Tracking Compensation and Getting It Right

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According to the IRS, one of the most common mistakes that employers make when administering their retirement plans is using the wrong employee compensation. If the wrong amount is sent to your provider, this will lead to incorrect contribution calculations, incorrect plan testing and leaves the plan not operating in accordance with the plan document. To administer your plan properly, it is import to understand how your plan defines compensation and to make sure your definition is properly set up in your payroll system.

One allowable definition is total compensation under Code Section 415, which picks up virtually all items earned during the year and is considered "gross compensation". Alternatively, there are several allowable safe harbor definitions under Code Section 414(s) that are deemed to be nondiscriminatory:

(1) A "general" definition of total compensation, which includes wages, salaries and other amounts received for personal services actually rendered in the course of employment with the employer maintaining the plan to the extent the amounts are includible in gross income or would have been includable in gross income but for a specific code section election that allows them to be excluded;
(2) Wages for purposes of income tax withholding under Code Section 3401 – which we generally call "withholding wages"; or
(3) Form W-2, Box 1 compensation, which includes withholding wages (option 2) plus all other payments of compensation to an employee by the employer for which the employer is required to furnish the employee a written statement - which we generally call "W-2 wages".

We typically find that withholding wages or W-2 wages are the most common definitions used in plan documents as they are the easiest to obtain. However, even the basic definitions can be subject to some adjustments.

Under all of these definitions, it is common to add back pre-tax deferrals under retirement plans, cafeteria plan premiums, and qualified transportation fringe benefits but you are not required to do so. It is also allowable under any of the above definitions to exclude the following items from compensation even though they would be includible in gross income:

- Reimbursements or other expense allowances
- Fringe benefits (cash and noncash)
- Moving expenses
- Deferred compensation

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- Welfare benefits
- Pay earned by employees before they become eligible for the plan (or that particular plan component)
- Any portion of compensation paid to a Highly Compensated Employee (which has a special meaning in the code but is not addressed in this article)

But in order to exclude these items, they must be noted in your plan document.

Other items may be excluded (for example, bonuses, overtime or commissions) so long as the exclusion doesn't favor Highly Compensated Employees, are reasonable and satisfy a numerical pay inclusion test. The special testing on these exclusions must be monitored and tested every year and if the testing doesn't pass, the plan is unable to exclude that type of compensation for that year.

Lastly, there are also different definitions of compensation for self-employed individuals who are not paid on a Form W-2, like partners or sole proprietors, who receive what is called earned income. Income for these individuals will come from their Form 1040, Schedule C or Form 1065 K-1 and have their own adjustments.

Tracking compensation can be one of the most challenging aspects of managing a retirement plan. If you have questions on how your compensation is defined, you should talk with an experienced provider or reach out to your Account Executive at RMS to discuss.