Common Mistakes in the Administration of Your 401(k) or Profit Sharing Plan: Compensation Definitions

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The IRS recently issued an update to its qualified plan correction guidance, the Employee Plans Compliance Resolution System ("EPCRS") which was effective January 1, 2017.

EPCRS may be used to correct plan qualification issues affecting certain types of retirement plans, including 401(k) and profit sharing plans. It permits the correction of errors either (i) by "self-correction," whereby a plan sponsor takes reasonable steps to correct an issue, or (ii) under the auspices of the IRS via its "voluntary compliance program", whereby a plan sponsor submits a proposed correction to the IRS for review, along with a user fee, and ultimately receives a compliance statement from the IRS "blessing" the correction. For the next several issues of this newsletter, I will be reviewing the most common errors plan sponsors make and how to correct them.

One of the most common plan errors that we see is the failure to use the correct definition of compensation to calculate participant deferrals and employer contributions. There are many different types of compensation that can be included or excluded from the definition of eligible compensation, such as bonuses, overtime pay, commissions, auto and other allowances, and fringe benefits, among others. Additionally, some plans use different definitions of compensation for employee deferrals, employer match, and even profit-sharing contributions, further complicating the calculations and plan administration.

What is the correct compensation? That depends on the employer's demographics and pay practices. Whatever definition(s) are chosen, each plan's definition of compensation must be clearly defined in the plan document. This may have been carefully selected when the plan was original created but may not have been reviewed when new payroll codes were implemented, or new employees hired.

Correcting this error can be quite burdensome for plan sponsors. The sponsor may have to go back multiple years to recalculate the correct definition of compensation for all employees and contribute additional amounts to the plan in order to make the plan participant accounts whole for any missed contributions and lost earnings. Plan administrators also need to consider the treatment for participants who have left the plan and may be due contributions as a result of this error. It is important to review the existing definitions of compensation in your plan document and summary plan description and if there are any discrepancies between the documents and actual practice, please contact us so we can help you determine the best correction method.

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