe harbor compensation to see if it will pass, or
  2. Amend the plan formula to change the allocations under 1.401(a)(4)-11(g) if the plan satisfies those requirements.
- 

**Example Of Demonstration 9 Narrative With Instructions**

A demonstration that a definition of compensation is nondiscriminatory under the test in section 1.414(s)-1(d) of the regulations (regarding alternative definitions of compensation that satisfy section 414(s)) should include the following information:

1. It should state whether the demonstration relates to a definition used to determine contributions or benefits, or a definition used in a section 401(k) or section 401(m) plan's ADP or ACP test. (If the demonstration is being submitted to support a determination that a plan satisfies a general test, a non-design-based safe harbor, or the average benefit test, the demonstration should instead identify the test or non-design-based safe harbor to which it relates.)

*For example, "The demonstration relates to a definition of compensation used to determine compensation for the general test, see Demonstration 6 item 8."*

2. It should state the definition of compensation being tested (and include the plan cite where applicable), and indicate whether the definition uses "rate of compensation" or includes prior-employer compensation or imputed compensation.
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## Calculation of the Demo 9, Continued

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**Example Of  
Demonstration  
9 Narrative  
With  
Instructions  
(continued)**

3. It should identify the period for which compensation data is given.

*For example, "1998 plan year".*

4. It should state whether the test is based on the compensation of all employees benefiting under the plan or all employees benefiting under all plans of the employer for which the same alternative definition of compensation is used to determine that the plan satisfies section 401(a)(4). It should also state whether all employees with zero total compensation have been excluded from the test. The demonstration should state the numbers of highly compensated and non-highly compensated employees whose compensation is taken into account in the demonstration.

*For example, "The test is based on the compensation of all employees benefiting under the plan. No employees with zero compensation have been included. The test includes 17 NHCEs and 23 HCEs."*

5. For each of the highly compensated and non-highly compensated groups of employees, it should state whether the test uses an aggregate, individual, or other reasonable method to calculate inclusion percentages. If an "other" method is used, this should be described.

*For example, "The test used the individual method to calculate inclusion percentages."*

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## Calculation of the Demo 9, Continued

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**Example Of  
Demonstration  
9 Narrative  
With  
Instructions  
(continued)**

6. With regard to the determination of total compensation and compensation included under the definition being tested, the demonstration should:

- a) Specify the IRC 415(c)(3) definition of compensation used in determining total compensation;

*For example, “The test uses 415(c)(3) compensation under Treas. Reg. 1.415-2(d)(11)(i) as modified by IRC 415(c)(3)(D) –W-2 wages plus elective deferrals.”*

- b) Indicate whether total compensation includes elective contributions and deferred compensation and, if applicable, whether and how the adjustment required by section 1.414(s)-1(d)(3)(ii)(B) has been made; and

*For example, “ Total compensation includes elective contributions and deferred compensation without adjustment under 1.414(s)-1(d)(3)(ii)(B).”*

- c) State whether, for purposes of the test, compensation included under the definition being tested is limited to total compensation and whether both total compensation and compensation included under the definition being tested are limited to amounts not in excess of the limit in section 401(a) (17).

*For example, “Compensation included the definition being tested is limited to total compensation and both total compensation and compensation included under the definition being tested is limited to amounts not in excess of section 401(a)(17).”*

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## Prior Employer & Imputed Compensation

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### Prior Employer and Imputed Compensation Definitions

Relating *only* to *defined benefit plans* for purposes of satisfying 410(b) and 401(a)(4), an alternative reasonable definition of compensation for 414(s) may include either prior-employer or imputed compensation provided that it is for determining benefits under the plan and it satisfies certain requirements under Treas. Regs. 1.414(s)-1(f).

*Prior employer compensation* is defined as compensation earned by the employee from his or her previous employer before becoming an employee participant in the current plan. (The previous employer has to be unrelated to the current employer.)

*Imputed compensation* is defined as compensation credited for a period of time that the employee is not performing services for the employer or is performing services for the employer at a reduced workload.

---

### Prior Employer and Imputed Compensation Requirements

In order to use prior-employer or imputed compensation in the 414(s) definition of compensation, there are three requirements that must be met. They are as follows:

- ❶ Must have a legitimate business reason for inclusion,
  - ❷ Must be applied consistently to all similarly situation participants, and
  - ❸ Must not discriminate significantly in favor of HCEs.
- 

### Pay Rate Definition of Compensation

At times, the compensation definition in the plan document will provide a rate of compensation for the employee instead of their actual compensation. Under Treas. Regs. §1.414(s)-1(e), this is an acceptable reasonable definition for 414(s) compensation. It can be listed as an hourly rate, weekly rate, or similar unit of pay scale.

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### Related Employers

Compensation used for 414(s) purposes must include all compensation earned from all related employers regardless if they maintain one or more plans.

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## **Compensation for Accrued Benefits**

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**Definition of Compensation to be Used**

Compensation defined for accrued benefits:

If a plan uses compensation as the basis for determining benefits under the plan, the plan must define compensation. The plan can use IRC 415 compensation, IRC 414(s) compensation, or may use any alternative definition of compensation.

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**Non-discrimination Testing**

Any safe harbor definition of compensation is inherently non-discriminatory.

If a plan uses an alternative definition of compensation for nondiscrimination testing, the plan benefits or contributions will be expressed as a percentage of compensation within the meaning of IRC 414(s). Under this method, the definition is non-discriminatory if the average percentage of total compensation included under the alternative definition for an employer's highly compensated employees as a group does not exceed by more than a de minimis amount the average percentage of total compensation included under the alternative definition for the employer's non-highly compensated employees as a group. Treas. Regs. §1.414(s)-1(d)(3)

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## **Compensation for Accrued Benefits, Continued**

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**Severance  
Payments**

Should severance payments be included in compensation when determining the employer's contribution or benefit accrual?

Essentially, it would depend on which definition of compensation is used for benefit accruals. For instance, if the plan document is using one of the four IRC 415 definitions under Treas. Regs. 1.415-2(d)(2), 1.415-2(d)(10), or 1.415-2(d)(11) for benefit accruals, then severance payments are generally included. However, if the compensation definition is a safe harbor definition under 414(s) that states it is excluding welfare benefits, then severance payments would be excluded. Ultimately, understanding which definition of compensation is being used for benefit accruals would indicate if severance payments are included.

NOTE - If an employee receives severance payments from an employer, you may **not** defer any to a 401(k) arrangement since the employee is no longer working for the employer.

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**M&P Plans**

When an employer is deciding on which definition of compensation to use in allocating an employer's contribution in a defined contribution plan or determining an accrued benefit in a defined benefit plan under an M&P plan, a standardized M&P plan can only use a 414(s) safe harbor compensation definition. However, a non-standardized M&P plans must at least offer the option of using a safe harbor definition of 414(s).

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## **Compensation Limitation**

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**Introduction** Prior to EGTRRA, IRC Section 401(a)(17) provided that a trust would not constitute a qualified trust unless the annual compensation of each employee taken into account under the plan for any year did not exceed \$150,000 (indexed). This limit was increased by EGTRRA to \$200,000.

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**Cost-of-Living Adjustment** The annual limit is adjusted annually to reflected increases in the cost-of-living:

- The annual adjustment is made at the same time and in the same manner as under IRC Section 415(d). The limit is only changed if the increase is \$10,000 or greater and is made in multiples of \$10,000. For example, the 1999 annual limit of \$160,000 was increased to \$170,000 in 2000. The adjustment was based on a cost-of-living increase that was greater than \$9,999 and less than \$20,000.
- Effective for years beginning after December 31, 2001, the limit is increased to \$200,000 and is adjusted in \$5,000 increments. Note that this change was made by EGTRRA and is subject to sunset provisions after 2010, meaning that absent actions by Congress, the pre- EGTRRA limits will return.
- The annual adjustment applies to plan years beginning in the calendar year in which the adjustment is effective. For example, if a plan has a plan year beginning July 1, 2000 and ending June 30, 2001, the annual limit in effect on January 1, 2000 applies to the plan for the entire plan year ending June 30, 2001.

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**Compensation Limitation, Continued**

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**Application of Compensation Limits for Non-calendar Year Periods**

The IRC 401(a)(17) limitation on annual compensation is applied to the compensation for the plan year in which allocations or benefit accruals are based.

If a plan determines allocations or benefit accruals based on compensation for:

- The plan year, then the annual compensation limit that applies to the compensation for the plan year is the limit in effect for the calendar year in which the plan year begins
- A 12-consecutive-month period, or periods, ending no later than the last day of the plan year, then the annual compensation limit applies to compensation for each of those periods based on the annual compensation limit in effect for the respective calendar year in which each 12-month period begins

See Treas. Reg. Section 1.401(a)(17)-1(b)(3)(ii).

---

**When Prorating is Required**

If compensation for a period of less than 12 months is used for a plan year, then the annual compensation limit is reduced in the same proportion as the reduction in the 12-month period

If the period for determining compensation used in calculating an employee's allocation or accrual for a plan year is a short plan year (that is, shorter than 12 months), the annual compensation limit is an amount equal to the otherwise applicable annual compensation limit multiplied by a fraction, the numerator of which is the number of months in the short plan year, and the denominator of which is 12

See Treas. Reg. Section 1.401(a)(17)-1(b)(3)(iii)(A).

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**Compensation Limitation, Continued**

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**When  
Prorating is not  
Required**

Prorating of the limitation is not required merely because the plan formula provides that the allocation or accrual for each employee is based on compensation for the portion of the plan year during which the employee is a participant in the plan.

Furthermore, prorating is not required under the following circumstances:

- Merely because an employee is covered under a plan for less than a full plan year, provided that allocations or benefit accruals are otherwise determined using compensation for a period of at least 12 months.
  
- Merely because the amount of elective contributions (within the meaning of Treas. Reg. Section 1.401(k)-1(g)(3)), matching contributions (within the meaning of Treas. Reg. Section 1.401(m)-1(f)(12)), or employee contributions (within the meaning of Treas. Reg. Section 1.401(m)-1(f)(6)) that is contributed for each pay period during a plan year is determined separately using compensation for that pay period.

See Treas. Reg. Section 1.401(a)(17)-1(b)(3)(iii)(B).

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## **Compensation Limitation Table**

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**Dollar  
Limitation  
Table**

The following table provides a summary of the dollar limitation in effect for the years 1998 through 2004:

<b>Year</b>	<b>Dollar Limit</b>
1998	\$160,000
1999	\$160,000
2000	\$170,000
2001	\$170,000
2002	\$200,000
2003	\$200,000
2004	\$205,000

Section 611(i)(1) of EGTRRA provides that the increase in the compensation limit of § 401(a)(17) of the Code applies to years beginning after December 31, 2001. Thus, for purposes of determining benefit accruals or the amount of allocations for plan years beginning on or after January 1, 2002, compensation taken into account may not exceed the compensation limit under § 401(a)(17), as amended by § 611(c) of EGTRRA. In the case of a plan that uses annual compensation for periods prior to the first plan year beginning on or after January 1, 2002, to determine accruals or allocations for a plan year beginning on or after January 1, 2002, the plan is permitted to provide that the \$200,000 compensation limit applies to annual compensation for such prior periods in determining such accruals or allocations.

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## Compensation Worksheet Questions

### Worksheet Questions

To provide you with better understanding of the world of compensation, the table below shows all of the questions from the defined contribution and defined benefit workbooks pertaining to compensation and indicates which definition of compensation it is referring to.

Worksheet Number	Worksheet Question	Type of Compensation Used
DC-Wk 5, X, a DB-Wk 5a, XIII, a  Coverage & Nondiscrimination Requirements	Does this design-based safe harbor plan use a nondiscriminatory definition of compensation for purposes of computing contributions?	415 or 414(s) Compensation
DC-Wk 5, X, b DB-Wk 5a, XIII, b  Coverage & Nondiscrimination Requirements	In the case of a plan that covers self-employed individuals, does the plan define compensation for these individuals in a manner that satisfies section 414(s)?	415 or 414(s) Compensation
DC-Wk 6, I, b DB-Wk 6, I, b  Limitations on Contributions & Benefits	Does the plan's definition of compensation satisfy the requirements of the IRC section 415(c)(3) and the regulations?	415 Compensation
DC-Wk, 7, II, d DB-Wk 7, II, d  Top-Heavy Requirements	Is compensation to be used for purposes of determining all minimums properly defined?	415 Compensation

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**Compensation Worksheet Questions, Continued**

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**Worksheet Questions**  
(continued)

Worksheet Number	Worksheet Question	Type of Compensation Used
DC-Wk 11, V, c DB-Wk 11, V, c  Employee & Matching Contributions	Does the plan define compensation and specify the period used to determine an employee's compensation for purposes of the ACP test?	415 or 414(s) Compensation
DC-Wk 12, VII, c  IRC § 401(k) Requirements	Does the plan define compensation and specify the period used to determine an employer's compensation for purposes of the ADP test?	415 or 414(s) Compensation
DC-Wk 12, X, f  IRC § 401(k) Requirements	Does the plan use the correct definition of compensation?	414(s) Compensation

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## **Summary**

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**Summary** After reading this chapter, you should understand all of the difficulties one faces regarding compensation within retirement plans.

Compensation is used to determine:

- If the section 415 limitations have been exceeded
- Who is a highly compensated employee
- Who is a key employee
- The minimum top heavy contributions
- Deductions for the employer
- Allocations of plan contributions
- Nondiscrimination testing
- Coverage testing
- If the compensation test has been passed

Getting a basic understanding of compensation will enable you to become better specialists while reviewing plan documents.

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## **Exercises**

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### **Exercise 1**

Dangling Performer, Inc. Profit Sharing Plan defines compensation for allocation purposes as Treas. Regs. 1.415-2(d)(2) but excludes reimbursements, deferred compensation, moving expenses, fringe benefits, and welfare benefits.

Carrie Dean is a non-highly compensated employee who gets reimbursed for childcare expenses totaling \$3,000 which would be one of the exclusions listed above. She earns \$45,000 per year. Her total compensation taken into account for this year's contribution is 93.33%.

Megan Noble is a highly compensated employee that does not have any of the exclusions listed above. She earns \$150,000 per year. Her total compensation taken into account for this year's contribution is 100%.

Which of the following statements is true?

- a. The definition of compensation is discriminatory because the percentage of includable compensation for the HCE exceeds the percentage of includable compensation for the NHCE by more than a de minimis amount.
- b. The safe harbor definition of compensation permits these modifications; therefore, this definition is not discriminatory and satisfies section 414(s).
- c. The compensation definition does not satisfy IRC 414(s) or 415.
- d. The definition of compensation is not discriminatory because the percentage of includable compensation for the HCE compared to the includable compensation for the NHCE is in the de minimis range.

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**Exercises, Continued**

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**Exercise 2** For 2003, OPQ Company has a profit sharing plan that defines compensation as Treas. Regs. 1.415-2(d)(2) and includes 401(k) deferrals but excludes welfare benefits, moving expenses, transportation subsidies, deferred compensation, and reimbursements. What would make this definition a safe harbor under 414(s)?

- (a) You will need to include transportation subsidies and exclude 401k deferrals in the definition of compensation
- (b) You will need to include welfare benefits and reimbursements and exclude fringe benefits in the definition of compensation
- (c) You will need to include transportation subsidies in the definition of compensation
- (d) Both (a) and (c)

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**Exercise 3** Which of the following modifications would be the least likely to cause a plan's compensation definition to be considered discriminatory?

- (a) Exclusion of tips
- (b) Inclusion of bonuses
- (c) Exclusion of commissions
- (d) Inclusion of overtime pay

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*Continued on next page*

**Exercises, Continued**

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**Exercise 4** XYZ Corporation defines IRC 414(s) compensation as 25% of the compensation definition under 1.415-2(d)(11). Is this a reasonable definition of 414(s) compensation?

Yes or No

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**Exercise 5** True or False...The three modifications that can be made to the alternative safe harbor 414(s) definition are the inclusion of elective deferrals, exclusion of certain benefits (that include fringe benefits, deferred compensation, welfare benefits, moving expenses, and reimbursements or other expense allowances), and bonuses.

True or False

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**Exercise 6** Which of the following, if excluded by itself, will satisfy IRC 414(s) without a compensation test?

- (a) Bonuses
  - (b) Fringe benefits
  - (c) Moving expenses
  - (d) Elective deferrals
- 

*Continued on next page*



**Exercises, Continued**

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**Exercise 7**      Gamma Rays, Inc. provides for a pro-rata employer contribution for the 2002 plan year based on their IRC 414(s) definition. Employees normally work a 40 hour week. The 414(s) compensation definition is defined as Treas. Regs. 1.415-2(d)(2), but excludes overtime and bonuses.

Please calculate the reasonable compensation for each employee, compute the individual compensation percentages, average the individual compensation percentages, and evaluate the results from the compensation test.

Employee	Total Comp	Bonuses	Overtime	Reasonable Comp	ICP
Ginger-HCE	\$100,000	\$5,375			
Harry-NHCE	\$42,000		\$600		
Ian-NHCE	\$31,960	\$200	\$645		
Jason-HCE	\$150,000	\$3,250			
Katy-HCE	\$260,000	\$22,470			
Lisa-HCE	\$136,930	\$2,220	\$250		
Morgan-NHCE	\$63,240	\$610	\$3,000		
Nick-NHCE	\$57,620	\$160	\$705		

The total percentage for the HCEs is: \_\_\_\_\_

The ICP average for the HCEs is: \_\_\_\_\_

The total percentage for the NHCEs is: \_\_\_\_\_

The ICP average for the NHCEs is: \_\_\_\_\_

Based upon the facts above, did the compensation test pass?

Why or why not?

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**Chapter 3- Compensation**

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**Exercise  
Answers**

1. B
2. C
3. D
4. NO
5. False
6. Elective Deferrals
7. Demo 9

Employee	Reasonable Comp	ICP
Ginger	94,625	$94,625/100,000 = 94.63\%$
Harry	41,400	$41,400/42,000 = 98.57\%$
Ian	31,115	$31,115/31,960 = 97.36\%$
Jason	146,750	$146,750/150,000 = 97.83\%$
Katy	200,000	$200,000/200,000 = 100\%$
Lisa	134,460	$134,460/136,930 = 98.20\%$
Morgan	59,630	$59,630/63,240 = 94.29\%$
Nick	56,755	$56,755/57,620 = 98.50\%$

NHCE's ICP :  $98.57 + 97.36 + 94.29 + 98.50 = 388.72$

$388.72 / 4 = 97.18\%$

HCE's ICP :  $94.63 + 97.83 + 100 + 98.20 = 390.66$

$390.66 / 4 = 97.67\%$

Did the compensation test pass? Why or why not?

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