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Don't Be Fooled! Compensation Definitions Are Tricky!

Insight — April 1, 2019

Contributions to your 401(k) plan are calculated as a percentage of an employee's compensation. Seems simple, right? Not so fast. The definition of "compensation" can actually be quite tricky to apply and can lead to errors that are costly to fix.

Let's start with the myriad definitions you might use. Many qualified retirement plans are required to use a definition of compensation that meets the nondiscrimination requirements of Code Section 414(s). The IRS allows several standard definitions that will meet that requirement:

- Code 415 compensation (the "long list")
- Code 415 compensation with standard exclusions (the "short list")
- W-2 wages
- Withholding wages

Each of these definitions has unique inclusions and exclusions. And when you add the optional modifications that employers might choose, the possible combinations are numerous. The complexity only multiplies when you consider how payroll systems are set up to identify various types of pay.

So ask yourself, what definition of compensation does our plan use, and have we set up the correct pay codes in our payroll system to apply it?

But wait, there's more...

Some other things to consider when designing compensation:

- Timing of Payment – Should compensation be included based on the year paid or the year earned?
- Post-Severance Compensation – Should compensation include accrued paid time off that is paid after termination of employment? What about severance paid on the last day of employment?
- Differential Pay – Is the company providing payments to employees who are absent for military service? If so, it may be required to be included in plan compensation.
- Nonqualified Deferred Compensation – If the Company has a nonqualified plan, is the deferred compensation being included or excluded appropriately?

Failing to follow the terms of the plan, like not using the correct compensation, can result in an operational failure. We can help! A simple (but thorough) review of the plan compensation provisions, compared to

what payroll codes are included for plan purposes, can insure proper administration and avoid costly corrections.

For more information about our employee benefits practice, please visit hollandhart.com/employee-benefits.

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