Compensation Case Studies - The Ins and Outs

S. Derrin Watson and David Schultz

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- Maureen Pesek

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Your Presenters Today

S. Derrin Watson, J.D., APM

David Schultz, J.D.

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Case Study #1: Post-Severance Compensation

- Compensation Definition:
  - W-2 Wages (gross)
  - Plan takes into account Post Severance Compensation
- Facts:
  - Zach is a plan participant
  - Makes $10,000 per month
  - Employer offers Zach a $20,000 “bonus”, paid on December 15, 2019 if he agrees to *sever* employment effective December 31, 2019; Zach agrees
- What is Zach’s 2019 plan compensation?

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Post-Severance Compensation

- **Compensation counts if two conditions are both met:**
  1. **It is paid no later than the later of:**
     - 2½ months after severance of employment, or
     - The last day of the limitation year of severance
  2. **Permitted purpose**
     - Wages for services
     - To the extent otherwise counted as comp and plan provides:
       - Leave cash-out
       - Unfunded deferred compensation payments

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Wages for services

- **It is a payment that would have been made while the employee continued in employment as:**
  - Regular compensation for services during the employee's regular working hours
  - Compensation for services outside the employee's regular working hours (such as overtime or shift differential)
  - Commissions
  - Bonuses
  - Other similar compensation

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Can’t count post-severance

- Some payments are never plan compensation if paid after severance (even if within 2½ months)
  - Severance pay
  - Unfunded nonqualified deferred compensation (409A, 457(f)) except as above
  - Parachute payments

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Polling question 1

- Facts:
  - Zach is a plan participant
  - Makes $10,000 per month
  - Employer offers Zach a $20,000 “bonus”, paid on December 15, 2019 if he agrees to *sever* employment effective December 31, 2019; Zach agrees
- Do we count the bonus?
  - A. Yes; Compensation = $140,000
  - B. No; Compensation = $120,000
  - C. I don’t know

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What about Zach?

- Facts:
  - Zach is a plan participant
  - Makes $10,000 per month
  - Employer offers Zach a $20,000 “bonus”, paid on December 15, 2019 if he agrees to *sever* employment effective December 31, 2019; Zach agrees
- It isn’t post-severance comp
- It is W-2 comp; count the bonus
- Plan comp is $140,000

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Case Study #2: 414(s) Compensation

- Safe-harbor 401(k) plan with 3% nonelective contribution
  - Compensation definition = W-2 Wages, net of bonuses
- HCEs and NHCEs alike have received bonuses annually
- Plan performs and passes the Comp Ratio Test annually…until 2019
- In 2018, employer stops bonuses to NHCEs
  - No one told the TPA/PA until 2020.
- Plan fails comp ratio test (not even close)
- How do you correct?

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- Exclusions must "knock out" as much for the HCEs as they do for the NHCEs.
- Compare the percentage of total compensation included for the NHCEs with the percentage included for the HCEs. The HCE percentage cannot exceed the NHCE percentage by more than a "de minimis" amount.

COMPENSATION RATIO TEST

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NHCE ratio =88.10%; HCE ratio =89.74%

	Status	Total Comp	Bonus	Plan Comp	Ratio
Kirk	HCE	$190,000	$20,000	$170,000	89.47%
Spock	HCE	$150,000	$15,000	$135,000	90.00%
McCoy	NHCE	$ 85,000	$10,000	$ 75,000	88.24%
Scotty	NHCE	$ 75,000	$10,000	$ 65,000	86.67%
Uhura	NHCE	$ 50,000	$ 5,000	$ 45,000	90.00%
Sulu	NHCE	$ 40,000	$ 5,000	$ 35,000	87.50%

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414(s) safe harbor issues

- Can't violate anti-cutback rule
  - Fortunately not an issue here
- Go with nondiscriminatory definition
  - Like total compensation for all participants
  - Increases safe harbor contribution
- Will require retroactive amendment
  - Notice 2016-16: Provide updated safe harbor notice
    - Hey! Hey! We're giving you more money!

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Case Study 2A: De Minimis?

- Safe-harbor 401(k) plan with 3% nonelective contribution
  - Compensation definition = W-2 Wages, net of overtime
- Plan performs and passes the Comp Ratio Test annually…until 2019
  - Traditionally, the comp ratio differential has been 2.5%
- In 2018, an unanticipated business spike causes additional NHCE overtime – comp ratio increases to 3.25%
- What should the plan do?

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What is De Minimis?

- "An isolated instance of a more than de minimis difference between the compensation percentages that is due to an extraordinary unforeseeable event (such as overtime payments to employees of a public utility due to a major hurricane) will be disregarded if the amount of the difference in prior determination periods was de minimis"
  - *Treas. Reg. §414(s)-1(d)(3)(v)*

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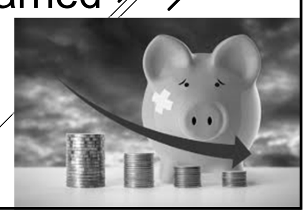
Case Study #3: Self-Employed Individuals

- Anne, 51, is the self-employed owner (sole prop) of a business with 4 employees
- Anne completes a deferral election form for 2020 on 1/1/20
  - Defers 10% of compensation
  - Deferrals are taken from monthly draws of $20,000
- In early 2021, Anne's CPA calculates her 2020 Earned Income to be only $25,000
- What amount can Anne defer for 2020?



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Deferral issues

- Deadline to file deferral election was 12/31/20
  - Anne chose to defer 10% of comp
  - Comp is earned income; not draws
- Deferrals = 10% X $25,000 = $2,500
- Catch-up doesn't help us in this case
- (Much different result if she had chosen to defer $2,000/month)

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Case Study #3A: Self-Employed Individuals

- Anne, 51, is the self-employed owner (sole prop) of a business with 4 employees
- Anne expects the business to operate at a loss in 2020 and she does not complete a deferral election form during 2020
- In early 2021, Anne's CPA calculates her 2020 Earned Income to be $250,000 and recommends that Anne max out her 401(k)
- What amount can Anne defer for 2020?

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Too late is too late

- Can't file an election after the year is over
- Suppose she had deferred $2,000/month
  - Earned income $15,000
  - Deferral = $15,000
  - Total deferrals, including catch-ups, can't exceed compensation

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Case Study #4

- Adam is a salaried employee making $10,000/month, paid monthly.
- Adam has elected to defer 10% of comp to his employer's 401(k) plan
- Adam died September 27, 2019
- The employer pays Adam's final paycheck to his widow, Eve
  - $9,000 salary
  - $3,000 leave cash-out
- What is Adam's compensation attributable to that paycheck for retirement plan purposes? (W-2 comp)
  - How much should the plan withhold in deferrals?

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Polling question 2

- The employer pays Adam's final paycheck to his widow, Eve
  - $9,000 salary
  - $3,000 leave cash-out
- What is Adam's plan comp from the final paycheck?
  - A. $0
  - B. $9,000
  - C. $12,000
  - D. Depends on whether plan counts leave cash-out
  - E. I don't know

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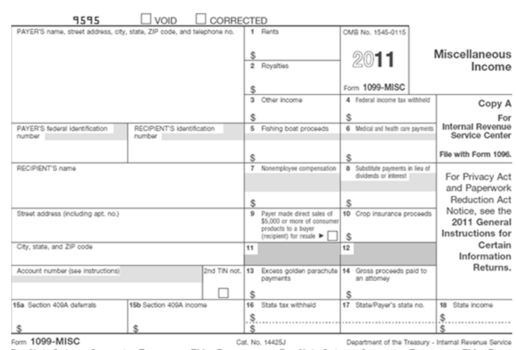
W-2 for deceased employee

- FICA/Medicare (W-2 boxes 3 – 6)
  - Wages paid in year of death reported on final W-2
  - Wages paid after year of death not on final W-2
- Income tax (W-2 boxes 1 – 2)
  - Wages paid after death not reported on W-2
  - Report instead on 1099-MISC, Box 3


9595 VOID CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.

1 Rents $

2 Royalties $

OMB No. 1545-0115

2011

Form 1099-MISC

Miscellaneous Income

3 Other income $

4 Federal income tax withheld $

Copy A For Internal Revenue Service Center

File with Form 1096.

PAYER'S federal identification number

RECIPIENT'S identification number

5 Fishing boat proceeds $

6 Medical and health care payments $

RECIPIENT'S name

7 Nonemployee compensation $

8 Substitute payments in lieu of dividends or interest $

For Privacy Act and Paperwork Reduction Act Notice, see the 2011 General Instructions for Certain Information Returns.

Street address (including apt. no.)

9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ►

10 Crop insurance proceeds $

City, state, and ZIP code

11

12

Account number (see instructions)

2nd TIN not.

13 Excess golden parachute payments $

14 Gross proceeds paid to an attorney $

15a Section 409A deferrals $

15b Section 409A income $

16 State tax withheld $ $

17 State/Payer's state no.

18 State income $ $

Form 1099-MISC Cat. No. 14425J Department of the Treasury - Internal Revenue Service

Do Not Cut or Separate Forms on This Page — Do Not Cut or Separate Forms on This Page

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Is there plan compensation after death?

Federal income tax withholding

- No income tax withholding on compensation paid after death

W-2

- “Wage” payments after death not reported on box 1 of W-2

415 regulations

- Unclear; Probably not, since not in participant’s income

Earned income for self-employed

- Schedule C/Partnership K-1 cuts off at death
- Could include cash after death
- Thereafter, successor in interest treated as partner

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Are there deferrals after death?

- If it isn’t comp, no
- So only possibility is draws from earned income
- Can estate change deferral election?
  - Probably, but
  - Rare that one would act that quickly

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Our answer

- The employer pays Adam’s final paycheck to his widow, Eve
  - $9,000 salary
  - $3,000 leave cash-out
- What is Adam’s plan comp from the final paycheck?
  - A. $0
- Side note: W-2 comp is W-2 box 1 (wages) increased for deferrals; not box 5 (Medicare wages)

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Case Study #5

- Plan document defines compensation for all purposes as gross W-2 comp
- Employer provides group term life insurance for employees
- Thelma’s salary + bonus = $90,000
- Thelma’s W-2 comp resulting from GTLI = $700
- Thelma deferred 10% of comp; employer withheld $9,000
  - Is this a problem? If so, how do we correct it?

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Definitional differences

	Current Income	Income Tax Withholding	W-2
Received from unfunded nonqualified plan	Out*	In	In
Tips	In	Generally In. Noncash Out. Tips < $20/month Out.	
Fringe benefits includible in income	In	Mostly In	In
Accident & health plan (if taxable)	Out*	Generally In. Self-insured medical Out.	In
Moving expense reimbursement	Out*	Out if deductible.	In*

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More differences

	Current Income	Income Tax Withholding	W-2
Group term life insurance > 50K	In	Out	In
Nonqualified stock option exercise	Out	In	In
Qualified stock option exercise	Out	Out	Out
Nonqualified option when granted	Out*	In	In
83(b) election	Out*	In	In

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So, back to our example

- W-2 compensation = $90,000 + $700
- Deferral election = $9,070
  - Insignificant difference; adjustment trivial

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(G) Excluded Compensation. Excluded Compensation means such Compensation as the Employer in its Adoption Agreement elects to exclude for purposes of this Section 1.11. Regardless of the definition of Compensation selected in the Adoption Agreement, the Plan Administrator may adopt a uniform policy for purposes of determining the amount of a Participant's elective deferrals of excluding Non-cash Compensation. For purposes of this Section 1.11(G), Non-cash Compensation means tips, fringe benefits, and other items of Compensation not regularly paid in cash or cash equivalents, or for which the Employer does not or may not have the ability to withhold Elective Deferrals in cash for the purpose of transmitting the Elective Deferrals to the Plan pursuant to the Participant's Deferral Election. Additionally, the

CHECK OUT PLAN DOCUMENT

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Case Study #6

- Hans is a US Citizen who is assigned to work 3 years in the Elbonian subsidiary of a US Corporation
- While there, he is paid in Elbows (the local Elbonian currency)
- The subsidiary does not give Hans a W-2
- The US Corporation's plan covers all employees of the Corporation and its subsidiaries, other than nonresident aliens
  - W-2 definition of compensation
- Questions:
  - Is Hans eligible to participate?
  - What is his compensation for plan purposes?

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Polling question 3

- Hans is a US Citizen who is assigned to work 3 years in the Elbonian subsidiary of a US Corporation
- While there, he is paid in Elbows (the local Elbonian currency)
- The subsidiary does not give Hans a W-2
- The US Corporation's plan covers all employees of the Corporation and its subsidiaries, other than nonresident aliens
  - W-2 definition of compensation
- If Hans eligible to participate? If so what is his comp?
  - A. He can't participate because he has no US source income
  - B. He can participate but his compensation is zero; No W-2
  - C. He can participate, and his compensation is based on what would have shown on his W-2
  - D. I don't know

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Difficult truths

- Of course he can participate
  - He is a US citizen
  - So the nonresident alien exclusion doesn’t apply
- W-2 is withholding compensation with adjustments
- When computing withholding compensation: “any rules that limit the remuneration included in wages based on the nature or *location of the employment* or the services performed . . . are disregarded”
- So convert each paycheck to dollars based on exchange rate at the time of payment

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Case Study #7

- Companies A and B are in a controlled group
- Company A sponsors a safe harbor match plan for A employees
  - Plan defines comp for purposes of allocation as W-2 comp *paid by A*
  - Match is 100% of deferrals up to 4% of comp, computed annually
- In July, A transfers 35% of its NHCEs to work at B
- Cathy’s 2019 comp is $60,000 from A and $40,000 from B
  - She defers $6,000 while at A; match per document is $2,400
  - Deferrals stop after she transfers to B
- Do we have a problem? If so, how do we fix it?

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Polling question 4

- Plan defines comp for purposes of allocation as W-2 comp *paid by A*
- Can we use that definition in a safe harbor 401(k) plan?
  - A. Yes, because it counts all A comp; B doesn't sponsor the plan
  - B. No, because B is in a controlled group with A
  - C. Yes, it is a safe harbor nondiscriminatory definition of comp
  - D. No, because it isn't a safe harbor nondiscriminatory definition
  - E. Maybe, if it passes the compensation ratio test
  - F. I don't know

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Consequences of controlled group status

- Not all controlled group members have to be in the same plan
  - Even if it's a safe harbor 401(k) plan
  - Just have to pass coverage and nondiscrimination taking into account all employees of all related employers
    - They are in the denominator
- Total compensation always includes compensation from all related employers
  - Whether or not they sponsor the plan
  - Need not use total comp for safe harbor contributions

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Nondiscriminatory (414(s)) compensation

- Counting comp of only one related employer is NOT a safe harbor 414(s) definition of compensation
- But the law doesn't require you to use a SH 414(s) definition
  - Some plans do
  - Some offices do
- The law does require you to use a 414(s) definition
  - If not safe harbor, must pass compensation ratio test
- Need not use 414(s) definition of deferral compensation
  - Must allow employees to defer enough to get maximum match

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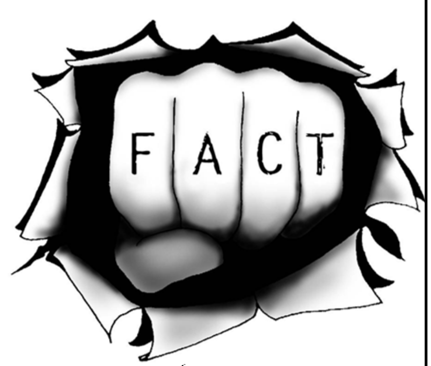
Back to the facts

- Companies A and B are in a controlled group
- Company A sponsors a safe harbor match plan for A employees
  - Plan defines comp for purposes of allocation as W-2 comp *paid by A*
  - Match is 100% of deferrals up to 4% of comp, computed annually
- In July, A transfers 35% of its NHCEs to work at B
- Cathy's 2019 comp is $60,000 from A and $40,000 from B
  - She defers $6,000 while at A; match per document is $2,400
  - Deferrals stop after she transfers to B
- Based on facts, plan likely fails compensation ratio test
  - E.g., Cathy's compensation ratio is 60%
- Nondiscriminatory comp is likely total comp from A + B
- Based on that, Cathy's match should have been $4,000
- Likely need retroactive corrective amendment under 1.401(a)(4)-11(g)



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Case study #8

- Corporation has ADP-tested 401(k) plan
  - Matching formula is 100% of elective deferrals up to 6% of comp
- Comp for deferrals = total comp
- Comp for match = total comp – bonus
- Does this pose an issue for testing?
- What is the impact if the working owner is a sole proprietor?

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Corporate complications

- Comp minus bonus isn't safe harbor 414(s) definition
- If it passes compensation ratio test, can use it for ACP test
- If it doesn't:
  - Must use 414(s) definition for ACP test
  - Must test for discriminatory rate of match
    - Benefits, rights, features

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Sole proprietorship complications

- Self-employed individual (SEI)
  - Not included in compensation ratio test
    - So, if SEI is only HCE, comp ratio test automatically passes
  - But SEI's 414(s) comp is NHCE comp ratio X SEI comp
- Example
  - NHCE comp ratio = 90%
  - SEI earned income = $200,000
  - SEI 414(s) compensation = $180,000
    - Must use for ACP test
  - If match not based on 414(s) comp, likely have BRF failure

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Case study #9

- A 401(k) plan excludes from the definition of compensation "reimbursements or other expense allowances, fringe benefits (cash and noncash), moving expenses, deferred compensation, and welfare benefits."
- Safe harbor nondiscriminatory
  - What if it only excludes "fringe benefits" but not the other items?

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Which of these is excludable as fringe/welfare benefit/allowance?

- Bonuses
- Car allowance
- Health insurance premiums for a more than 2% S Corp shareholder
- Employer contributions to a health savings account
- Phone reimbursement
- Cash in lieu of benefits

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Which of these is excludable as fringe/welfare benefit/allowance?

- Bonuses
- Car allowance
- Health insurance premiums for a more than 2% S Corp shareholder
- Employer contributions to a health savings account
- Phone reimbursement
- Cash in lieu of benefits

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Case #10

- Kim owns two sole proprietorships.
- The businesses jointly sponsor a plan
- Kim’s earned income:
  - Business 1: $200,000
  - Business 2: ($60,000)
- What is Kim’s compensation?

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Polling question 5

- Kim owns two sole proprietorships.
- The businesses jointly sponsor a plan
- Kim’s earned income:
  - Business 1: $200,000
  - Business 2: ($60,000)
- What is Kim’s compensation?
  A. $200,000
  B. $140,000

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Business runs at a loss

- No clear guidance
- If the businesses were incorporated, Kim’s W-2 comp would be $200,000
  - Makes sense that should be the result
- Treat NESE from each business as not less than $0
  - Unless owner is playing games and shifting income from one to the other

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Case #11

- Corporations A and B are in a controlled group
- A sponsors a plan covering only A employees
  - PS allocations pro rata based on A compensation
  - B has 1 HCE and 2 NHCEs who don’t benefit
- Can we test for nondiscrimination using A compensation only?
- Can we make safe harbor nonelective contributions using A comp only?
- Can we make top heavy contributions based on A comp only?

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Polling question 6

- Can we make top heavy contributions based solely on compensation from A?
    A. Yes, A is the only plan sponsor
    B. Yes, if it is nondiscriminatory
    C. No, top-heavy contributions are always based on total compensation

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Compensation ratios

Employee	HCE?	A Comp	B Comp	Total Comp	Comp %
Harry	Yes	$180,000	$20,000	$200,000	90%
Holly	Yes	$150,000	$0	$150,000	100%
Nick	No	$90,000	$10,000	$100,000	90%
Nancy	No	$40,000	$10,000	$50,000	80%
Neville	No	$10,000	$30,000	$40,000	25%
Nadia	No	$30,000	$0	$30,000	100%
Norma	No	$25,000	$0	$25,000	100%

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Allocations

- Here are allocations under plan document
  - Norma is a part-time employee and doesn't get regular PS
- Do we follow document terms for allocations? How do we test?

Employee	A Comp	B Comp	Total Comp	Comp %	Top Heavy	Regular PS	Total Alloc.	% A Comp	% Total Comp
Harry	$180,000	$20,000	$200,000	90%	$0	$27,000	$27,000	15%	13.5%
Holly	$150,000	$0	$150,000	100%	$0	$22,500	$22,500	15%	15.0%
Nick	$90,000	$10,000	$100,000	90%	$3,000	$10,500	$13,500	15%	13.5%
Nancy	$40,000	$10,000	$50,000	80%	$1,500	$4,500	$6,000	15%	12.0%
Neville	$10,000	$30,000	$40,000	25%	$1,200	$300	$1,500	15%	3.8%
Nadia	$30,000	$0	$30,000	100%	$900	$3,600	$4,500	15%	15.0%
Norma	$25,000	$0	$25,000	100%	$750	$0	$750	3%	3.0%

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General nondiscrimination test

- Concentration percentage is 70%
- Midpoint percentage is 37.5%
- 15% rate group benefits 1/7 NHCEs and 1/3 HCEs; coverage fraction = 42.85%
- 13.5% rate group benefits 2/7 NHCEs and 2/3 HCES; coverage fraction = 42.85%
- ABPT = 71.05%; we pass

Employee	HCE?	% Total Comp
Harry	Yes	13.5%
Holly	Yes	15.0%
B HCE	Yes	0%
Nick	No	13.5%
Nancy	No	12.0%
Neville	No	3.8%
Nadia	No	15.0%
Norma	No	3.0%
B NHCE 1	No	0%
B NHCE 2	No	0%

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Case #12

- Doug owns an interest in the businesses shown below
- A and B jointly sponsor a DB plan; C does not sponsor the plan
- Ignore earned income adjustments for contributions & SE tax
- What is Doug's comp for purposes of
  - 415
  - Nondiscrimination testing
  - Allocations

Company	Form	Ownership %	Comp/ NESE
A	Corporation	100%	$100,000
B	Sole proprietorship	100%	$100,000
C	Partnership	80%	$150,000

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Treas. Reg. §1.415(c)-2(g)(2)

- In the case of an employee of two or more corporations which are members of a controlled group of corporations (as defined in section 414(b) as modified by section 415(h)), the term *compensation* for such employee includes compensation from all employers that are members of the group, regardless of whether the employee's particular employer has a qualified plan.
- Also applies to common control and ASGs

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Code §401(d)

- Code: A trust forming part of a pension or profit-sharing plan which provides contributions or benefits for employees some or all of whom are owner-employees shall constitute a qualified trust under this section only if, in addition to meeting the requirements of subsection (a), the plan provides that contributions on behalf of any owner-employee may be made only with respect to the earned income of such owner-employee which is derived from the trade or business with respect to which such plan is established.

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Treas. Reg. §1.401-10(b)(2)

- If a self-employed individual is engaged in more than one trade or business, each such trade or business shall be considered a separate employer for purposes of applying the provisions of sections 401 through 404 to such individual. Thus, if a qualified plan is established for one trade or business but not the others, the individual will be considered an employee only if he received earned income with respect to such trade or business and only the amount of such earned income derived from that trade or business shall be taken into account for purposes of the qualified plan.

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Case #13

- XYZ is a limited partnership
- What is the compensation of the following partners?
  - Ignore SE tax & plan contributions
  - What if Able also received a W-2 for $50,000?

Partner	General/ Limited	Guaranteed payments	Share of profit/loss
Able	General	$30,000	$170,000
Bonnie	General	$50,000	($100,000)
Chuck	Limited	$0	$200,000
David	Limited	$50,000	$50,000

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SEI comp is earned income

- XYZ is a limited partnership
- What is the compensation of the following partners?
  - Ignore SE tax & plan contributions
  - What if Able also received a W-2 for $50,000?
- Earned income of limited partner based on guaranteed payments for services

Partner	General/ Limited	Guaranteed payments	Share of profit/loss	Unadjusted earned inc.
Able	General	$30,000	$170,000	$200,000
Bonnie	General	$50,000	($100,000)	($50,000)
Chuck	Limited	$0	$200,000	$0
David	Limited	$50,000	$50,000	$50,000

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Case #14

- Warren made $50,000/year before quitting to entering military in 2019
- Company continues to pay Warren $20,000/year until he leaves the military in 2022
  - Does Warren get top heavy minimum for 2019, 2020, 2021?
  - If so, based on what compensation?
  - Is he eligible to defer out of the military continuation pay?
- Warren is rehired in 2022; Company pays Warren $55,000/year taking into account raises he would have received had he stayed
  - Does Warren get makeup contributions? Based on what?

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Military pay

- Warren made $50,000/year before quitting to entering military in 2019
- Company continues to pay Warren $20,000/year until he leaves the military in 2022
  - Does Warren get top heavy minimum for 2019, 2020, 2021?
    - Yes; he hasn’t separated from service
  - If so, based on what compensation?
    - $20,000 continuation pay
  - Is he eligible to defer out of the military continuation pay?
    - Yes if plan allows; optional
- Warren is rehired in 2022; Company pays Warren $55,000/year taking into account raises he would have received had he stayed
  - Does Warren get makeup contributions? Based on what?
    - Yes, based on comp he would have had

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Additional Educational Opportunities

- If you found this presentation helpful, please consider attending one of our upcoming conference events:
  - Advanced Pension Conference – Orlando, FL
    - February 5 – 7, 2020
    - Discounted registration available through January 15th
  - Pensions on Peachtree – Atlanta, GA
    - May 4 – 5, 2020
- Visit relius.net/events for registration and more information

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CE Credit

- Credit is offered for ERPA/ASPPA-ARA/NIPA
- Those that attended the requisite time in the video portion of the webcast today will receive a certificate by email in a few days (ERPA will take longer).
- Please check spam folder.
- Any questions? Email: support@erisapedia.com.
- After the webcast you will be presented with a short Google Forms survey. Please let us know how we are doing.

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For Further Study

Joanne Pecina will demonstrate how to find more information on today's topic from the ERISApedia.com resources.

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