

Adjustments to Compensation and 414(s) Testing Considerations

Q: How is 414(s) compensation used?

A: Internal Revenue Code (Code) section (§)414(s) requires that a nondiscriminatory definition of compensation be used when performing the nondiscrimination tests (i.e., actual deferral percentage (ADP) test and actual contribution percentage (ACP) test) that a qualified retirement plan must satisfy.

Q: What 414(s) compensation choices are available?

A: Generally, your plan document will contain three basic definitions of plan compensation that satisfies the 414(s) compensation requirement. These three plan compensation definitions are:

- Wages, tips and other compensation reported in IRS Form W-2 (payments required to be reported under Code sections (§§) 6041, 6042 and 6051)
- Wages subject to withholding (Code §3401(a) wages)
- Code §415 compensation

Additionally, your plan document may contain one or more of the three exclusions that will automatically satisfy the 414(s) compensation requirement. These 414(s) compensation “safe harbor” adjustments are:

- Excluding compensation which is not currently includible in a participant’s gross income under Code §§ 125 (cafeteria plan), 132(f)(4) (qualified transportation fringe benefit), 402(e)(3) (401(k) plan deferrals), 402(h)(1)(B) (simplified employee pension plan), 414(h) (employer pickup contributions under a governmental plan), 403(b) (tax sheltered annuity) or 457(b) (eligible deferred compensation plan).

(Note: Compensation used in testing 415 limits always includes the elective deferrals listed.)

- Excluding reimbursements or other expense allowances, fringe benefits (cash or non-cash), moving expenses, deferred compensation (other than deferrals specified above) and welfare benefits.
- Excluding compensation paid to an employee during the nondiscrimination testing (determination) period while the employee was not a participant in the plan.

There is one additional 414(s) compensation “safe harbor” adjustment that does not require 414(s) nondiscrimination testing. Any item of compensation paid to some or all highly compensated employees (HCEs) that is excluded if the same item of compensation paid to non-highly compensated employees (NHCEs) is included. For example, a plan’s definition of compensation excludes bonuses paid to HCEs, but includes bonuses paid to NHCEs. This exclusion would automatically satisfy the 414(s) compensation definition and no 414(s) nondiscrimination testing would be required.

The compensation choices allow flexibility in choosing the compensation used for retirement plan purposes while still automatically satisfying the 414(s) nondiscrimination requirements.

Q: When is 414(s) testing required?

A: Any exclusions from plan compensation other than the exclusions previously discussed would cause plan compensation to be considered an “alternative definition” of compensation and subject to 414(s) nondiscrimination testing.

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In order to satisfy the Code §414(s) nondiscrimination requirements, an alternative definition of compensation must meet all of the following three requirements:

- An alternative definition must be reasonable.
- An alternative definition must not favor HCEs by design.
- An alternative definition must satisfy a compensation percentage test.

Q: *What is the reasonableness test?*

A: To use a non-safe harbor definition for 414(s) nondiscrimination purposes, the resulting definition must be reasonable. Aside from exclusions to HCE compensation, a reasonable modification to compensation must be applied on a consistent basis to all employees. A reasonable modification may exclude all or any portion of irregular or additional compensation. For example, exclusions of all or a portion of overtime pay, premiums for shift differential, call-in premiums and bonuses are considered reasonable exclusions.

Further, the IRS considers it a reasonable modification to compensation if one or more of the following items of compensation are excluded:

- Reimbursements or other expense allowances
- Fringe benefits (cash or non-cash), moving expenses or welfare benefits
- Deferred compensation (other than deferrals under Code §§ 125 (cafeteria plan), 132(f)(4) (qualified transportation fringe benefit), 402(e)(3) (401(k) plan deferrals), 402(h)(1)(B) (simplified employee pension plan), 414(h) (employer pickup contributions under a governmental plan), 403(b) (tax sheltered annuity) or 457(b) (eligible deferred compensation plan))

If you exclude any of the items above, the reasonableness test is satisfied. However, 414(s) testing would be required.

If **all** of these items of compensation are excluded, it is considered a 414(s) compensation “safe harbor” adjustment; therefore, no 414(s) testing is required.

The IRS does not consider it a reasonable modification to compensation if a specified percentage of each employee’s total compensation is excluded. For example, plan compensation defined as 80 percent of the employee’s Code §415 compensation would not satisfy 414(s).

Plan sponsors are responsible for ensuring the reasonableness test is satisfied.

Q: *What is an example of “favoring HCEs by design?”*

A: When a plan’s definition of compensation excludes overtime pay and the employer adopting the plan pays overtime only to NHCEs, this exclusion favors HCEs by design.

Plan sponsors are responsible for ensuring that your definition of compensation does not favor HCEs by design.

Q: *What is the compensation percentage test?*

A: An alternative definition of compensation that is reasonable and does not by design favor HCEs must also satisfy the 414(s) nondiscriminatory compensation ratio requirement, which is also referred to as the “compensation percentage test,” each year.

Any reasonable method may be used to determine the average compensation percentages for HCEs and NHCEs as long as the method used cannot reasonably be expected to create a significant variance from the average compensation percentages determined under the individual percentage method described above.

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One such method is explained below. First, calculate the individual compensation percentage for each employee. To calculate an employee's compensation percentage, the employee's compensation under the alternative definition is divided by the employee's total compensation. For example, a plan's alternative definition of compensation excludes bonuses.

- An employee's total compensation is \$60,000, including a \$3,000 bonus.
- The employee's compensation under the alternative definition is \$57,000.
- The employee's compensation percentage is \$57,000/\$60,000, or 95 percent.

Once the individual compensation percentages have been calculated, the percentages of the HCEs are averaged to determine the HCEs' average compensation percentage, and the percentages of the NHCEs are averaged to determine the NHCEs' average compensation percentage.

The HCEs' average compensation percentage cannot exceed the NHCEs' average compensation percentage by more than a de minimis amount. Whether a difference is de minimis depends on the facts and circumstances, but generally, a difference of between 1 percent and 3 percent is considered de minimis.

Q: What is an employee's "total compensation" for compensation percentage testing purposes?

A: "Total compensation" is any definition of compensation that satisfies Code §414(s).

Total compensation could be:

- W-2 wages (payments required to be reported under Code sections (§§) 6041, 6042 and 6051)
- Wages subject to withholding (Code §3401(a) wages)
- Code §415 compensation

Q: Which employees must be included in the compensation percentage test?

A: The compensation percentage test must include the employees required to be in the applicable nondiscrimination test. For example, a plan using an alternative definition of compensation provides for 401(k) deferrals and employer matching contributions. To show that the alternative definition of compensation used in performing the nondiscrimination testing for deferrals under Code §401(k) (the ADP test) satisfies the compensation percentage test, only the employees eligible to defer in that plan year would be included.

To show that the alternative definition of compensation used in performing the nondiscrimination testing for matching contributions under Code §401(m) (the ACP test) satisfies the compensation percentage test, only the employees who are eligible to receive match in that plan year would be included.

Q: What happens if the 414(s) test fails?

A: If the 414(s) test fails, a nondiscriminatory definition of compensation must be used for nondiscrimination testing. Specifically, Code §415 compensation will be used for the ADP and ACP tests. Additional nondiscrimination testing under Code §401(a)(4) is also needed to determine if an additional employer non-elective contribution is required. If a safe harbor 401(k) plan uses a definition of compensation that fails the 414(s) test, it has a qualification issue.

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Q: What does this mean to me as a plan sponsor?

A: From this overview, you can see that performing 414(s) testing can be complicated, so you may want to consider selecting one of the compensation definitions that automatically satisfies the 414(s) requirements. If you decide to reduce participants' compensation by something other than the 414(s) compensation "safe harbor" adjustments, we will notify you that 414(s) testing is needed and offer to perform the 414(s) compensation percentage test, which is one of the optional services outlined in your plan's administrative services agreement. There is an additional charge for this testing.

Reminder: You will be responsible for doing the reasonableness and design tests.

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