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employee benefits & executive compensation law

in focus

July 2011

Compensation Check Ups

Using the wrong definition of compensation is a common error in qualified plans and can be costly if left undiscovered and uncorrected

A typical 401(k) or other qualified retirement plan contains multiple and complicated definitions of "compensation" in the governing plan document. All too often, the definition of compensation in the plan document does not match the definition actually being used to administer the plan, especially for purposes of calculating a participant's elective deferral contributions or the company's matching or profit sharing contributions.

Failure to use the definition of compensation that is specified in the plan document is considered in an "operational error" that can be quite costly to resolve if left unchecked over a period of time or discovered in the course of an IRS audit. The IRS recently observed that half of the plans they audit have operational errors related to compensation.

Plan sponsors can take steps to help mitigate this risk:

First, review the plan document to determine what types of compensation are should be included for various purposes of the plan. For example, some plans include all types of bonuses for purposes of calculating a participant's elective deferral percentage, while other plans may specifically exclude bonuses, or only include certain types (e.g., annual bonuses are included, but referral bonuses are not). Some plan sponsors are surprised to find that their plan calls for them include amounts like non-cash awards (prizes, gift certificates, etc.) and the value of stock option exercises when processing a participant's elective deferrals.

- Some plan sponsors create a chart that lists the employer's payroll codes and indicates whether that type of pay should be included or excluded for various plan purposes (*e.g.*, elective deferrals, matching contribution, profit sharing contribution, 415 limit testing, etc.). As new types of pay are introduced, they can be reviewed prior to being implemented and added to the chart with the appropriate indicators.

- Plan sponsors should ensure that everyone responsible for properly allocating deferrals and contributions is trained to understand the plan's requirements, as well as any changes to the plan that may occur over time. For example, some plan sponsors find that the plan's requirements regarding the types of compensation to include or exclude have not been properly communicated to their payroll administrators, which can result in costly errors.

- Similarly, plan sponsors must make sure those responsible for reporting compensation amounts for purposes of plan compliance testing understand the definition of compensation that the plan document requires for testing. If the plan sponsor is responsible for reporting these amounts to an outside vendor that conducts testing, and the sponsor reports the wrong compensation amounts, the plan may not be in compliance with various tax code requirements.

Once the plan sponsor understands which types of compensation should be included or excluded for various plan purposes, check whether the appropriate types of compensation are in fact being used in practice.

- Many plan sponsors find it useful to set a schedule of "spot-checks" either annually or at various points throughout the year to confirm that the correct types of compensation are being included for each of the various purposes under the plan.

- There may be opportunities to correct errors through the IRS Employee Plans Compliance Resolution System (EPCRS), which encourages plan sponsors to self-check for errors and voluntarily make corrections.

- Adopting a unilateral amendment to retroactively change the definition of compensation to reflect the definition that was used in practice is generally not considered an acceptable method of correction in the absence of IRS approval.

For more information about plan compensation and compliance, please contact:

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