

# **COMPENSATION ISSUES IN THE QUALIFIED PLAN**

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### **I. Basic Logic – How do we get there?**

- . "Thou Shalt Not Discriminate" – 401(a)(4)
  - 1. Which leads to:
- . Highly Compensated Employee Definition – 414(q)
  - 1. Compensation for the HCE definition is at 414(q)(7)
  - 2. Which leads to (with some minor modifications which we will cover later):
- . Defined Contribution Limitations – 415(c)
  - 1. Compensation is defined as "compensation of the participant from the employer for the year" – 415(c)(3)(A)
  - 2. Applies **REGARDLESS** of type of plan (DB or DC!)
  - 3. Basically meaningless without additional guidance (called "Regs.")
  - 4. Which leads to:
- . The definitions sections for qualified plans, which are found under Section 414, Definitions and Special Rules; specifically, 414(s).
  - 1. Compensation is defined by starting with 415(c)(3), our basic reference point, but still not too helpful – 414(s)(1)
  - 2. This means any definition that satisfies 415(c)(3) will also **automatically** satisfy 414(s) but not vice versa.
  - 3. Employer may elect to exclude (and therefore, also may elect to include) Sec. 125 reductions, as well as 401(k), SEP, and TSA reductions – 414(s)(2). This makes 414(s) compensation potentially **smaller** than 415(c)(3) compensation.
  - 4. Secretary can issue regulations for alternative methods of determination of compensation. He did, and they include safe harbor definitions.

## II. Basic 415(c)(3) Compensation Definition

Basic reference point for participation, coverage, and nondiscrimination is IRC Section 415(c)(3). IRS regulations provide a basic definition and two safe harbor definitions.

- . Basic Definition – The following forms of compensation are included under the 415(c)(3) basic definition of compensation:
  1. Wages, salaries, fees for professional services, and other amounts received for services rendered in the course of employment (whether or not paid in cash), to the extent that amounts are includible in taxable gross income, (including but not limited to commissions, compensation paid on the basis of a percentage of profits, tips, bonuses, fringe benefits, reimbursements, and expense allowances) whether earned from services inside or outside the United States.
  2. For a self-employed individual (including owner-employees), compensation means earned income, as described under Code Section 401(c)(2).
  3. Employer provided accident or health insurance benefits and medical reimbursement plan benefits, but only to the extent includible in the gross income of the employee.
  4. Amounts paid or reimbursed by the employer for moving expenses incurred by the employee to the extent that it is reasonable to believe that such amount are not deductible under Code Sec. 217.
  5. Value of a non-qualified stock option granted to the employee by the employer to the extent that the value of the option is includible in gross income of the employee for the taxable year in which granted.
  6. Amount includible in an employee's gross income upon transfer of property in connection with performance of services pursuant to the election described in Code Sec. 83(b).
  7. Employer contribution to certain deferred compensation plans to the extent the amounts are not includible in taxable income of the employee for the taxable year in which contributed, e.g., 401(k) plan deferrals or SAR-SEPs. Also, amounts contributed by the employer at the election of the employee which is not includible in the gross taxable income of the employee for a cafeteria plan (section 125) or a deferred compensation plan of state and local governments and tax-exempt organizations under section 457. *(This is a change enacted by SBJPA in 1996)*
  
- . Excluded forms of compensation – All other forms of compensation that are not characterized within the preceding list are **excluded** from the Code Sec. 415(c)(3) basic definition of compensation. The following forms of compensation are specifically excluded:

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1. Amounts realized from the exercise of a non-qualified stock option or when restricted stock or property becomes freely transferable or is no longer subject to a substantial risk of forfeiture.
2. Amounts realized from the disposition of stock acquired under a qualified stock option.
3. Certain amounts which receive special tax benefits, such as premiums for group-term life insurance (to the extent not includible in taxable gross income) or employer contributions to a TSA whether or not excludible from the income of the employee.

### Alternative Safe Harbor Definition

In lieu of the Code Sec. 415(c)(3) basic definition of compensation, a plan may define compensation for purposes of Code Sec. 415 using either of the following two employment tax definitions for all employees (other than self-employed individuals).

Though regulations have not been updated by IRS following the passage of SBJPA, it is presumed that these definitions may be modified to include elective deferrals from 401(k), 125, and 457 plans. However, plan document language must be closely examined to see whether the language itself excludes these amounts for purposes of testing 415 limits under the plan.

1. Income Tax Withholding Wages – Amounts defined in Code Sec. 3401(a) for purposes of federal income tax withholding at the source, determined without regard to limitations relating to the nature or location of employment.
2. Form W-2 Box 1 Wages – Amounts defined in Code Sec. 3401(a) for purposes of federal income tax withholding at the source, determined without regard to limitations relating to the nature or location of employment; **plus** all other payments for which the employer is required to furnish the employee a written statement under Code Sec. 6041(d) or Code Sec. 6051(a)(3).
  - a. This compensation definition may be modified to exclude amounts paid or reimbursed by the employer for moving expenses incurred by the employee to the extent that it is reasonable to believe that such amounts are deductible under Code Sec. 217.
  - b. As long as the instructions for Form W-2 concerning the amount to report in Box 1 remain the same as for the 1990 and 1991 tax years, the amount reported in Box 1 will satisfy this safe harbor.

### III. Highly Compensated Employee Compensation Definition – 414(q)

- . HCE compensation was modified by SBJPA so that it now matches the definition under 415(c)(3). Under the **prior law**, we started with a 415(c)(3) compensation definition and added back in the following amounts:
  1. Elective deferrals made under IRC Section 401(k).
  2. Salary reductions under a cafeteria plan qualified under Code Sec. 125.
  3. Salary reductions made under a SAR-SEP under Code Sec. 408(k)(6).
  4. Employee contributions made pursuant to a salary reduction agreement under IRC Section 403(b).
- . Compensation for Code Sec. 414(q) purposes is only relevant to determine whether an individual has exceeded the threshold compensation level (currently \$80,000, but to be adjusted for cost of living) used for determining whether the participant is indeed a highly compensated employee.

#### **IV. IRC Section 414(s) Compensation Definition – Basic and Safe Harbor Definitions**

IRC Section 414(s) is used in applying nondiscrimination testing requirements.

**Note:** The safe harbor definitions (under IV C, D, and E below) do not apply to self-employed individuals. (See VI below.)

- . A plan **need not** use a definition of compensation that satisfies Code Sec. 414(s). However, it would then:
  1. Not be able to rely on a nondiscrimination safe harbor.
  2. Make it potentially more difficult to satisfy the tests for coverage and nondiscrimination, particularly if the plan's compensation definition is itself discriminatory.
  3. Need to determine compensation for each employee on two different bases for purposes of the average benefit percentage test or the general nondiscrimination test:
    - a. one under the **plan's** definition for determining the actual allocations
    - b. the second which satisfies Code Sec. 414(s) for conducting the test.
- . Basic 414(s) Definition

Any definition of compensation will automatically satisfy Code Sec. 414(s) if it includes all compensation within the meaning of Sec. 415(c)(3) and excludes all other compensation.

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1. Basic 415(c)(3) definition – See II A & B
2. Safe Harbor 415(c)(3) definitions – See II C 1 & 2
- . Safe Harbor Alternative Definition – 1.414(s)-1(c)(3) (Also called Reduction Safe Harbor)
  1. Start with IV B (above) reduced by **ALL** of the following amounts (even if includible in taxable gross income):
    - a. Reimbursements or other expense allowances
    - b. Fringe benefits (cash and noncash)
    - c. Moving expenses
    - d. Deferred compensation
    - e. Welfare benefits
- . Supplemental Safe Harbor – 1.414(s)-1(c)(4)
  1. Start with IV B **or** C, **increased** by **ALL** of the following types of elective contributions and **ALL** of the following types of deferred compensation:
    - a. Elective contributions made by the employer to a cafeteria plan under Code Sec. 125, a qualified 401(k) plan under Code Sec. 402(a)(8), a simplified employee pension (SEP) plan under Code Sec. 402(h), or a tax sheltered annuity under Code Sec. 403(b).
    - b. Deferrals under a eligible Code Sec. 457 deferred compensation plan.
    - c. Governmental plan pick-up contributions described in Code Sec. 414(h)(2).
- . HCE Exclusions Safe Harbor – 1.414(s)-1(c)(5)
  1. Start with IV B or C above (with or without the modification permitted under II D above), modified to **exclude**:
    - a. Particular compensation items or amounts on a uniform basis from the compensation of any highly compensated employee.
      - (1) Any compensation items may be identified by the employer for exclusion under this safe harbor, even if the item was included by virtue of reference to the Supplement Safe Harbor.

- (2) The exclusions made under this safe harbor may not be applied to any non-highly compensated employee.

**V. Alternative Code Section 414(s) Definitions**

- . Any alternative definition of compensation designated by the employer will satisfy the compensation definition of Code Sec. 414(s) with respect to employees (other than self-employed individuals) if it satisfied all three of the following conditions:
  1. Reasonability
  2. Nondiscriminatory form
  3. Nondiscrimination test
- . Reasonability
  1. Subject to facts and circumstances
  2. May exclude certain forms of compensation, such as:
    - a. overtime pay
    - b. shift differential premiums
    - c. bonuses
    - d. any (but not necessarily all) of the forms of compensation excluded under the Reduction Safe Harbor (see IV C above)
  3. May include any (but not necessarily all) of the forms of compensation included under the Supplement Safe Harbor (see IV D above).
  4. An alternative compensation definition is not reasonable if it includes an item or amount that would not be includible under any of the safe harbor definition.
  5. It is acceptable to limit compensation to a specified dollar amount.
  6. It is not reasonable to limit compensation to a specified percentage of on otherwise permissible definition.
  7. An alternative definition that relies on rate of pay can be considered reasonable if it meets additional regulatory conditions under 1.414(s)-1(e)(2).
- . Nondiscriminatory Form
  1. An alternative compensation definition must not favor highly compensated employees by design.

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- a. Example – including bonuses but excluding overtime would most likely not qualify.
- . Nondiscrimination Test
  1. Satisfied if the average percentage of total compensation included in the alternative definition for HCEs does not exceed (by more than a de minimus amount) the average percentage of total compensation included for other employees.
  2. Total compensation (for this purpose) must be one of the Code Sec. 415(c)(3) based definitions (but not the safe harbor alternatives) – see II A & B.
  3. Total compensation is limited to the 401(a)(17) limit of \$160,000 (as indexed).
  4. Average percentage is generally to be determined by averaging individual compensation percentages for each employee.
    - a. Average for each group may be determined by any other reasonable method only if the results are not expected to vary significantly from the results that would be obtained by the basic method – see 1.414(s)-1(d)(3)(iv)(B).

### **VI. Compensation for Self-Employed Individuals – Code Sec 414(s)**

- . If employer uses a safe harbor alternative or "any reasonable" definition of compensation, then it must calculate equivalent alternative compensation amounts for self-employed individuals.
- . Multiply self-employed individual's earned income by percentage of total compensation included under the alternative definition for the non-highly compensated common-law employees.
- . If elective contributions are included in an alternative definition, earned income of self-employed individual also must include elective contributions made on their behalf.

### **VII. Imputed Compensation**

- . Final regs added two types of imputed compensation provisions to be used in the "any reasonable definition" category of compensation definitions.
- . This will require that the nondiscrimination requirements under Section V above must be met.
- . Rate of Pay Compensation
  1. Plan must use rate of pay under the benefit formula.

2. Generally, only applies for period during which the employee actually is receiving compensation.

. Absence From Service

1. Defined benefit plan only.
2. If for other than military or jury duty, no more than six months of imputed compensation may be included.
3. Plan must actually use the same definition in its benefit formula.
4. Must apply uniformly to all similarly situated employees.
5. Must satisfy the effective availability requirement for benefits, rights, and features under Code Sec. 401(a)(4) regs.
6. Amount imputed must be reasonably representative of what the employee would have received if not on leave.

**VIII. Compensation Limitation under Code Sec. 401(a)(17)**

- . For any plan participant for any plan year, a qualified plan may not take into account annual compensation greater than \$160,000 (as indexed).
- . The 401(a)(17) limit applies for three purposes:
  1. A plan may not base the allocation of contributions or accruals on the basis of compensation in excess of the limit.
  2. The amount of compensation taken into account in applying nondiscrimination rules cannot exceed the limit.
  3. An employer may not determine the maximum deductible amount to a 401(k) plan by taking into account compensation in excess of the limit.

PERTINENT INTERNAL REVENUE CODE SECTIONS

401. Qualified Pension, Profit-Sharing, and Stock Bonus Plans

(a) Requirements for Qualification -- A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section --

(1) if contributions are made to the trust by such employer, or employees, or both, or by another employer who is entitled to deduct his contributions under section 404(a)(3)(B) (relating to deduction for contributions to profit-sharing and stock bonus plans), for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan;

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries (but this paragraph shall not be construed, in the case of a multiemployer plan, to prohibit the return of a contribution within 6 months after the plan administrator determines that the contribution was made by a mistake of fact or law (other than a mistake relating to whether the plan is described in section 401(a) or the trust which is part of such plan is exempt from taxation under section 501(a), or the return of any withdrawal liability payment determined to be an overpayment within 6 months of such determination);

(3) if the plan of which such trust is a part satisfies the requirements of section 410 (relating to minimum participation standards); and

(4) if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees (within the meaning of section 414(q)). For purposes of this paragraph, there shall be excluded from consideration employees described in section 410(b)(3)(A) and (C).

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414. Definitions and Special Rules

(q) Highly compensated employee

(4) Compensation -- For purposes of this subsection, the term "compensation" has the meaning given such term by section 415(c)(3)

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415. Limitations on benefits and contribution under qualified plans

(c) Limitation for Defined Contribution Plans

(3) Participant's compensation -- For purposes of paragraph (1) --

(A) In general -- The term "participant's compensation" means the compensation of the participant from the employer for the year.

(B) Special rule for self-employed individuals -- In the case of an employee within the meaning of section 401(c)(1), subparagraph (A) shall be applied by substituting "the participant's earned income (within the meaning of section 401(c)(2) but determined without regard to any exclusion under section 911)" for "compensation of the participant from the employer".

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(C) Special rules for permanent and total disability -- In the case of a participant in any defined contribution plan--

- (i) who is permanently and totally disabled (as defined in section 22(e)(3)),
- (ii) who is not a highly compensated employee (within the meaning of section 414(q)), and
- (iii) with respect to whom the employer elects, at such time and in such manner as the Secretary may prescribe, to have this subparagraph apply,

the term "participant's compensation" means the compensation the participant would have received for the year if the participant was paid at the rate of compensation paid immediately before becoming permanently and totally disabled. This subparagraph shall apply only if contributions made with respect to amounts treated as compensation under this subparagraph are nonforfeitable when made. If a defined contribution plan provides for the continuation of contributions on behalf of all participants described in clause (i) for a fixed or determinable period, this subparagraph shall be applied without regard to clauses (ii) and (iii).

(D) Certain deferrals included – The term “participant’s compensation shall include –

- (i) any elective deferral (as defined in section 402(g)(3)), and
- (ii) any amount which is contributed or deferred by the employer at the election of the employee and which is not includible in the gross income of the employee by reason of section 125 or 457.

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## 414. Definitions and special rules

**(s) Compensation** - For purposes of any applicable provision -

(1) **In general** -- Except as provided in this subsection, the term "compensation" has the meaning given such term by section 415(c)(3).

(2) **Employer may elect to treat certain deferrals as compensation** -- An employer may elect to include as compensation any amount which is contributed by the employer pursuant to a salary reduction agreement and which is not includible in the gross income of an employee under section 125, 402(e)(3), 402(h), or 403(b).

(3) **Alternative determination of compensation** -- The Secretary shall by regulation provide for alternative methods of determining compensation which may be used by an employer, except that such regulations shall provide that an employer may not use an alternative method if the use of such method discriminates in favor of highly compensated employees (within the meaning of subsection (q)).

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## 401. Qualified Pension, Profit-Sharing, and Stock Bonus Plans

**(a) Requirements for qualification**

**(17) Compensation limit.** --

(A) In general. -- A trust shall not constitute a qualified trust under this section unless, under the plan of which such trust is a part, the annual compensation of each employee taken into account under the plan for any year does not exceed \$150,000. In determining the compensation of an employee, the rules of section 414(q)(6) shall apply, except that in applying such rules, the term "family" shall include only the spouse of the employee and any lineal descendants of the employee who have not attained age 19 before the close of the year.

(B) COST-OF-LIVING ADJUSTMENT. -- The Secretary shall adjust annually the \$150,000 amount in subparagraph (A) for increases in the cost-of-living at the same time and in the same manner as adjustments under section 415(d); except that the base period shall be the calendar quarter beginning October 1, 1993, and any increase which is not a multiple of \$10,000 shall be rounded to the next lowest multiple of \$10,000.