

COMPENSATION
A MINE FIELD FOR ERRORS

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Topics

1. Section 415 Compensation – Optional Provisions
2. Including Taxable Fringe Benefits
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I. Section 415 Compensation – Optional Provisions

The final section 415 regulations created a dilemma for many plan administrators and employers. It provides choices with respect to the section 415(c) definition of compensation. The impact can go beyond what definition is used for the 415 limit.

A. Definition

Section 415(c) defines compensation as:

A participant's wages, salary, fees for professional services, overtime, bonuses, commissions, compensation based on a percentage of profits, tips, fringe benefits, reimbursements or other expense allowances under a non-accountable plan under section 1.62-2(c) of the Regulations, and any other amounts received (whether or not in cash) for personal services rendered while in service from any employers or affiliated employers in the control group.

A self-employed participant's 415 compensation is his earned income from any employer under section 401(c)(2) of the Code, excluding income from an employer for which the participant's personal services are not a material income-producing factor. A self-employed participant's earned income excludes any qualified plan contributions made on his behalf which are deductible under section 404 of the Code, and shall take into account the employer's deduction under section 164(f) of the Code.

A participant's 415 compensation shall include (i) amounts which are excluded from the employee's gross income as salary deferral under sections 125, 132(f)(4), 401(k), and 457(b) of the Code, (ii) amounts excludable from gross income under foreign income rules, (iii) amounts includable in gross income as taxable health or accident benefits, (iv) amounts received from an employer for moving expenses which are not deductible under section 217 of the Code, (v) amounts includable in gross income in the year of, and on account of, the grant of a nonqualified stock option, or under an unfunded nonqualified plan of deferred compensation, or otherwise includable pursuant to section 83(b) of the Code, and (vi) amounts includable in income under section 409A or 457(f)(1)(A) of the Code or because the amounts are constructively received by the participant.

A participant's 415 compensation shall exclude (i) employer contributions to or amounts received from a plan of deferred compensation (whether or not qualified), a simplified employee pension account, or a SIMPLE IRA under section 408(p) of the Code, if these amounts are not included in income, (ii) amounts includable in gross income pursuant to section 83(a) of the Code for receipt of property for the performance of services, (iii) amounts includable in gross income upon the exercise of a nonqualified stock option or upon the disposition of stock acquired under any stock option (including a statutory stock option) or grant, (iv) any other amounts that receive special tax benefits which are excludable from the participant's income and are not salary deferrals under section 125 of the Code.

A participant's 415 compensation shall include compensation paid after his severance from service if (a) it is regular compensation for services during the participant's regular working hours or regular overtime, shift differentials, commissions and bonuses, or (b) it is paid no later than 2½ months after the participant's severance from service with the employer, or before the end of the limitation year which includes the severance from service, if later and (c) the amounts would have been included in 415 compensation if they had been paid before the severance from service. In addition, a participant shall be deemed to have 415 compensation equal to the compensation he would have received if he were not on military leave for the period he is on leave for qualified military service as defined in section 414(u)(1) of the Code based on his rate of pay or if compensation for the period is not reasonably certain, based on the participant's average compensation during the 12-month period (or such shorter period if he does not have 12 months of service with the employer) preceding the qualified military service.

B. Optional Provisions:

The final regulations published in April 2007 introduced a new concept with respect to the 415 definition: it created categories of compensation that were optional. The final regulations provide an option regarding the following: unused accrued vacation, bona fide sick leave or other leave, or payments from a nonqualified unfunded deferred compensation plan. These amounts may be included in 415 compensation if paid no later than 2½ months after the participant's severance from service with the employer, or before the end of the limitation year which includes the severance from service, if later, and the amounts

would have been included in 415 compensation or the participant would have been able to use the leave if it had been taken before the severance from service.

Since section 415 tests contributions or benefits against the maximum limits of 100% of pay, the first reaction would be to include everything you can into the 415 compensation. But does the plan use the 415 compensation definition for determining contributions or benefit accruals?

1. Post Severance Compensation

Before the final regulations were issued, the IRS had always taken the position informally that post severance pay was not compensation for contributions or benefit accruals. They took the position that only pay received while the individual was an active employee could be counted. This has always been a problem, especially when an employment lawyer writes a separation agreement allowing former employees to continue to have 401(k) deductions taken from their severance pay.

The final regulations tried to deal with this issue by providing a window on which post severance pay would be included, but limited it to pay the employee would have received if they had remained employed. So severance payments are still not valid pay for purposes of section 415 regardless of how soon after severance they are paid. Also, providing benefits on severance pay may be a problem in a later year because the individual will not have any 415 pay on which to base a benefit and create an automatic 415 violation and qualification error.

2. Accrued Vacation and Sick Leave

For most employees, payments for accrued vacation and sick leave should not be significant sums and should not have a significant impact. However, if a plan uses 415 compensation as the definition of pay for contributions or benefit accruals, you will want to check with the client whether to include it.

3. Deferred Compensation

Deferred compensation, meaning any compensation earned in one year but payable in a later year, may also be included. However, if it is being used for determining contributions on benefits - it would be wise to check with the

client before including it. Often deferred compensation consists of employer provided benefits for highly compensated employees who could not get the full benefit under the qualified plan because of the section 415, 401(a)(17) or 402(g) limits. By including these amounts in the definition of pay, benefits are being provided on other benefits. That is probably not what the employer intended.

4. Disability

The final regulation also allows an employer to input income for 415 purposes if the participant becomes permanently and totally disabled, based on his rate of pay before his severance. The participant must be permanently and totally disabled as defined in section 22(e)(3) of the Code, and the 415 compensation is based on the rate of compensation the participant received immediately prior to becoming disabled. The income inclusion can continue for a number of years as determined by the employer following his severance on account of disability. Again, this decision should be presented to the employer because it will involve additional cost.

Caution: Many plans used a default election in the 415 amendment and included many of these optional provisions as part of 415 compensation. You should review these choices with your clients.

II. Including Taxable Fringe Benefits

W-2 pay is often considered a simple alternative for determining benefits. W-2 pay allows an employer to pull the number off of Box 1 and plug it into the worksheets. Maybe 401(k) and section 125 deferrals need to be added back into pay, they're on the payroll records also, so the adjustment is easy.

A. Taxable Fringe Benefits

In a 401(k) plan, using W-2 pay can create real problems. W-2 includes taxable fringe benefits and deferred compensation – everything an employee is paid. How does one take 401(k) contributions out of the term value of group life insurance benefits over \$50,000? What about the taxable value of the company car? Non-excludable moving expenses?

If the plan uses W-2 pay for contributions, these amounts must be included. If you can monitor it, you can certainly take the withholding from other compensation. However, many of the

taxable fringes are determined at year-end and included in compensation with the last paycheck for the year.

B. Cash or Deferred Arrangement

Many people have argued that with respect to 401(k) elections, no deferral election is permitted on taxable fringe benefits because the section 401(k) Regulations only permit elections where the employee has a right to receive cash – the cash or deferred election. Regulations section 1.401(k)-1(e)(2)(i) provides that “Cash must be available. A cash or deferred arrangement satisfies this paragraph (e) only if the arrangement provides that the amount that each eligible employee may defer as an elective contribution is available to the employee in cash. Thus, for example, if an eligible employee is provided the option to receive a taxable benefit (other than cash) or to have the employer contribute on the employee’s behalf to a profit sharing plan an amount equal to the taxable benefit, the arrangement is not a qualified cash or deferred arrangement. The cash availability requirement applies even if the cash or deferred arrangement is part of a cafeteria plan within the meaning of section 125.”

C. ABA JCEB Question

The question was presented to the IRS in informal questions and answers by the American Bar Association, Joint Committee on Employee Benefits in May 2009.

Question

If a plan defines compensation for purposes of plan benefits as W-2 compensation, and the employee receives employer provided group term life insurance coverage in excess of \$50,000 over which the employee has no election to decline coverage and take cash instead, is the employer required to calculate deferrals and deduct deferrals from other cash income of the employee based on the taxable imputed income reported on the employee’s Form W-2 that results from the excess group term life insurance coverage?

Proposed Response

No. Imputed taxable income that results from excess group term life insurance coverage over which the employee had no election between taxable coverage and deferrals to the plan and over which the employee also had no election to take cash instead of the excess group term life insurance coverage does not satisfy the requirement of Treasury Regulation Section 1.401(k)-1(e)(2)(i) because there is no cash option under the arrangement. As a result,

taking deferrals based on the imputed income does not qualify as amounts over which an employee can make a cash or deferred election under Section 401(k). The fact that the employee has no election to take cash instead of the deferral prevents this type of income from being the type of income to which a deferral election may apply. This is also consistent with the Service's conclusion in Private Letter Ruling 200247050 where the Service ruled that the choice between unused sick leave and a contribution to the qualified plan did not constitute a cash or deferred election because the employee did not have the option to receive additional cash or any other taxable benefit in lieu of the additional contribution to the plan.

IRS Response

The Service representative disagrees with the proposed response. The proposed answer cites to the Section 401(k) regulations which provide that elective deferrals may only be made from cash. The Service representative indicated that there is a distinction between the compensation to which a deferral election is applied and the compensation from which the elective deferrals actually come out. Because the value of group term life insurance is included in compensation, it must be taken into account in applying the employee's deferral election. For example, if an employee elects to defer 10% of compensation and the employee has \$45,000 of cash compensation and \$5,000 of taxable group term life insurance, then \$5,000 must be deferred into the plan. Since the \$5,000 deferral amount cannot be taken from the imputed income from the group term life insurance, the elective deferrals must be taken from cash compensation. The group term life insurance cannot be disregarded for purposes of determining the amount of an employee's compensation unless the plan was specifically drafted to provide that the group term life insurance is excluded from the plan's definition of compensation.

III. Plan Audit Activity with Respect to Compensation

Monica Templeman, Director, EP Examinations, Internal Revenue Service lists errors made with regard to compensation as one of the top five errors the IRS finds in plan audits. The problem with using the correct definition of compensation occurs in audits of both small and large employers.

The typical problems include failure to make contributions on taxable fringe benefits— such as group term life insurance in excess of \$50,000, automobile allowances, or income inclusion for health benefits for domestic partners.

Alternatively, the employer may fail to withhold 401(k) contributions from bonus payments, even though the plan does not exclude bonuses or provide for a separate election with respect to bonuses.

Any of these failures will mean the employer has failed to follow the terms of the plan and will result in the plan being disqualified.

The IRS has focused on the deferral election forms and expects that the participant be allowed to make an election on compensation as defined in the plan document.

Plan auditors are also aware of the issue and will review deferral elections against the plan's definition of "Compensation" in their annual audit.

IV. How to Fix an Error

What happens when the plan's definition of compensation is W-2 and the employer does not withhold on taxable fringe benefits such as the term value of group term life insurance over \$50,000? In order to avoid plan disqualification, the employer will have to correct under the IRS correction program, Rev. Proc. 2008-50.

In most cases the employer can decide whether it wants to make a submission to the IRS under the VCP program or to self correct. Any errors discovered within 2 years can be self corrected. Beyond that period, insignificant errors can be self corrected. The significance of an error depends on the number of participants involved, the amount of plan assets and similar criteria.

If a plan amendment is required, a submission under the VCP is required. The fee for making a VCP application depends on the number of participants in the plan as shown on the last Form 5500.

Rev. Proc. 2008-50– Sec. 12.02(1) – Standard Fees

Number of Participants	Standard Fees
20 or fewer	\$ 750
21 to 50	\$1,000
51 to 100	\$2,500
101 to 500	\$5,000
501 to 1,000	\$8,000
1,001 to 5,000	\$15,000
5,001 to 10,000	\$20,000
Over 10,000	\$25,000

The examples in the correction procedure do not describe the specific situation of a failure to contribute on taxable fringe benefits, but there is a similar situation whose methodology may be used for excluding an employee who was eligible to participate as the appropriate correction. If the plan requires including taxable fringe benefits or bonuses, then the employer must contribute the missed contribution plus earnings from the date the contribution should have been made.

For a 401(k) plan, the employer must contribute 50% of the 401(k) deferral that would have been made to the plan (the “missing deferral”) and the entire matching contribution. The 401(k) contribution is treated as a QNEC.

Of course, if the contributions would exceed any statutory limits - based on pay over the \$245,000 section 401(a)(17) limit, the 415 limit, or the \$16,500 402(g) limit, they cannot be made.

For a profit sharing plan, the employer can either make the same contribution on the missing pay that was made on the other compensation under the plan or reallocate the contributions made to the plan to include the missing compensation.

There is a diminimus exception in the correction procedure that is not applicable here – the correction procedures says that if an eligible employee is excluded for a short period of time, there is no need to do a correction, as long as they can make contributions for at least 9 months during the year.

In our case, the employee has already made an election and there is no reason not to follow it.

Failure to self correct could result in significantly higher penalties. The sanction under Audit CAP is a negotiated percentage of the maximum payment amount which is equal to the taxes that would be payable if the plan were disqualified. The procedure provides that sanctions will not be excessive and will bear a reasonable relationship to the nature, extent, and severity of the failures, based on the following factors:

- (1) the steps taken by the plan sponsor to ensure that the plan had no failures;
- (2) the steps taken to identify failures that may have occurred;
- (3) the extent to which correction had progressed before the examination was initiated, including full correction;
- (4) the number and type of employees affected by the failure;
- (5) the number of nonhighly compensated employees who would be adversely affected if the plan were not treated as

qualified; (6) whether the failure is a failure to satisfy the requirements of [§401\(a\)\(4\)](#), [§401\(a\)\(26\)](#), or [§410\(b\)](#); (7) whether the failure is solely as a result of the employer not being able to maintain the type of plan maintained; (8) the period over which the failure(s) occurred (for example, the time that has elapsed since the end of the applicable remedial amendment period under [§401\(b\)](#) for a plan document failure); and (9) the reason for the failure(s) (for example, data errors such as errors in transcription of data, the transposition of numbers, or minor arithmetic errors). Factors relating only to qualified plans also include: (1) whether the plan is the subject of a Favorable Determination Letter; and (2) whether the failure(s) were discovered during the determination letter process.