Compensation Case Study Questions 1/9/2020

Case Study #1

1. A company's payroll period ends on Dec 27, 2019. The employees are paid on Jan 3, 2020. How should this be recorded on the W-2 for 2019 or 2020? If it is considered for 2020, the participant did not work any hours in 2020. If the plan is a safe harbor non-elective plan, does the participant receive the 3% SH contribution for 2020?

The compensation paid in 2020 should be reported on a 2020 Form W-2. The answer to the question as to which year it counts is dependent on the plan document language. Many pre-approved plan documents include an election that provides compensation paid within the first few weeks after the end of the plan year is counted in the plan year in which it was earned. (Candidly, I believe this election to be generally ill-advised as it is the source of many compensation errors.) Can the participant defer out of it? Unless you have the rare document that forbids people from deferring out of their last paycheck, yes, they can defer. We have never seen a 401(k) plan which required that a participant (who previously met the plan’s eligibility requirements and entered the plan) to meet an hour of service threshold to defer. Is it entitled to the 3% safe harbor contribution? Yes, unless the plan does not allow people to defer out of their last paycheck.

2. As a follow up, if it is a non-safe harbor 401(k) plan, is this participant included in the 2020 ADP test?

If it is 2020 compensation, and under the terms of the plan the participant was eligible to defer, then, yes, it counts in the 2020 ADP test.

3. A plan uses full-year compensation for new participants. An employee stops being a union employee in August and becomes a non-union employee. Should their compensation earned while a union employee be used in the calculation of their Safe Harbor Non-Elective/Profit Sharing contributions?

That will depend on the language in your plan document. For example, if you elect to use “date of participation” compensation, the comp earned while the employee is an excluded union employee will not count. Otherwise, it would. Additionally, many plan documents expressly deal with compensation earned after becoming ineligible. Follow the plan. IF the compensation is not for services rendered how wouldn’t it be considered "earned Income"

It should not be – but owner compensation is not always correctly reported.

4. The post-severance regulations count regular pay which "...would have been made while employment continued..." The $20k in the first case study would NOT have been paid had he continued employment. He received it for quitting.

True; however, it was paid PRIOR to termination of employment. Therefore, it is not post-severance compensation and the limitation regarding severance pay does not apply.

5. What if it is conditioned on a full release - is it a severance payment, not compensation for services?
7. What if it is commissions paid after termination?

If it relates to sales made while an employee, it would be “regular pay” and would be subject to the requirement that it be paid by the later of 2½ months after termination or the end of the limitation year of termination.

8. Study Case #1: it seems you contradicted yourselves. If its severance paid prior to last day, its included and you said it’s excluded? I’m confused.

Then, my apologies as I misspoke. If it is paid prior to termination, it is not post-severance compensation and the limitation regarding severance pay does not apply.

Would the answer change if the plan’s compensation definition used 415(c) compensation instead of W-2?

No change.

Case Study 2

1. If employee receives advanced pay before termination date, can you count it for allocation purposes with last day rule (12/31) condition?

Not sure I understand this question. If, for example, I quit on 12/31/19 and I would normally be paid for the 12/16-12/31 pay period on 1/15/20, but the employer accelerates the payment and pays it to me on 12/31/19, then it is 2019 comp and would be treated as such.

2. How does HCE compensation test fail if the NHCE aren’t receiving bonus? Wouldn’t the test pass if the only people receiving excluded comp (bonus) are HCE?

The Case Study had a flaw and was intended to reflect that bonuses to HCEs were discontinued. You are correct. It would always pass of the only people with excluded comp are HCEs.

3. A person retires and starts distributions from a NQDC plan. These are reported on the W-2, and the 401(k) plan defines compensation as W-2 compensation. If the plan makes a profit sharing contribution (no allocation requirements) the plan year he retires - is the NQDC compensation considered for the contribution?

The answer depends on the terms of the plan document. The plan may elect count such compensation provided that it is paid within the 2½ month/end of the limitation year and would have been paid anyway without regard to termination of employment.

4. Does 414(s) state as less than 3%?? De minimis?

There is no set amount for “de minimis” found in the code and regulations. The 3% amount comes from references to other areas in which the IRS has addressed similar issues, as well as
informal comments from the IRS. That said, it is certainly broadly treated as the standard for de minimis in this context.

5. What about failure to withhold deferrals on a nondiscriminatory definition?

Deferrals do not have to be based on a nondiscriminatory definition of compensation; rather the definition must only be reasonable. However, this can give rise to a discriminatory rate of match.

6. Is retroactive amendment for that plan year only the plan failed 414(s) or should it be permanent amendment?

That would be a decision that should be made based on the events that caused the need for the amendment. If the change to the compensation structure is permanent (or even multi-year), I would recommend making a permanent change. Otherwise, I would just recommend amending for the impacted year.

7. Can't you also use the Ave Ben Percentage Test as a remedy to non-safe harbor comp issues?

You can allocate a contribution using a discriminatory definition of compensation, however, you do, you must pass general nondiscrimination testing under §401(a)(4). You can use the average benefits test to pass that testing, but that testing must be completed using a nondiscriminatory definition of compensation (either safe harbor compensation or 404(s)).

8. What if it was a Safe Harbor match deposited ongoing with NO true-up at plan year end?

It would be a safe harbor contribution improperly calculated using a discriminatory definition of compensation. The contribution calculation must be revised using a nondiscriminatory definition of comp.

9. In Case Study 2 if the plan were a safe harbor match plan with a per payroll allocation and no annual true-up would it be appropriate to do a retroactive amendment and add an annual true-up provision at the same time?

Assuming the change to the compensation definition (to nondiscriminatory) would result in increased matching contributions for the full plan year to the employees, you would not satisfy the requirement that the match (properly) accrued for each quarter be deposited by the end of the following quarter (even if most of it was), in order to avoid a true-up. Accordingly, amending for the true up, or relying on a plan override provision that mandates it, would be necessary.

10. What if they exclude bonus from deferral compensation only and give the 3% SH based on total comp? The 414s test fails for the deferrals. However, they are passing 401a4 based on total comp. Is there an issue that would void the SH?

As noted above, deferral compensation must be reasonable, but it does not need to need to comply with 414(s). Excluding bonuses from deferrals would (IMHO) be reasonable. There should be no issue here.
CASE Study #3

1. If she elects 10% but waits until comp is known, when does it need to be deposited to the plan?

   Since it is an ERISA plan, it must be deposited as soon as it can be determined.

2. Is there a way around the 10% election? Post compensation determination election, maybe?

   Deferral elections must be made before the end of the year.

3. What is the other $21.5k considered?

   It is an excess allocation, to be returned to the participant.

4. Could her election have been "whatever my final compensation allows?"

   She could have chosen to defer the lesser of 100% of earned income or the 402(g) limit (adjusted for catch-ups) assuming the plan permits it.

5. It was my understanding a partnership or a schedule C could actually do a deferral for a prior year until their tax filing deadline.

   Treas. Reg. §1.401(k)-1(a)(6)(iii) disagrees with you.

6. Do you agree that if there were a plan level deferral level that the amount over that would be reclassified as catch-up to the extent possible?

   The participant elected to defer $2,500. The catch-up rules do not change your deferral election. It allows you to implement your deferral election notwithstanding plan or statutory limits.

7. Many sole proprietors don't fill out a deferral form. They just deposit the maximum or what they can before their tax filing deadline. What is the ramification of not having that form on file?

   The election must be made prior to deferral. Do you allow employees to elect without a deferral form? I suspect not. Can the plan allow the owner to have a simpler procedure for the owner to make a deferral election than for employees? I’d suggest that is dangerous and may be treated as a discriminatory benefit, right, or feature. You may also want to check plan document language and see if it doesn’t require a formal election.

8. I thought the catch-up was above and beyond any limit, so she could go above her actual compensation?

   No. The catch-up rules provide that total deferrals, including catch-ups, cannot exceed compensation. Code §414(v)(2)(A).

9. We have been under the impression that the catchup deferral does allow someone to defer more than 100% of their compensation. The catchup is not included in 415.

   A catch-up can allow you to exceed the 415 dollar limit. But catch-ups cannot cause total deferrals to exceed compensation.
10. Don’t you have to take into account self-employment taxes which would further reduce their compensation for self-employed individuals? Can this person (in slide 21) really defer $15,000 or are the SE taxes coming out of this?

The case study said her “earned income” was $15,000. Earned income takes SE tax into account. It is net earnings from self-employment, adjusted for SE Tax and plan contributions. Compensation for the self-employed is earned income increased by deferrals.

11. Are HCE only plans exempt from needing to have their election made during the plan year?

No. This isn’t a nondiscrimination issue.

CASE # 4

1. What’s a leave cash-out?

Payment for accrued time off (vacation, PTO, sick days, etc.).

2. Can a deferral election state to defer "maximum" as opposed to a dollar amount or %? And, if it states "maximum", can that deferral deduction be automatically adjusted each year for the increased 402(g) limit? Or must the participant submit a new election form each year?

A deferral election may say “maximum” rather than an actual dollar amount. In general, that would be an evergreen election that would reflect the applicable §402(g) and §415 limit each year. The plan could create an administrative procedure to require that such elections be reset annually (but why?).

3. My understanding is the final paycheck is paid on a 1099R to the spouse?

Payments made after the employee’s death, but in the same year of death are reported on boxes 3-6 (not NOT boxes 1-2) of the Form W-2 for the employee’s year of death. That is, the payments are subject to FICA/Medicare taxes. In addition, such payments – in the year of death and thereafter – are reportable on a Form 1099-MISC, box 3, to the employee’s estate.

4. Is the answer different if the comp definition is 3401(a)?

No.

5. Can you answer that polling question assuming the participant terminated employment rather than died?

If the employee terminated rather than died, the final paycheck would not go to his spouse. Whether or not the leave cash out would be plan compensation would be based on the election of the plan to include or exclude leave cash out as post severance compensation.

6. What if the employer doesn’t report this correctly or doesn’t pay it to the spouse and just direct deposits it into the same account as they have been using all along?

An error on how it is reported does not change the actual and proper nature of the payment as plan compensation or non-plan comp.
7. What happens if a plan takes deferrals from this comp?

They would reflect an excess allocation and should be distributed, with associated earnings.

8. What if the plan defined compensation as wages, salary, etc., for services performed while employed. Does that change the discussion on post-death compensation?

The payment at question in the example was for services performed (or leave accrued) while the employee was still employed; it was merely paid after the employee died. Accordingly, no change.

9. Can a sole proprietor defer on draws paid throughout the year if it is known that the earned income will support the draws as compensation?

Yes, the participant can defer based on draws, provided the final earned income supports it.

10. What is meant by "Thereafter, successor in interest treated as partner?"

The individual/trust that inherits the deceased individual’s ownership interest will thereafter be the partner-owner of the business (with all the associated economic rights); not the deceased individual.

11. How are loan payments for 401(k) Loans impacted by death? Should those be deducted from the final paycheck?

The final payment is due to the participant’s estate. The plan loan impacts the plan beneficiary. The final payment should not include loan repayments as the plan loan is not an obligation of the estate – and the payment (of the estate’s money) to reduce the participant loan (to the benefit of the plan beneficiary) is not appropriate.

Case Study # 5

1. What about fringe benefits?

Group term life insurance is a fringe benefit. But the document in the case study didn’t exclude fringe benefits from the definition of compensation. Could the document be drafted to exclude fringe benefits? Yes.

2. Are there other examples of differences between W-2 and 3401a outside of excess GTL?

Please see the charts on slides 29 and 30. If you didn’t download the slides earlier, you can do so from this link. https://www.erisapedia.com/static/CompensationCaseStudiesTwo.pdf.

3. Non-cash compensation is excluded from compensation for deferrals only or also for employer non-elective contributions as well if in the BPD?

The clause we showed was limited to deferrals. Check your document.

4. Does the "uniform policy" of excluding non-cash compensation need to be written?

Check your document. In the document from which that clause was taken, it does not need to be.
5. Using an admin policy to exclude non-cash comp...If the plan uses W-2...does this mean the deferral of comp doesn't meet a safe harbor definition?

   The definition of compensation for deferrals need not be nondiscriminatory. Using a discriminatory definition for deferral compensation does not require a BRF test so long as the same definition applies to everyone.

6. An employee is terminated 7/31. He is owed commissions but the company pays commissions when they are paid. If they pay the commissions in December, does the employer withhold deferrals? I'm thinking "NO" but is it because the payment was made after 2 1/2 months? How would I confirm that information?

   Assuming they are paid within the same limitation year (such as a calendar year plan), then the commissions count even if paid after 2½ months. It is unusual for a plan to excluded regular compensation paid post-severance if it is paid in the limitation year of severance (or within 2 ½ months after severance).

7. Plan excludes consulting fees from plan compensation (only paid to HCEs so is non-discriminatory). Their intent was to not calculate profit sharing on that compensation. Do we have a choice of including that excluded compensation when performing the ADP test?

   Yes, assuming the plan document allows you to select a different definition.

8. If an employer utilizes the (G) Excluded Comp definition in the plan document for deferrals, how would this impact the comp used for a Safe Harbor match or SHNE calculation?

   In that document, it applies only to deferral compensation and does not impact employer contributions. Check your document.

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**CASE # 6**

1. How does this US citizen paid in non-us compensation make deferrals?

   Very carefully! The subsidiary has to reduce the elbows paid to the participant and the employer must deposit dollars into the plan. This is a reason a plan may wish to exclude people not on the employer’s US payroll, even though those individuals must be counted in the coverage test (as zeroes).

2. If the compensation is not taxable can Roth contributions be made?

   Yes, and that would be a good choice.

3. Can you explain 3401(a) "withholding comp" further?

   3401(a) withholding compensation is the definition of compensation used to compute income tax withholding, increased by elective deferrals, and calculated without regard to special rules based on the nature or location of services performed.

4. If someone is in the US on a VISA and my document excludes nonresident aliens, however they has satisfied eligibility for all other intents and purposes, they are paid on a W-2, are they eligible to participate in the plan? If not, I’m assuming we would have to test them as ineligible?
Your document presumably excludes non-resident aliens without US-source income (the full definition may be found in your Basic Plan Document, rather than in the Adoption Agreement). The W-2 reflects US-source income; accordingly, they would not be excluded from the plan.

5. When converting foreign comp to dollars is there any reasonable estimate to avoid calculating the conversion as of every pay date? (Beginning/End of Plan Year...)

I’ve never found one, and I’ve looked.

**CASE # 7**

1. If I’m dealing with Earned Income, do you think I can test using the net of deferral's approach?

   Yes

2. Could it be argued that Company A transferred 35% of its EEs to B to avoid funding their July-Dec match? Is that anti-cutback?

   I don’t think so. The document began the year said that only compensation from A counts. Code §411(d)(6) prohibits plan amendments which reduce benefits. This is not an amendment.

3. Speaking of 11(g) amendment - do they have to be done before 10/15 to go SCP? If after 10/15 has to go through VCP. Thanks.

   For a calendar year plan, you are correct. The deadline for an 11(g) amendment is October 15. It is not exactly SCP, however, because there wasn’t a failure. EPCRS wasn’t involved. EPCRS is only involved after October 15, and then, typically, you would need VCP to make the amendment.

4. If we amend the plan to change definition of compensation, would company need to make QNEC since deferrals were not taken from the B comp?

   You can amend the compensation definition to compute the safe harbor contribution without amending the definition to compute deferrals.

5. Is that a potential partial plan term?

   Perhaps it could trigger full vesting for the affected participants, but it is not certain. I’d want to look more closely at the facts.

**CASE # 8**

1. How can you determine a portion of SE income as a "bonus"?

   You don’t. That’s why there are the special rules on slide 43.

2. Company excludes bonus and overtime from eligible plan compensation. The plan has a safe harbor match so no ADP/ACP test. Does the Plan have to pass the compensation ratio test?

   Yes. If it doesn’t pass comp ratio, then you cannot use that definition to contribute and allocate the safe harbor match.
CASE Study # 9 / Case Study # 10 & Misc.

1. If eligible wages are W-2 wages, are 2% shareholder insurance premiums always considered eligible wages? Doesn't this pose a problem since this amount is not known until after YE and the W-2 is prepared?

   See the earlier discussion of handling noncash compensation in calculating deferrals.

2. I would argue the 2% shareholder Health Insurance is excludable. Can you explain?

   Can I explain your argument? No. I will try to explain mine. W-2 comp is W-2 comp. Unless there is some exclusion in the plan document, such as an exclusion of fringe benefits or an exclusion for deferrals of noncash compensation, the document definition reigns supreme. If you don’t like the effect of the document definition, or you consider the document less than clear, change it!

3. "Kim has TWO sole props". For a true sole props, there is NO way to have two sole props for the same individual. Everything is combined from both on her 1040. The example did not specify that the income was from some other entity such as an LLC.

   I disagree. The compensation may be reported on two different Schedules C with different EINs. The document may specify that the employees of one business can participate while the employees of the other cannot.

4. 50% of the actual FICA would not be the same as FICA on the $200K. This inconsistency to me would indicate that the correct answer is "comp is $140K"

   Is there a question that goes with that answer? 😊 You are welcome to your opinion. As I've said, guidance here is limited. Be reasonable; be consistent.

Case Study # 11

1. Why are you not discussing passing 410(b) with controlled groups? If they pass coverage while excluding another group I thought you did not have to include the other group for discrimination testing.....

   This is a very important question. When a plan can pass coverage, using whatever exclusions are in the plan, then ADP testing, ACP testing, and safe harbor 401(a)(4) analysis is limited to the plan participants. But, the general nondiscrimination test considers all nonexcludable employees of all related employers. (For that matter, the minimum participation rules of Code §401(a)(26) consider all nonexcludable employees of all related employers as well).

CASE Study # 12 and 13

1. For a guaranteed payment partner with a loss that nets to below $0, is the compensation considered for a 3 year average going to use $0 or the negative figure?

   I had never considered that, but I’d say zero.

2. So if I understand correctly, a SEI cannot defer on draws even though draws are included in determining net earned income?
Correct. Earned income is compensation. Draws are merely part of earned income.

3. For that last case, does it matter if it’s an LLP or LLC?
   
   One of the great debates in the tax field is who is a limited partner in an LLC, where everyone enjoys limited liability. You may find it profitable to review CCA 201436049. The issue is also addressed in controversial proposed regulations §1.1402(a)-2(h).

4. Case # 13. On a K1 which box do I get pay from for LLC
   
   Line 14A is net earnings from self-employment if the return is prepared properly. However, that number is subject to several adjustments.