PRECISION

Expert Guidance and Creative Solutions for Retirement Professionals VOL 3 2015

Things You Might Not Know About Your Retirement Plan

A DWC ERISA CONSULTANTS PUBLICATION

Compensation Jeopardy

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Employees work; they get paid. Easy peasy. Not so fast. According to the IRS, using incorrect compensation amounts to calculate retirement plan benefits and conduct annual compliance testing is one of the most common errors they see. How can such a straight-forward topic be that confusing? Find out in this episode of Compensation Jeopardy! Be sure to phrase your responses in the form of a question!

Our first category is
COMPENSATION PAID TO BUSINESS OWNERS

And the answer is:

Sole proprietors, partners and certain LLC members have THIS in common.

Response:

What is earned income?

ding, ding, ding

You are correct!

If you are self-employed, special rules apply when calculating your retirement plan compensation. There are several variables and tricky calculations that are enough to make anyone's head spin. The calculation is further complicated if you have other employees. For example, if you are a sole proprietor with employees covered by your retirement plan, you must deduct any matching and profit sharing contributions you make for them as a business expense, which reduces your earned income. If you have an equal partner, then each of you must reduce your earned income by half of the total company contributions for employees. The more owners/ partners involved, the trickier the calculation becomes.

Earned income is further reduced by half of the self-employment taxes you owe for the year. This involves another set of equations to derive the amount of the deduction.

The next step is to calculate your company contribution, which is based on your compensation as described above but is also a business expense which further reduces the compensation used to calculate your contribution.

audience laughter

Yes, a circular calculation indeed. And just because your total earned income is well above the annual compensation limit ($265,000 for 2015) doesn't mean you can skip all the fun. It is still important to go through the process to ensure that the reductions

described do not reduce your net earned income below the limit.

If your head isn't spinning, you are doing better than most! The good news is that DWC can work with you and your accountant to ensure all of the necessary factors are considered and take care of these calculations for you.

applause

And the Double Jeopardy answer is:

This type of payment to a business owner is *not* considered earned income for retirement plan purposes.

Response:

What is a subchapter S corporation dividend?

Correct again!

Although reported on a Schedule K-1 that is very similar to partnership income, S corporation profits that are passed through to the owners at the end of the year are not counted as compensation when it comes to the retirement plan. So, if an S corp owner receives $100,000 in W-2 compensation and $150,000 in distributed profits, the plan only considers $100,000 and not the full $250,000. For that reason (among others), it is important for S corp owners to review their own compensation strategy to make sure they don't inadvertently reduce or increase their own contribution.

Our second category is AMOUNTS PAID AFTER AN EMPLOYEE TERMINATES

And the answer is:

This type of compensation is NEVER counted as eligible plan compensation.

Response:

What is severance pay?

Right you are!

audience applause

But contestant beware, "severance pay" is not the same as "post-severance pay." Confused? We would be impressed if you weren't! Post severance compensation includes any amount that is paid to an employee after he or she has terminated employment and includes items such as:

- Payment for unused vacation or sick leave;
- Payment of earned but not yet paid bonuses or commissions;
- Distributions from certain non-qualified deferred compensation plans; and
- Traditional severance when someone is essentially paid to leave.

The first three (3) are amounts the employee would have been entitled to receive even if s/he remained employed, and the default is to include them in plan compensation if paid to the employee by the later of:

- 2 ½ months following the employee's date of termination, or
- The end of the plan year in which the employee terminates.

However, the plan documents can be amended to modify this definition.

The last – traditional severance - is only paid if an employee leaves. It can never be counted as plan compensation, so it is important not to promise a departing employee that they can make deferrals or receive company contributions on those amounts.

Our third category is NON-RECURRING OR IRREGULAR COMPENSATION

And the answer is:

These types of non-recurring compensation are always counted as plan compensation unless specifically excluded by definition in your plan document.

Response:

What are bonuses, overtime and commissions?

You are on a roll – CORRECT!

The most common definitions of compensation in plan documents are tied to amounts reported on Form W-2 or amounts used to determine income tax withholding. Although there can be some nuances that separate these two definitions, both include bonuses, commissions and overtime. In most instances, these amounts should be treated just like any other payroll with employee deferral elections applied. If included with regular paychecks, it doesn't create much, if any, additional effort; however, if paid in a separate check outside of payroll, it can be easy to overlook them. In addition to withholding 401(k) deferrals, these forms of compensation must also be considered when calculating matching and profit sharing contributions and performing compliance testing.

There are some exceptions, but they must be spelled out in the plan document. In other words, the plan must be written in a manner that specifically excludes these compensation "extras" if that is your intent.

Contestant beware! The exclusion of these types of irregular compensation requires special nondiscrimination testing each year. If you exclude a greater percentage of compensation from your lower paid employees than your higher paid employees, you may not be able to exclude that compensation after all, AND you may have to make some additional corrective contributions to the plan.

Our final category is ALLOWANCES AND NON-CASH COMPENSATION

The final jeopardy answer is:

Personal use of a company car, relocation allowances and gift cards are examples of this type of compensation.

Response:

What is a taxable fringe benefit?

That is correct! We have a winner!

Fringe benefits come in two varieties, taxable and non-taxable. The taxable ones are part of plan compensation, while the non-taxable ones are not. The difference usually depends on whether the employee must provide substantiation of expenses in order to receive the payment. For example, if a company agrees to reimburse an employee for costs associated with relocation for the job and the employee must provide receipts to document actual expenses, the payment is considered a reimbursement, is not taxable, and is not reported on Form W-2. However, if the company simply pays the employee, say $5,000, to cover moving expenses regardless of the costs actually incurred, it is treated as a taxable allowance and is reported on the W-2. It is similar with automobile related expenses ...

a direct mileage reimbursement is non-taxable, while a monthly auto allowance is a taxable fringe benefit.

What if the benefit does not involve cash? Items like gift cards or allowing an employee to use a company-owned car for personal use have monetary value and are subject to income tax (and therefore count as plan compensation) even though there was no actual cash involved. If there was no payment, how can deferrals be made? This can be tricky and depends on how your plan document is written. If you pay non-cash compensation, the plan can be designed to exclude these amounts completely or just with regard to employee deferral elections. The good news is that if the plan is written to exclude all taxable fringe benefits, no additional testing is required each year.

If you aren't sure what your plan requires or you pay different types of non-traditional compensation, give us a call. We once had a client who paid "fish tank pay."

No matter what you call it, we can help you know and understand your plan's definition of compensation so that you keep the plan out of jeopardy.

Additional Reading

IRS Publication 15 – Circular E, Employer's Tax Guide

http://www.irs.gov/pub/irs-pdf/p15.pdf

IRS Publication 15-A – Employer's Supplemental Tax Guide

http://www.irs.gov/pub/irs-pdf/p15a.pdf

IRS Publication 15-A – Employer's Tax Guide to Fringe Benefits

http://www.irs.gov/pub/irs-pdf/p15b.pdf

With over 20 years in the pension consulting trenches, Joni brings a wealth of experience to her role as Principal and Team Leader at DWC ERISA Consultants. As a long-time volunteer for ASPPA (the American Society of Pension Professionals and Actuaries), she has served on the Government Affairs Committee and Conferences Committee, and she currently sits on the Board of Directors of the ASPPA Benefits Council of Atlanta.

CHEAP TECH TOOL #63

IFTTT – www.IFTTT.com

Four words - If This Then That – get it? No really, you should get it. Their tagline is "put the internet to work for you." We call it automating your life. Using their website or mobile app (both of which will cost you a big fat nothing), create "recipes" that turn online accounts and web-enabled gizmos you already use into your own personal eMinions.

Use a Fitbit to track your sleep? A little grumpy if you don't catch enough Zs? Set IFTTT to check your Fitbit and post a warning to all your friends on Facebook to steer clear (or bring you coffee) any time you burn the midnight oil. If Weather.com reports a high UV index for the day, have IFTTT send you a reminder to apply sunscreen or pack a hat. Need a more businessy example? Ok, how about automatically sending a LinkedIn request every time you add a new contact to your smartphone's address book?

There are hundreds of pre-programmed templates just waiting for you. The hardest part of using the app is trying to remember how many Ts there are in IFTTT. Fair warning – it is addictive as you imagine the possibilities. I wonder if Al Gore imagined this possibility when he invented the internet.