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401(k) Plans

Communicating Compensation

Complexities in defining and calculating compensation require a team approach to achieve clients' desired outcomes. The client, TPA, CPA, and actuary need to work together to determine compensation and eligible deduction amounts, especially after 199A and Tax Cuts and Jobs Act changes.

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Internal Revenue (Code) Section 199A was created with the passage of the Tax Cuts and Jobs Act (TCJA) on December 22, 2017. Section 199A allows for owners of sole proprietorships, S Corporations, or partnerships to deduct up to 20 percent of the income earned by the business. This deduction allows these business owners to keep pace with the significant corporate tax cut provided to C corporations.

C corporation income is subject to taxation at the entity level and again at the shareholder level when the corporation distributes the income as a dividend. While the TCJA retained the top tax rate on dividend income of 20 percent, it reduces the top corporate rate from 35 percent to a flat rate of 21 percent.

Meanwhile, owners of sole proprietorships, S Corporations, or partnerships are subject to a single level of tax. While TCJA reduced the ordinary income

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for such individuals from 39.6 percent to 37 percent, it also enacted Code Section 199A, retaining for such owners the similarly sizeable tax advantage over C corporations that existed before the new law. The new concept of Qualified Business Income (QBI) also affects the definition of compensation for retirement plan purposes.

Section 199A significantly affects the overall taxability for entities with pass-through income. This article discusses the intricacies of calculating deductible contribution amounts for the 401(k) client in light of the new rules, and the need for the Third Party Administrator (TPA) to work hand-in-hand with clients and their other trusted advisors to end up with the desired tax and benefit results. (A more detailed explanation of Section 199A can be found in the article by Kevin Donovan beginning on page 3 of this issue.)

Defining Compensation

In the 401(k) world, the plan design is often a matter of simply allowing participants to defer a portion of their paycheck on a pre-tax or Roth basis. On the participant's side, the choices are fairly straightforward: pre-tax or after-tax, and which investments to select from the available line-up. If there is a matching contribution, it rarely poses a deductibility concern for the employer just by the nature of the formula and relatively small percentage of eligible compensation. While the contributions may be straightforward, the difficulty comes with how complex the compensation definition is that the plan sponsor and the plan designer developed in relation to the contribution calculation. Collecting correct compensation and using that data properly present compliance issues on a regular basis. Compensation problems continue to be one of the most common errors discovered by auditors, often due to the complexities of the compensation definition, payroll systems not being set up to accommodate it properly, or a misunderstanding of the components of includible compensation by the employer.

Those issues may arise even with the simplest of compensation definitions, such as where all employees receive W-2 compensation and there is no pass-through income. If defining eligible compensation can be a challenge even with a straightforward plan, the practitioner must be even more diligent with self-employed, partnership, and other pass-through income to ensure that the correct compensation is used, for both the employer's and the employees' sakes. Typically, an employer does not understand the complexity of compensation use for calculation of benefits and expects its advisors—TPA, CPA, and actuary—to help get to the desired result.

Communicating Compensation to Employer

In an ideal world, the plan design would begin with a conversation that includes the plan sponsor, the plan consultant responsible for plan design, the person who best understands the payroll, the accountant who best understands the tax implications, and the investment advisor. Frequently, not all parties are involved, and miscommunications may result. Many plans define compensation as W-2 compensation. The consultant designing the plan should inquire about items that the employer may want to exclude from pay for calculation of contributions. Some of the most frequently problematic exclusions, whether excluded intentionally or otherwise, are:

- *Bonuses.* Employers may pay bonuses through special paychecks that are created manually or otherwise avoid the regular payroll process. For these situations, it is best to determine whether a special election is desired and address how that should be administered appropriately.
- *Special incentives.* Gift cards are taxable, and so should be included in W-2 compensation; but there will not be deferrals withheld from those funds. Should they be excluded from compensation? Other types of incentives are frequently paid in special checks and included in W-2 taxable income, but not in deferral calculations.
- *Cafeteria plan deductions.* Pre-tax cafeteria plan deferrals are not includible in W-2 compensation. Employers who are told to report W-2 compensation for contribution calculations may miss reporting gross wages and, as a result, may short-change employees who have contributed to the cafeteria plan.

After determining how the employer pays its employees and what it wants to include or exclude, the plan design consultant must then determine what will be problematic for the plan design and for the employer. Just because compensation can be excluded, it does not automatically follow that it should be—or that the exclusion does not create ramifications with which the parties must deal! For example, those exclusions may mandate additional compliance testing, which can be particularly disconcerting for a safe harbor plan design that was intended to eliminate non-discrimination testing. The advisors need to make

sure that the employer understands all the results caused by the choices it makes in relation to compensation. The employer needs to also understand that if it uses special compensation definitions, it will need to be able to provide the plan consultant with the correct information needed. That may require extensive payroll reports that the payroll provider is not in a position to prepare.

Collecting Data from the Employer

When the employer understands how compensation is defined, it is more likely to provide the appropriate compensation for contribution calculation for employees. The plan consultant must decide whether it will depend on the employer to provide accurate compensation, or take additional steps to ensure that it is correct. Our firm, for example, has chosen to request census information electronically, as well as a copy of Form W-3 and a gross payroll report, so that we can reconcile compensation for plan purposes. This is done even for employers that choose to upload their payroll information each pay date to their investment platform. It is not unusual to find that those special bonus payrolls did not make it into the regular upload because there were no deferral contributions taken. Other payments reported on final Forms W-2 for S-Corporation shareholders, such as medical expenses, typically are not reported on payroll uploads, but would be included in income for contribution calculations. Those items are found by reconciling gross compensation payroll reports with Forms W-3 and individual Forms W-2 when discrepancies arise.

Employers with Pass-Through Income

If all of the above complexities come with "straightforward" W-2 income, pass-through or self-employment income add another dimension to communicating and gathering the information needed to calculate an appropriate and deductible contribution amount for the client. The plan consultant and accountant must work closely together to ensure that the correct compensation and deductions are used together to maximize, or even just correctly calculate, employer contributions. If there also is a related cash balance or defined benefit plan, the actuary will be a significant part of the conversation as well.

With the changes coming from Section 199A, plan consultants will need to work closely with accountants in regard to partnership and sole-proprietor income. Also, the dichotomy caused by the two different types of S-corporation shareholder income affects not only the compensation used for plan purposes, but also the definition of QBI for purposes of the 20 percent deduction. Therefore, the considerations in determining what part of the company income will be paid to the shareholder as W-2 compensation, and what part will flow through to the shareholder as profit (and, therefore, QBI), are much broader than they were pre-TCJA. It will be imperative for the accountant, TPA, and (where relevant) the actuary to be involved in calculating contributions for owner-employees, particularly in 2019 as we work through how the new rules will operate on a practical basis.

To facilitate those computations, the plan consultant will still need to gather the correct compensation for rank-and-file employees and work through required contributions, such as safe harbor contribution commitments, and communicate that information to the accountant so that the owner-employer's compensation can be properly calculated.

Opportunities for the Plan Consultant

The opportunity for the plan consultant is to enlarge his or her role to consult not only with the client, but with the accountant and other advisors as well. While plan consultants are focused on what QBI is and what effect that will have on their client's business, even whether they should change the business entity to take tax advantage of different thresholds, they may not be aware of how the plan and certain types of contributions may be used to their client's advantage; for example, increasing the contribution may lower the QBI to a level where the 20-percent deduction is preserved. The TPA plan consultant could take the opportunity to be advisor to the accountant in that aspect.

It may also be time for the plan consultant to review the definition of compensation with all of his or her clients. Each employer will need to figure out the best practice and normal operating procedures for determining and reporting compensation to the TPA and plan consultant, and that process may be a challenge that requires assistance. Additionally, the plan consultant should evaluate how it is requesting compensation information, how it may need to change its collection process with its clients, and how it may best build the bridge with its clients' accountants—essentially, creating an information highway rather than a roadblock. The desired outcome is to provide the client with the tools and plan design that meets its needs while working with the accountant and actuary

to provide the desired tax reduction and plan benefits, as well.

Conclusion

TCJA provides many new opportunities for retirement plans to assist plan sponsors in tax planning, as well as accumulating benefits for the future. While we need to concentrate on the new rules within which we must operate, we must also remember to consider how to take best advantage of those rules, and how to ensure that information passes effectively from plan sponsors to their advisors. Part of the challenge we face as retirement plan practitioners is to assist in that part of the process. ■

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