This article first reviews the statutory definitions of compensation and then looks at some common situations where definitional mishaps can occur as well as some types of compensation that can present traps for the unwary. While issues involving a plan's definition of compensation can arise in the context of both defined benefit and defined contribution plans, many of the more thorny issues tend to arise in the context of defined contribution plans. Accordingly, this article primarily focuses on the potential issues as they relate to defined contribution plans.

Many aspects of tax-qualified plan design and administration can be complicated and confusing and few more so than the plan's definition of "compensation." Each tax-qualified retirement plan is required to have a definition of compensation. On its face, it would seem to be a relatively straightforward concept. However, when viewed through the lens of tax-qualified plan compliance, it becomes an ostensible quagmire of potential errors that can jeopardize the tax-qualified status of the plan and result in potentially staggering remedial costs for plan sponsors.
Part of the complexity stems from the fact that the definition of compensation is used for a variety of purposes under a plan. For example, a definition of compensation is used to determine the following:

1. the maximum permitted contribution for each participant;
2. participant elective contributions;
3. employer contributions, allocations, and benefit accruals;
4. whether the plan satisfies certain nondiscrimination requirements;
5. highly compensated employees (HCEs) for plan testing purposes; and
6. the amount of any top-heavy contributions that may be required.

In addition, there are multiple definitions that can be used, and different definitions can be used for different purposes. Thus, plan sponsors have some flexibility to select definitions that may improve plan economics or ease plan administration. However, it is that very flexibility that gives rise to many of the potential issues surrounding the concept of compensation.

Scrutiny of a plan's definition of compensation and its use in plan administration continues to be a focal point of any IRS plan audit. Obtaining a favorable IRS determination letter for a plan may provide assurances that the plan document is using permissible definitions of compensation. However, if a plan is not being administered in accordance with its definition of compensation, that will be considered a failure to follow the plan document, which, in itself, may be the basis for the IRS to disqualify the plan. In addition, failure to follow the terms of the plan document can give rise to a breach of fiduciary duty under the Employee Retirement Income Security Act of 1974 (ERISA). Furthermore, if the plan is not being administered in accordance with its definition of compensation, there is a good chance that the required plan testing has been done incorrectly, thereby possibly raising further potential disqualification issues.

While actual IRS disqualification of the plan is unlikely, correcting the problem may involve additional employer contributions or refunds and forfeitures of prior contributions, depending on the nature of the failure. The IRS has taken the position that even though the statute of limitations has expired with respect to a given tax year, a disqualifying defect continues in subsequent years. Thus, the plan remains disqualified until the defect is corrected retroactively, starting with the year in which the operational defect first occurred.¹
Understanding the Definition of Compensation

IRC SECTION 415(C)(3) COMPENSATION

The starting point for understanding compensation for qualified plan purposes is Internal Revenue Code (IRC) Section 415(c)(3). Regulations under IRC Section 415(c)(3) provide a general definition of compensation along with three alternative safe harbor definitions that can be used for plan purposes.

In certain contexts, a plan is required to use a definition of compensation that satisfies the requirements of IRC Section 415(c)(3). For example, a plan must use an IRC Section 415(c)(3) definition for purposes of determining HCEs\(^2\) for purposes of determining maximum permissible contributions under IRC Section 415, and for determining required top-heavy contributions under IRC Section 416.

As noted, the regulations under IRC Section 415(c)(3) effectively provide four different definitions of compensation that can be used where a definition of compensation that complies with IRC Section 415(c)(3) is required:

1. **The General 415 Definition.** This definition generally includes the participant's wages, salaries, and other amounts received for his or her services rendered in the course of employment (e.g., bonuses and commissions) to the extent that the amounts are includible in the participant's gross income.\(^3\) It also includes some less intuitive items such as taxable medical or disability benefits, taxable moving expense reimbursements, fringe benefits, other taxable reimbursements, amounts included as a result of an IRC Section 83(b) election (e.g., an election to treat restricted stock as taxable on the date of grant rather than vesting), and amounts included as a result of a violation of IRC Section 409A ("additional compensation").\(^4\) This definition also specifically excludes certain types of remuneration, such as contributions to deferred compensation plans, income received as a result of vesting of restricted stock or the exercise of nonstatutory stock options, income triggered by a disqualifying disposition of an incentive stock option, and amounts that receive special tax benefits (e.g., employer provided life insurance under $50,000).\(^5\)

2. **The Simplified 415 Definition.** This definition is effectively the same as the General 415 Definition except that it excludes income from additional compensation.\(^6\)

3. **The 3401(a) Definition.** This definition includes compensation items treated as wages subject to federal income tax withholding at the source under IRC Section 3401(a).\(^7\)

4. **The W-2 Definition.** This definition includes all the compensation items included under the 3401(a) Definition and any other additional compensation required to be reported under IRC Sections 6041, 6051, or 6052.\(^8\)
Note that under all of the definitions, pre-tax elective deferrals under IRC Section 401(k) plans, IRC Section 403(b) plans, IRC Section 457 plans, IRC Section 125 cafeteria plans, and IRC Section 132(f)(4) qualified transportation fringe plans are added back to the definition.

**IRC SECTION 414(S) COMPENSATION**

In addition to the IRC Section 415(c)(3) Definitions of compensation, there is also a definition of compensation found in IRC Section 414(s). This is sometimes referred to as the "nondiscrimination" definition of compensation, since its primary function is to provide permissible definitions of compensation that can be used for various nondiscrimination tests applicable to tax-qualified plans. For example, a 414(s) Definition must be used for nondiscrimination testing of employer contributions and benefits under the general nondiscrimination testing rules under IRC Section 401(a)(4), testing of pre-tax elective deferrals under IRC Section 401(k), testing of matching and after-tax contributions under IRC Section 401(m), and calculation of permitted disparity formulas under IRC Section 401(l). In addition, tax-qualified plans relying on a design-based safe harbor profit share or defined benefit formula to avoid annual IRC Section 401(a)(4) testing must use a 414(s) Definition of compensation for formula purposes. Also, plans relying on safe harbor matching or nonelective contributions to pass the required actual deferral percentage (ADP) and actual contribution percentage (ACP) testing under IRC Sections 401(k) and (m) are required to use a 414(s) Definition.

Each of the four 415(c)(3) Definitions will automatically constitute a safe harbor 414(s) Definition of compensation. However, a 414(s) Definition of compensation can include certain modifications that are not otherwise permissible where a 415(c)(3) Definition is required. For example, a plan could use the General 415 Definition reduced by reimbursements or other expenses, fringe benefits (cash and noncash), moving expenses, deferred compensation and welfare benefits, and/or decreased by pre-tax elective deferrals under IRC Section 401(k) plans, IRC Section 403(b) plans, IRC Section 457 plans, IRC Section 125 cafeteria plans, and IRC Section 132(f)(4) qualified transportation fringe plans. Also, a 414(s) Definition of compensation can exclude compensation items paid to HCEs (e.g., any bonus paid to HCEs) that would not otherwise be excluded under a 415(c) (3) Definition of compensation.

As an alternative to the 415(c)(3) Definitions or the modified safe harbor 414(s) Definitions, a plan sponsor is free to develop its own definition of compensation to be used for IRC Section 414(s) purposes, provided the definition does not discriminate in favor of HCEs. Treasury Regulations under IRC Section 414(s) require that any such definition be reasonable and that it pass certain nondiscrimination tests.
UNDERSTANDING THE PLAN’S DEFINITION OF COMPENSATION

Many plan sponsors operate under the assumption that their outside recordkeepers are monitoring the compensation information sent to the recordkeeper to ensure compliance with the plan and applicable testing requirements. However, more often than not, the recordkeeper merely relies on the payroll information submitted by the plan sponsor. Thus, if the payroll information submitted to the recordkeeper is based on a definition of compensation not fully understood by the plan sponsor, the plan’s benefit allocations and/or testing may be incorrect.

Most mistakes involving a plan’s definition of compensation are the result of the plan sponsor not being aware of the plan’s definition of compensation or not being aware of what is included and excluded under the plan’s definition of compensation.

For example, assume that a plan document provides for the use of the General 415 Definition for all purposes under the plan and the plan had a number of participants who exercised nonstatutory stock options during the plan year. Notwithstanding the definition of compensation used by the plan, the plan sponsor used Form W-2 compensation for purposes of determining elective deferrals and employer contributions and sent Form W-2 compensation to the plan recordkeeper for testing purposes. That error would result in potential disqualification issues for the plan as well as a possible breach of fiduciary duty under ERISA.

First, assuming some of the affected participants did not already have other compensation in excess of the IRC Section 401(a)(17) limit for the plan year, elective deferrals and employer contributions would have been overstated, since income from the exercise of nonstatutory stock options is not included under the General 415 Definition but would be included in the W-2 compensation actually used by the plan sponsor. That error could be voluntarily corrected under the IRS Employee Plans Compliance Resolution System (EPCRS), which would require a refund of elective deferrals (and associated earnings) to affected participants and forfeiture of employer contributions (and associated earnings) that were based on the overstated compensation.19 As noted, the IRS generally requires complete retroactive correction in order to avoid a disqualification issue. Thus, if the above problem had occurred in multiple years, affected participants could be looking at a fair amount of additional taxable income in the year of distribution as a result of the refunds of elective deferrals and earnings.

Second, the plan would have used an incorrect definition of compensation for plan testing purposes. Thus, depending on the facts, some of the test results could be affected.
Even where plan sponsors understand their definition of compensation, they may not always be familiar with all the contexts in which it applies. For example, Employer A maintains a 401(k) plan that permits pre-tax elective deferrals and provides a match of 100 percent up to 3 percent of compensation and a profit sharing contribution equal to 2 percent of compensation. The plan uses the W-2 Definition for all purposes under the plan. Employer A submits the appropriate W-2 Definition information to the plan recordkeeper for testing purposes. However, for whatever reason, Employer A believes that bonuses are excluded for purposes of determining elective deferrals and calculating matching and profit sharing contributions. Accordingly, elective deferrals and employer contributions are all understated. This will require remedial contributions to the plan to avoid a potential disqualification issue.20

Assume a participant in Employer A's plan with an annual salary of $100,000 had elected to defer 10 percent of compensation and had a bonus of $10,000. Accordingly, the participant's elective deferrals were understated by $1,000, since the $10,000 bonus was not included in calculating the appropriate deferral amount. In addition, the participant's matching contributions and profit sharing contributions would have been understated by $300 and $200 respectively. Accordingly, under EPCRS, Employer A would be required to make a contribution of $1,000 \((\$1,000 \times 50\%)^{21} + \$300 + \$200\) plus lost earnings for the above participant from the time the contributions otherwise should have been made to the plan.22 Depending on the number of plan participants, the deferral elections made by participants, and the amount of their bonuses, the required remedial contributions for the plan year could add up quickly. Furthermore, if the improper exclusion had persisted for a number of years, the required retroactive contribution needed to fix the plan could be very substantial, particularly if the plan had experienced a positive return on investments during that period.23 In addition, Employer A would likely incur additional administrative fees and experience lost man-hours in determining the required contributions and earnings.

If Employer A wanted to properly exclude bonuses solely for purposes of calculating elective deferrals and employer contributions, it could certainly amend the plan to do so. However, that approach is not without its issues. As mentioned previously, plans relying on a design-based safe harbor formula (e.g., allocations based on a uniform percentage of compensation) to avoid annual testing under IRC Section 401(a)(4) are required to use a 414(s) Definition of compensation. None of the safe harbor 414(s) Definitions would permit the exclusion of bonuses.24 Thus, exclusion of the bonuses for purposes of calculating a profit sharing contribution would require the plan to test the modified definition of compensation to determine whether the compensation excluding bonus could be considered a nondiscriminatory definition of compensation under IRC Section 414(s).
If Employer A had structured its plan to be an ADP/ACP safe harbor plan, excluding bonuses would require the plan to either test the modified definition of compensation to determine whether the compensation excluding bonus could be considered a nondiscriminatory definition of compensation under IRC Section 414(s) or perform the ADP and ACP tests the plan was originally designed to avoid. Adding an additional layer of plan testing would likely increase the annual administrative cost of the plan. Further, depending on the participants receiving bonuses (HCEs versus non-HCEs) and the amounts of the bonuses, those testing results could vary from year to year, leading to uncertainty regarding the possibility of future remedial contributions or forfeitures.

The above examples illustrate simple mistakes in understanding a plan's single compensation definition. As noted, plans can use different definitions of compensation for different purposes, and there may be good reasons for doing so. However, plan sponsors must recognize that with that additional flexibility comes a need for greater administrative vigilance.

TIMING ISSUES

In general, compensation paid after a severance from employment will not be considered compensation under the 415(c)(3) Definitions. However, certain compensation paid after severance from employment is includable under the 415(c)(3) Definitions. In order to be included, the relevant compensation must be paid by the later of (1) two-and-one-half months after the participant's severance from employment, or (2) the end of the IRC Section 415 limitation year that includes the participant's severance from employment date (the post-severance period).

Certain types of compensation paid during the post-severance period must be included under the 415(c)(3) Definitions. Specifically, the 415(c)(3) Definitions include (1) the participant's regular compensation for services rendered during the participant's regular working hours, and (2) the participant's compensation for services rendered outside the participant's regular working hours (such as overtime or shift differential), commissions, bonuses, or other similar payments that would have been paid to the employee before a severance from employment had the employee continued in employment with the employer.

Certain types of compensation paid during the post-severance period may be included if the plan sponsor so chooses. For example, a plan may provide that unused accrued bona fide sick, vacation, or other leave is included under a 415(c)(3) Definition if:

1. The participant would have been able to use the leave if employment had continued; and

2. The amounts would have been included in the plan's definition of compensation if they were paid prior to the participant's severance from employment.
Similarly, a plan may provide that amounts paid to a participant under a nonqualified deferred compensation (NQDC) plan may be included in a 415(c)(3) Definition if:

1. The payment would have been paid to the participant at the same time if he or she had continued in employment;
2. The payment is includible in the participant's gross income; and
3. The amounts would have been included in the definition of compensation if they were paid prior to the participant's severance from employment.29

These mandatory and optional adjustments to the otherwise applicable timing rules can present issues for plan sponsors depending on how their payroll systems are configured. For example, some plan sponsors may have payroll systems that automatically shut down all deductions for deferrals as of a participant's termination date. Thus, elective deferrals are not taken from payments of accrued wages or bonuses that are paid after termination of employment. Unless those types of post-employment payments have been specifically carved out of the definition of compensation for purposes of elective deferrals, the plan will have an operational error. While the remedial contributions needed to fix the error in this context may be relatively small even on a cumulative basis, the error is still an issue that the IRS can bring up on audit and, if combined with other operational failures, may contribute to a perceived pattern of noncompliance that could bring stiffer sanctions.

As noted, the plan sponsor could amend its plan to carve out payments of accrued wages or bonuses that are paid after termination of employment for purposes of elective deferrals and, if desired, for purposes of employer contributions. However, the plan sponsor would need to take care not to go too far. If the plan was relying on a design-based safe harbor to pass IRC Section 401(a)(4) for a profit sharing contribution, the carve out would require the plan to run the 414(s) definitional nondiscrimination test or IRC Section 401(a)(4) general nondiscrimination test mentioned previously.

As another example, assume a plan sponsor has not carved out payments of accrued wages or bonuses that are paid after termination of employment from its definition and is properly deducting deferrals from such post-termination payments and the plan sponsor happens to include unused vacation pay on the participant's final check paid after termination. If the plan has not been amended to include post-employment payments of unused vacation, there would be an operational error.
INTERNATIONAL COMPENSATION

For employers with a globally mobile workforce, the safe harbor definitions of compensation may produce some unexpected consequences with respect to foreign source income. Many employers do not realize that compensation paid to an expat employee in a foreign country will typically be picked up for tax-qualified plan purposes.

As an example, assume US Co sends one of its employees (a US citizen) to work at its wholly-owned subsidiary, Japan Co for two years. During that period, the employee remains a US Co employee (and is thus technically eligible to participate in the US Co 401(k) plan) and receives $100,000 of his salary through the US Co payroll (in part, to facilitate continued participation in the US Co 401(k) plan) with Japan Co paying another $100,000 locally. The US Co 401(k) plan uses the General 415 Definition for all purposes under the plan and provides for a matching contribution of 100 percent on amounts deferred up to 3 percent of the participant’s total compensation. The employee elects to contribute 5 percent of his pay to the US Co 401(k) plan. US Co assumes that since it is only paying the employee $100,000, then that is the correct amount to use for purpose of the US Co 401(k). Accordingly, US Co contributes $5,000 to the US Co 401(k) plan as employee elective deferrals and contributes a matching contribution of $3,000.

Unfortunately, US Co would have understated both the employee deferral and the employer match. Both the General 415 Definition and the Simplified 415 Definition provide that compensation does not fail to be included merely because the compensation is not included in the employee’s gross income on account of the location of the services. Thus, even if all of the salary paid by Japan Co were excludable for US income tax purposes, that salary would still be included under the General 415 Definition and the Simplified 415 Definition. Accordingly, in the above example, US Co would be required to make a remedial contribution on behalf of affected participants as described previously.

In a similar fashion, plans using the 3401(a) Definition could have unexpected results when compensation paid outside the United States is involved. For example, assume that instead of the General 415 Definition, the US Co 401(k) plan described above used the 3401(a) Definition for all purposes under the plan. Assume further that the employee described above qualifies for the foreign income exclusion provided under Code Section 911 and files a Form 673 so that no US withholding is required. Intuitively, one might expect that there is no compensation for purposes of the US Co 401(k) plan. However, similar to the General 415 Definition, the 3401(a) Definition includes a provision that provides that any rules that limit the remuneration included in wages based on the nature or location of the employment or the services performed are disregarded for purposes of determining what is considered.
compensation under the 3401(a) Definition. Once again, the remedial contributions required to address these types of errors may not amount to much depending on the size of the plan sponsor’s relevant expat population. However, it remains an issue that can be raised by the IRS on audit.

NONQUALIFIED DEFERRED COMPENSATION

Another common issue that comes up in connection with the definition of compensation is the treatment of nonqualified deferred compensation. Many plan sponsors inadvertently include compensation deferred by participants under an NQDC plan when determining compensation for purposes of their tax-qualified plans.

None of the 415(c)(3) Definitions include amounts deferred under an NQDC plan. So for example, if an employee earning $250,000 per year elects to defer $50,000 of that amount under an NQDC plan, that $50,000 deferral is not included for qualified plan purposes. Thus, for purposes of the tax-qualified plan, the employee only has $200,000 of compensation. Accordingly, if employee elective deferrals and employer contributions are based on the unreduced $250,000, those deferrals and contributions will be overstated.

As noted, employers are generally free to base employer contributions on any definition of compensation they choose. Thus, an employer could write the plan benefit formula to include NQDC plan deferrals for purposes of determining any employer matching or profit sharing contributions. Unfortunately, the rules regarding the compensation that can be used for determining employee pre-tax elective deferrals are less flexible. Regulations under IRC Section 401(k) require that pre-tax elective deferrals be based on a compensation that would qualify as compensation under IRC Section 415(c)(3). Thus, the plan would not be able to include deferrals under the NQDC plan for purposes of determining elective deferrals.

Assuming an employer chose to amend its plan to include NQDC plan deferrals for purposes of determining employer matching contributions and profit sharing contributions, the employer would need to have a payroll interface with its recordkeepers that is going to (1) exclude NQDC plan deferrals for purposes of calculating participant elective deferrals and for all relevant plan testing purposes, and (2) include NQDC plan deferrals for purposes of calculating employer matching and profit sharing contributions. Further, as discussed previously, if the plan is using a design-based safe harbor for purposes of the profit sharing contribution, the plan is going to be forced into annual testing of the modified definition of compensation or general nondiscrimination testing under IRC Section 401(a)(4).
Once again, following the remedial principles set forth in EPCRS, fixing this problem is going to involve refunding participant elective deferrals (along with associated earnings) and forfeiting any employer contributions (along with associated earnings) that resulted from the use of the overstated compensation.

There are also potential issues associated with payouts from NQDC plans. Whether amounts paid out under an NQDC plan are included as compensation under the tax-qualified plan in the year of payment will depend on the definition of compensation used by the plan. Under the W-2 Definition and 3401(a) Definition, payments from an NQDC plan would be included, since those payments would typically be subject to both wage withholding and W-2 reporting in the year of payment. Under the General 415 Definition and the Simplified 415 Definition, payments of nonqualified deferred compensation are not included in the definition of compensation for the year of payment unless the plan specifically provides for inclusion of those payments.36

CONCLUSION

As the above suggests, understanding of the elements of the plan's definition of compensation is key to avoiding potentially costly plan errors. Similarly, those in charge of administering a plan must have a complete understanding of the types of compensation being paid to participants and how that compensation fits into (or out of) the plan's definition.

Certainly, there are specific situations that can give rise to potential mismatches between administration and the actual plan document — for example, if an employer adds or eliminates different types of compensation, or if the plan is restated in connection with moving from one recordkeeper to another. However, even without those types of changes, plan sponsors will need to remain vigilant with respect to the administration of a plan's definition of compensation. For better or worse, plan sponsors should periodically reconcile payroll data to the plan document to ensure that each item of compensation is being properly included or excluded. Where a plan is using multiple definitions of compensation, the plan sponsor should review those definitions and their use to see if they truly warrant the additional administrative oversight necessary to ensure compliance. Even where a plan is using a single definition of compensation for all plan purposes, the plan sponsor should consider whether that definition is best based on the plan sponsor's overall compensation structure.

NOTES

2 Code Section 414(q)(4).
3 Treas. Reg. § 1.415(c)-2(b)(1).
4 Treas. Reg. § 1.415(c)-2(b)(3)-(7).
Under EPCRS, the required remedial contribution for missed elective deferral opportunities in this context is 50 percent of the amount actually elected by the participant. Remedial contributions are generally subject to all other applicable plan limits (e.g., the limits on elective deferrals under Code Section 402(g) and the limit on annual additions under Code Section 415).

Under EPCRS, lost earnings are generally based on the actual returns participants would have experienced had the contributions been made at the appropriate time. However, in certain circumstances, certain rules of administrative convenience may be employed in calculating lost earnings.

As noted, if the bonus exclusion were limited to HCEs, the definition of compensation could still qualify as a safe harbor 414(s) Definition.

Because the employee is a US citizen, the Code Section 410(b)(3)(C) exclusion from participation for nonresident aliens with no US source income normally found in most plans will not apply.

Note that there could be foreign currency exchange issues associated with using the non-US compensation for plan purposes.

Note, the analysis would differ if US Co and Japan Co were not in the same controlled group of companies as determined under Code Section 414.