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ADP/ACP Safe Harbor Compensation Compliance Confusion

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ADP and ACP safe harbor plans require that a nondiscriminatory definition of compensation be used to determine safe harbor matching contributions. However, the plethora of permitted compensation definitions, and the rules surrounding them, can create compliance issues, particularly if the plan document, payroll, and record keeping are not properly coordinated.

INTRODUCTION

The actual deferral percentage (ADP) and actual contribution percentage (ACP) safe harbors generally require use of an Internal Revenue Code (Code) Section 414(s) definition of compensation. However, there are several possible safe harbor compensation definitions available. Further, the ADP and ACP safe harbors are permitted to use alternative compensation definitions that also satisfy Code Section 414(s). Finally, the ADP and ACP safe harbor regulations permit yet another alternative definition of compensation for purposes of limiting the types of compensation that may be deferred or contributed, which may be different than the definition of compensation for purposes of determining ADP and ACP safe harbor matching contributions. For ease of exposition, this article focuses on elective deferrals and does not consider after-tax (non-Roth) employee contributions in the context of ADP and ACP safe harbor designs.

While all these choices for safe harbor compensation may be a good thing, such abundance can lead to compliance issues in plan administration, particularly if the plan document, payroll, and record keeping are not properly coordinated. Plan compensation documentation and administration is an area of focus of the Internal Revenue Service (IRS) from which some of the most common defined contribution plan mistakes are found. Issues around compensation are also among the top errors uncovered by auditors and the U.S. Department of Labor (DOL). This article considers safe harbor matching contributions and does not consider the use of ADP and ACP safe harbor nonelective contributions.¹

COMPENSATION USED FOR ADP AND ACP SAFE HARBORS MUST BE NONDISCRIMINATORY

Compensation for purposes of the ADP and ACP safe harbor designs must consist of nondiscriminatory compensation as defined by regulations under Code Section 414(s).² Code Section 414(s) compensation rules are designed to prohibit compensation definitions that disproportionately include a greater percentage of total compensation for highly compensated employees (HCEs) than for non-highly compensated employees (NHCEs), that is, that discriminate in favor of HCEs. Several *safe harbor* 414(s) definitions of compensation are automatically deemed to be nondiscriminatory. Other, alternative, *nonsafe harbor* 414(s) compensation definitions can satisfy 414(s) requirements, provided that they: (1) do not by design favor HCEs, (2) satisfy certain requirements to be “reasonable,” and (3) satisfy a numerical pay inclusion test.³

SAFE HARBOR 414(s) DEFINITIONS OF COMPENSATION

The fundamental safe harbor definitions of compensation are the total compensation definitions of Code Section 415. Each definition of compensation for purposes of Code Section 415 automatically satisfies Code Section 414(s).⁴ In addition to the total compensation safe harbor definitions, there are alternative safe harbor compensation definitions, reduced safe harbor compensation definitions, and HCE reduction only safe harbor compensation definitions, each of which is described in more detail below. All nondiscriminatory compensation definitions, including the alternative 414(s) nonsafe harbor compensation definitions described later, derive from the total compensation definitions of Code Section 415.

Total Compensation 414(s) Safe Harbor Definitions

Safe harbor 414(s) definitions of pay start with one of the following four *total compensation* definitions provided under Treasury regulations for Code Section 415:⁵

- (1) A “general” definition of total compensation, which includes wages, salaries, and other amounts received for personal services actually rendered in the course of employment with the employer maintaining the plan to the extent the amounts are includible in gross income or to the extent amounts would have been received and includible in gross income but for an election under Code Sections 125(a), 132(f)(4), 402(e)(3), 402(h)(1)(B), 402(k), or 457(b), plus certain other items and excluding certain other items of compensation;⁶
- (2) A “simplified general” definition that excludes certain items otherwise included in the general definition;⁷
- (3) Wages for purposes of income tax withholding under Code Section 3401, modified to disregard rules that limit wages based on the nature or location of employment, plus amounts that would be included in wages but for an election under Code Sections 125(a), 132(f)(4), 402(e)(3), 402(h)(1)(B), 402(k), or 457(b);⁸ or
- (4) Form W-2, Box 1, compensation, which includes amounts that are compensation under (3) immediately above, plus all other payments of compensation to an employee by the employer for which the employer is required to furnish the employee a written statement under Code Sections 6041(d), 6051(a)(3), and 6052. The

definition under this paragraph (4) may be modified to exclude amounts paid or reimbursed by the employer for moving expenses incurred by the employee, but only to the extent that, at the time of the payment, it is reasonable to believe that the amounts are deductible by the employee under Code Section 217.⁹

While the included and excluded items of compensation vary somewhat among these four definitions of total compensation, the differences are not generally substantial in dollar terms, but could be in some cases. The differences relate primarily to employer-paid disability, distributions from nonqualified plans, and items relating to employer stock, such as stock options or appreciation rights. The total compensation definitions can be used when safe harbor compensation is required for the ADP or ACP safe harbor designs.¹⁰

Alternative Safe Harbor 414(s) Compensation Definitions

An *alternative safe harbor* 414(s) safe harbor compensation definition is any of the preceding four definitions of total compensation 414(s) safe harbor definitions reduced by *all* of the following items, even if includible in gross income:¹¹

- Reimbursements or other expense allowances;¹²
- Fringe benefits (cash and noncash);¹³
- Moving expenses;
- Deferred compensation;¹⁴ and
- Welfare benefits.¹⁵

Like the total compensation definitions, an alternative safe harbor definition can be used when safe harbor compensation is required for the ADP or ACP safe harbor designs.¹⁶

Reduced Safe Harbor 414(s) Compensation Definitions

A *reduced safe harbor* 414(s) safe harbor compensation definition is any of the four total compensation safe harbors or any of the alternative safe harbor compensation definitions, but reducing either by *all* of the following pre-tax amounts:

- Amounts contributed by the employer pursuant to a salary reduction agreement that are not includible in the gross income of an

employee under Code Section 125 (*i.e.*, a cafeteria plan), such as employee-paid health insurance premiums and employee contributions to flexible spending accounts;

- Amounts contributed by the employer pursuant to a salary reduction agreement that are not includible in the gross income of an employee under Code Section 132(f)(4) (*i.e.*, qualified transportation fringe benefits); and
- Amounts contributed by the employer pursuant to a salary reduction agreement that are not includible in the gross income of an employee under Code Section 402(e)(3), 402(h), or 403(b) (*i.e.*, elective deferrals to a 403(b), 401(k), or 408(k) simplified employee pension plan and, perhaps, a 457(b) plan).¹⁷

A reduced safe harbor definition can be used when safe harbor compensation is required for the ADP or ACP safe harbor designs.¹⁸

HCE Reduction Only Safe Harbor 414(s) Compensation Definitions

Any of the preceding 414(s) safe harbor compensation definitions (total compensation, alternative safe harbor, or reduced safe harbor) can be modified to exclude any portion of the compensation received by some (or all) HCEs, but without any similar reduction for any NHCEs, and remain safe harbor compensation for the ADP or ACP safe harbor designs.¹⁹

ALTERNATIVE 414(s) NONSAFE HARBOR COMPENSATION DEFINITIONS

An *alternative 414(s) nonsafe harbor* compensation definition is a definition of compensation that:

- Does not by design favor HCEs;
- Satisfies certain requirements to be considered reasonable; and
- Satisfies a mathematical *pay inclusion test*.²⁰

Such an alternative nonsafe harbor definition satisfies Code Section 414(s) and can be used when safe harbor compensation is required for the ADP or ACP safe harbor designs. This is different than

a compensation definition that is not safe harbor and does *not* satisfy 414(s), which *cannot* be used when a 414(s) definition of compensation is required, such as when safe harbor compensation is required for the ADP or ACP safe harbor designs.

Definition Does Not by Design Favor HCEs

The first requirement, that the compensation definition must not by design favor HCEs, is really an anti-abuse rule, based on facts and circumstances. For example, a definition of pay that only included \$10,000 of pay plus any pay in excess of the minimum amount to be considered an HCE (*e.g.*, \$120,000 in 2016) would by design favor HCEs.

Reasonable Compensation Test

A compensation definition is reasonable for purposes of Code Section 414(s) if it is one of the safe harbor definitions described above (total compensation, alternative safe harbor, reduced safe harbor, or HCE reduction only safe harbor) modified to *exclude*, on a consistent basis, all or any portion of irregular or additional compensation, including but not limited to one or more of the following:²¹

- Any type of additional compensation for employees working outside their regularly scheduled tour of duty, such as overtime pay, premiums for shift differential, and call-in premiums;
- Bonuses; or
- Any one or more of the types of compensation excluded under the alternative safe harbor compensation definition described above, that is, reimbursements or other expense allowances, fringe benefits (cash and noncash), moving expenses, deferred compensation, or welfare benefits.

Whether any particular type of compensation is irregular or additional is determined based on all relevant facts and circumstances.

A reasonable definition of compensation is also permitted to *include*, on a consistent basis, all or any portion of the of the types of compensation excluded to obtain a reduced safe harbor compensation definition described above, that is, amounts contributed by the employer pursuant to a salary reduction agreement that are not includible in the gross income of an employee under Code Section 125, 132(f)(4), 402(e)(3), 402(h), or 403(b).²²

A nonsafe harbor definition is not reasonable if it uses a specified portion or percentage of compensation for an otherwise applicable

period. For example, a definition that takes into account only 95 percent of employees' Code Section 415 compensation would not be reasonable nor would a definition using one month of compensation to satisfy a provision with a 12-month compensation period. A nonsafe harbor definition can exclude all compensation in excess of a specified dollar amount *except* for purposes of an ADP/ACP safe harbor design.²³

Pay Inclusion Test

The purpose of the pay inclusion test is to ensure that the non-safe harbor definition to be used for nondiscrimination testing does not include disproportionately more compensation for HCEs than for NHCEs, which could cause an ADP or ACP safe harbor design to favor HCEs.²⁴ The nonsafe harbor compensation definition cannot be larger than the total compensation 414(s) safe harbor compensation definition and such total compensation cannot exceed the annual compensation limit of Code Section 401(a)(17).²⁵

The first step of the pay inclusion test is to calculate an inclusion percentage for each participant by dividing the nonsafe harbor compensation for the participant by the participant's total compensation, as defined by one of the total compensation safe harbor definitions described above (or one of those total compensation safe harbor definitions as a reduced safe harbor definition described above). For example, an inclusion percentage would be calculated for each employee eligible for matching contributions under the plan, that is, each employee who would receive a match on match eligible deferrals (or match eligible after-tax contributions), regardless of whether the employee actually makes match eligible deferrals (or match eligible after-tax contributions).

The second step of the pay inclusion test is to separate the participants into HCEs and NHCEs, and then average the inclusion percentages separately for the HCEs and NHCEs.²⁶ To pass the pay inclusion test, the average HCE inclusion percentage must not exceed the average NHCE inclusion percentage by more than a *de minimis* amount, based on all the relevant facts and circumstances. The IRS has not provided a numerical value of what is meant by a *de minimis* amount, as it is intended to be an anti-abuse rule like most other facts and circumstances tests.²⁷ Of course, the pay inclusion test is satisfied if the average HCE inclusion percentage is less than the average NHCE inclusion percentage.

Potential Concern with Alternative Nonsafe Harbor Compensation for ADP/ACP Safe Harbor

One potential concern with using an alternative nonsafe harbor compensation definition for an ADP or ACP safe harbor design plan is that the pay inclusion test generally cannot be performed until after the year

ends.²⁸ If it turns out the alternative nonsafe harbor compensation definition does not pass the pay inclusion test for the year, then the plan would not be an ADP or ACP safe harbor plan for the year. Because notice of the safe harbor plan must generally be provided to participants prior to the start of the plan year and must include “sufficiently accurate and comprehensive” information about the plan, including “The type and amount of compensation that may be deferred under the plan,” it would seem that the safe harbor definition of compensation could not be changed midyear, if it seemed the pay inclusion test would not otherwise be satisfied.²⁹

THE INCREDIBLE SHRINKING SAFE HARBOR COMPENSATION

One result of excluding elective deferrals from a plan’s definition of safe harbor compensation is that safe harbor compensation itself is then affected by the participant’s elective deferrals. The examples below illustrate how, in such instance, safe harbor compensation decreases as deferrals increase, which affects the safe harbor matching contributions.

For simplicity, we consider a 401(k) plan that defines safe harbor compensation as reduced safe harbor compensation based on a total compensation safe harbor definition.³⁰ Suppose the plan sponsor has no Code Section 132(f)(4) qualified transportation fringe benefits and, rather unrealistically, no Code Section 125 plan, such that the only difference between a participant’s gross compensation and safe harbor compensation is the amount of the participant’s elective deferrals to the 401(k) plan.³¹ Assume further that the plan uses the basic matching formula of the ADP safe harbor regulations to provide a safe harbor matching contribution equal to 100 percent of the amount of elective deferrals that do not exceed 3 percent of the participant’s safe harbor compensation plus 50 percent of the amount of elective deferrals that exceed 3 percent of the participant’s safe harbor compensation but that do not exceed 5 percent of the participant’s safe harbor compensation.³²

Example with Five Percent Deferral Election

If a participant elects to defer 5 percent of compensation and the election is applied to the participant’s gross compensation rather than to the participant’s safe harbor compensation, the 5 percent election ends up being a deferral election of 5.2632 percent on safe harbor compensation.³³ For a participant with gross income of \$40,000, the 5 percent election on gross income would equal \$2,000, reducing the participant’s safe harbor compensation to \$38,000. To satisfy the ADP safe harbor, only the deferrals on the first 3 percent of \$38,000 would be matched at the 100 percent matching rate, yielding a match of \$1,140. The next 2 percent of deferrals

on \$38,000 would be matched at the 50 percent matching rate, yielding an additional match of \$380, for a total safe harbor match of \$1,520.

If the 5 percent deferral election is applied to safe harbor compensation, the amount of the deferral itself affects the safe harbor compensation and the corresponding deferral percent of gross compensation is 4.7619 percent.³⁴ The participant's safe harbor compensation becomes \$38,095.24 and the participant's deferrals become \$1,904.76. To satisfy the ADP safe harbor, only the deferrals on the first 3 percent of \$38,095.24 would be matched at the 100 percent matching rate, yielding a match of \$1,142.86. The next 2 percent of deferrals on \$38,095.24 would be matched at the 50 percent matching rate, yielding an additional match of \$380.95, for a total safe harbor match of \$1,523.81.

Example with Ten Percent Deferral Election

Now repeat the prior example, but with a 10 percent deferral rate. If the deferral election is applied to the participant's gross compensation rather than to the participant's safe harbor compensation, the 10 percent election ends up being a deferral election of 11.1111 percent on safe harbor compensation. For the participant with gross income of \$40,000, the 10 percent election on gross income would equal \$4,000, reducing the participant's safe harbor compensation to \$36,000. To satisfy the ADP safe harbor, only the deferrals on the first 3 percent of \$36,000 would be matched at the 100 percent matching rate, yielding a match of \$1,080. The next 2 percent of deferrals on \$36,000 would be matched at the 50 percent matching rate, yielding an additional match of \$360, for a total safe harbor match of \$1,440.

If the 10 percent deferral election is applied to safe harbor compensation, the amount of the deferral again affects the safe harbor compensation and the corresponding deferral percent of gross compensation is 9.0909 percent. The participant's deferrals are then \$3,636.36 and the participant's safe harbor compensation is \$36,363.64. To satisfy the ADP safe harbor, only the deferrals on the first 3 percent of \$36,363.64 would be matched at the 100 percent matching rate, yielding a match of \$1,090.91. The next 2 percent of deferrals on \$38,095.24 would be matched at the 50 percent matching rate, yielding an additional match of \$363.64, for a total safe harbor match of \$1,454.55.

Safe Harbor Matching Contributions Can Shrink as Deferral Election Increases

The examples above illustrate that, if a plan's safe harbor compensation excludes elective deferrals, the dollar amount of elective deferrals and safe harbor matching contributions can be different, depending whether the plan bases elective deferrals on gross compensation or

the plan's safe harbor compensation. Further, if a plan's safe harbor compensation excludes elective deferrals, the dollar amount of safe harbor matching contributions can, and generally will, decrease as the percentage deferral election increases deferrals beyond the minimum deferrals needed to receive the plan's maximum safe harbor matching contributions.

The examples also illustrate the importance of aligning plan document provisions, payroll practices, and record keeping requirements to both ensure that the ADP/ACP safe harbor plan provides the safe harbor matching contributions required by the plan document and ensure that the ratio of matching contributions made on account of any individual HCE's deferrals for the plan year to that individual's deferrals is not greater than the ratio of matching contributions to deferrals that would apply with respect to any eligible NHCE with deferrals at the same percentage of safe harbor compensation.³⁵ In the examples above, whether the deferral percentage elected is based on gross compensation or the plan's definition of safe harbor compensation, the safe harbor matching contribution equals 100 percent of the amount of the elective deferrals that does not exceed 3 percent of the participant's safe harbor compensation plus 50 percent of the amount of the elective deferrals that exceeds 3 percent of the participant's safe harbor compensation but does not exceed 5 percent of the participant's safe harbor compensation. However, the total dollar amount of the safe harbor matching contribution is different, depending on whether the deferral percentage elected is based on gross compensation or the plan's definition of safe harbor compensation, and the administration of the plan should follow whichever compensation the plan requires to determine the amount of elective deferrals.

COMPENSATION TO DETERMINE DEFERRALS NEED NOT BE SAME AS TO DETERMINE MATCH

As indicated above, the compensation defined by the plan document to determine elective deferrals as a percentage of compensation need not be the same as the ADP/ACP safe harbor plan's definition of safe harbor compensation used to determine safe harbor matching contributions. Further, the ADP safe harbor regulations expressly permit an ADP/ACP safe harbor plan to limit the types of compensation that may be deferred, provided that each eligible NHCE is permitted to make deferrals under a definition of compensation that would satisfy the reasonableness test described previously in this article, without regard to the pay inclusion test described previously.³⁶ However, this does not mean, as some may have initially imagined, that the ADP safe harbor does not

require a pay inclusion test of an alternative non-safe harbor definition of compensation used to satisfy the ADP/ACP safe harbor designs. The regulations never say that such compensation limited for deferral purposes can be used as safe harbor compensation.

Example from ADP Safe Harbor Regulations

The ADP safe harbor regulations provide an example of limiting the types of compensation that may be deferred, using an enhanced matching formula rather than the basic matching formula in the examples above.³⁷ The enhanced matching formula of the example in the regulations provides a safe harbor matching contribution equal to 100 percent of each eligible employee's deferrals up to 4 percent of safe harbor compensation.³⁸ Safe harbor compensation is defined under the plan as one of the total compensation safe harbor definitions. Deferrals under the plan are limited to 15 percent of the employee's basic compensation, which is defined under the plan as total compensation excluding overtime pay. The example in the regulations concludes that such basic compensation definition satisfies the reasonableness test and does not cause the plan to fail the ADP/ACP safe harbor requirements, provided that each eligible NHCE is able to make elective deferrals equal to at least 4 percent of the employee's safe harbor compensation.³⁹

Importantly, the example does not use basic compensation as safe harbor compensation. A definition of total compensation is used as safe harbor compensation and each eligible NHCE must be able to make elective deferrals equal to at least 4 percent of the employee's safe harbor compensation. Presumably, if the example had also used basic compensation as safe harbor compensation, the example would have required the pay inclusion test as well as the reasonableness test apply to basic compensation.

Potential for Misunderstanding and Plan Errors

The example in the regulations does not elaborate, but a participant with overtime pay who elects to defer 4 percent of compensation under the plan would not necessarily receive the full match available under the plan. Consider a participant with \$45,000 in total compensation of which \$5,000 is overtime pay. If the participant elects to defer 4 percent of compensation, the 4 percent must be determined using basic compensation under the terms of the plan, which excludes the overtime pay and for this participant is \$40,000. The 4 percent election translates into \$1,600 of deferrals. However, the maximum safe harbor match under the plan is 4 percent of total compensation, which for this participant would be \$1,800. The participant would need to make a deferral election of 4.5 percent of compensation to receive the maximum

safe harbor matching contribution. Without proper communication, the participant might think only a 4 percent deferral election is required to receive the maximum matching contribution. Inadequate communication of the plan's terms among the plan sponsor, payroll provider, and plan record keeper could result in a plan error requiring correction to maintain plan qualification if, for example, the participant making the 4 percent deferral election is provided with matching contributions equal to \$1,800.

Broad Compensation for Deferrals, Limited Compensation for Safe Harbor Match

Some plan sponsors wish to allow elective deferrals broadly on compensation, but base safe harbor matching contributions on a more limited definition of compensation. This is permissible under the ADP/ACP safe harbor regulations, provided the safe harbor matching contribution requirements are satisfied, but may be more difficult to administer and more prone to errors than if both deferrals and matching contributions are based on the same safe harbor definition of compensation.⁴⁰

An Example Excluding Bonuses and Overtime

Consider a plan that determines elective deferrals based on a percentage of one of the total compensation safe harbor definitions but excludes overtime and bonuses from total compensation to determine safe harbor matching contributions. Suppose the plan uses the same enhanced matching formula of the example in the regulations described above to provide a safe harbor matching contribution equal to 100 percent of each eligible employee's deferrals up to 4 percent of safe harbor compensation. However, in this case the safe harbor compensation is an alternative nonsafe harbor compensation definition that would be subject to the pay inclusion test.

A participant in the plan has \$60,000 in total compensation of which \$10,000 is overtime and bonus. The participant elects to defer 4 percent of total compensation, which is \$2,400. The \$2,400 amount of deferrals is 4.8 percent of the participant's safe harbor compensation. The plan provides safe harbor matching contributions equal to 100 percent of elective deferrals, but only up to 4 percent of safe harbor compensation, which for this participant is \$50,000, so the participant is entitled to a safe harbor matching contribution of \$2,000. If the participant had no overtime or bonus, such that the \$60,000 in total compensation was also the participant's safe harbor compensation, the participant would be entitled to a safe harbor matching contribution of \$2,400 instead.

Compliance reviews of plan administration occasionally uncover situations of the safe harbor match being provided on the basis of the amount of elective deferrals without regard to the plan's definition of safe harbor compensation. In the instant example with total compensation including \$10,000 of overtime and bonus, such an error would translate into the participant receiving a 100 percent match on the \$2,400 of elective deferrals, despite only being entitled to a safe harbor matching contribution of \$2,000 under the terms of the plan.

Base Pay as Safe Harbor Compensation

At one end of the plan design spectrum, some plans permit elective deferrals on total compensation and provide the ADP/ACP safe harbor matching contribution on base pay. Such an ADP/ACP safe harbor design introduces all three complications described in this article:

- Requires a pay inclusion test of base compensation as an alternative nonsafe harbor compensation definition;
- Must take into account the different compensation definitions when determining the safe harbor match on the elective deferrals; and
- Safe harbor compensation shrinks as the elective deferral percentage increases, which can decrease safe harbor matching contribution amounts.

CONCLUSION

Plan advisors should work closely with plan sponsors, payroll administrators, record keepers, and others involved in preparing plan documents (whether individually designed or pre-approved plan documents and their adoption agreements) and setting up payroll and plan administration, both to ensure all parties understand how the plan is supposed to work and to ensure administration of the plan matches that understanding in compliance with the ADP and ACP safe harbor requirements. As noted in the Introduction, compliance issues surrounding plan compensation are among the top errors uncovered by the IRS, DOL, and plan auditors.

NOTES

1. See Treas. Reg. §§ 1.401(k)-3(b) and 1.401(k)-3(c) for the distinction between safe harbor non-elective contributions and safe harbor matching contributions.

2. As modified by Treas. Reg. §§ 1.401(k)-3(b)(2), 1.401(k)-3(c)(6)(iv), 1.401(k)-6, 1.401(m)-3(d)(6)(iv), and 1.401(m)-5.
3. This article does not discuss certain Code § 414(s) compensation definitions based on rates of pay or the use of prior-employer and imputed compensation permitted by the applicable regulations in certain circumstances. Code § 414(s) definitions based on rates of pay are not permitted for purposes of the ADP or ACP tests, including use of the ADP or ACP safe harbor designs. *See* Treas. Reg. § 1.414(s)-1(e)(2). Prior-employer and imputed compensation are permitted for purposes of Code § 414(s) solely for defined benefit plans. *See* Treas. Reg. § 1.414(s)-1(f)(1).
4. *See* Code § 414(s)(1). Note that Treas. Reg. § 1.414(s)-1(c)(4) has not been revised to reflect the addition of Code § 415(c)(3)(D), which expressly adds elective deferrals, as defined in Code § 402(g)(3), and any amount contributed or deferred by the employer at the election of an employee that is not includible in the gross income of the employee by reason of Code § 125, 132(f)(4), or 457. Prior to the addition of Code § 415(c)(3)(D), compensation for purposes of Code § 415 did not include those amounts, which is why Treas. Reg. § 1.414(s)-1(c)(4) was written to permit them to be added. Code § 414(s)(1) was simultaneously amended by the Small Business Job Protection Act of 1996 (and further amended by the Consolidated Appropriations Act of 2001) to permit those amounts to be subtracted when Code § 415(c)(3) was amended to add them.
5. *See* Code § 414(s)(1) and Treas. Reg. § 1.414(s)-1(c)(2).
6. *See* Treas. Reg. §§ 1.415(c)-2(b) and 1.415(c)-2(c).
7. *See* Treas. Reg. § 1.415(c)-2(d)(2).
8. *See* Treas. Reg. § 1.415(c)-2(d)(3).
9. *See* Treas. Reg. § 1.415(c)-2(d)(4).
10. *See* Treas. Reg. §§ 1.414(s)-1(c)(2), 1.401(k)-3(b)(2), 1.401(k)-6, and 1.401(m)-5.
11. *See* Code § 414(s)(3) and Treas. Reg. § 1.414(s)-1(c)(3).
12. According to this linked internal IRS training chapter on retirement plan compensation, reimbursements, or other expense allowances for this purpose would include when “your company pays you back for expenditures for childcare, traveling expenses, etc.”: <http://www.irs.gov/pub/irs-tege/epchd304.pdf>.
13. According to the internal IRS training chapter on retirement plan compensation referenced in footnote 12, for this purpose these are any taxable “extras,” such as the personal use of a company car, educational assistance, etc.
14. According to the internal IRS training chapter on retirement plan compensation referenced in footnote 12, deferred compensation for this purpose is any income earned at the present date but will be provided to the employee at a later date.
15. According to the internal IRS training chapter on retirement plan compensation referenced in footnote 12, for this purpose these are certain benefits provided by the employer, such as disability insurance, college scholarship funds, prepaid legal services, or unemployment benefits.
16. *See* Treas. Reg. §§ 1.414(s)-1(c)(3), 1.401(k)-3(b)(2), 1.401(k)-6, and 1.401(m)-5.
17. The treatment of 457(b) deferrals or simple retirement account deferrals is not completely clear. Code Section 414(s) does not expressly permit the exclusion of 457(b) deferrals, but the regulations under 414(s) do. However, as noted in footnote 3 above, the 414(s) regulations

have not been revised to reflect statutory changes. Neither Code Section 414(s) nor the 414(s) regulations expressly permit the exclusion of simple retirement account deferrals under Code § 408(p)(2)(A)(i) either, but their exclusion would be consistent with the treatment of the other elective deferrals

18. *See* Treas. Reg. §§ 1.414(s)1(c)(4), 1.401(k)-3(b)(2), 1.401(k)-6, and 1.401(m)-5. *But also see* footnote 4 above.
19. *See* Treas. Reg. §§ 1.414(s)1(c)(5), 1.401(k)-3(b)(2), 1.401(k)-6, and 1.401(m)-5.
20. *See* Treas. Reg. § 1.414(s)1(d).
21. *See* Treas. Reg. § 1.414(s)1(d)(2).
22. *See* Treas. Reg. § 1.414(s)1(d)(2)(ii).
23. *See* Treas. Reg. §§ 1.401(k)-3(b)(2), 1.401(m)-3(d)(6)(iv), and 1.414(s)-1(d)(2)(iii).
24. *See* Treas. Reg. § 1.414(s)1(d)(3). Note that the regulations permit certain employees to be disregarded and apply some special rules if the alternative non-safe harbor compensation definition excludes amounts for some but not all HCEs.
25. For this reason, a definition that includes employee deferrals to a nonqualified retirement plan (with the possible exception of employee deferrals to a 457(b) plan) cannot satisfy 414(s). *See also* footnote 17 above.
26. *See* Treas. Reg. § 1.414(s)1(c)(3)(iv)(A). Instead of calculating individual inclusion percentages, an employer can use any other reasonable method to determine an average inclusion percentage for either or both groups (HCEs and NHCEs). The 414(s) regulations allow testing to be based on an aggregate inclusion percentage equal to the aggregate amount of compensation included under the nonsafe harbor definition for all employees in the group divided by the aggregate amount of total compensation for employees in that group. This method is available only if it is not reasonably expected to vary significantly from the average percentage produced by using the individual percentage method. *See* Treas. Reg. § 1.414(s)1(c)(3)(iv)(B).
27. While not directly relevant, some practitioners have referred to the spin-off and merger rules of Code Section 414(l), where the term *de minimis* has been defined by regulations to mean 3 percent. Other practitioners, taking a more conservative approach, have concluded that employers should proceed cautiously where the HCE average exceeds the NHCE average by any amount.
28. *See* Treas. Reg. §§ 1.401(k)1(b)(1), 1.401(k)2(a)(3), 1.401(k)3(b)(2), 1.401(k)6, 1.401(m)1(b)(1), 1.401(m)2(a)(3), and 1.401(m)-6.
29. *See* Treas. Reg. § 1.401(k)3(d).
30. Note, for instance, that one could also exclude elective deferrals under an alternative nonsafe harbor compensation definition that excluded elective deferrals, but then the pay inclusion and reasonableness tests would apply.
31. Including reductions for amounts contributed by the employer pursuant to a salary reduction agreement that are not includible in the gross income of an employee under Code Section 125 and 132(f)(4) would complicate the mathematics of the examples and change the actual numeric results, but not the general conclusions.
32. *See* Treas. Reg. § 1.401(k)3(c)(2).
33. If we define P as the percentage election as applied to gross compensation and R as the actual percentage rate of the election as applied to safe harbor compensation, where the only

difference between gross compensation and safe harbor compensation is the amount of elective deferrals, the relationship between P and R is expressed as $R = P/(1 - P)$.

34. The relationship between P and R defined in the prior footnote can also be expressed as $P = R/(1 + R)$. For the example, the 5 percent deferral election based on safe harbor compensation translates into a 4.7619 percent deferral of the participant's gross compensation of \$40,000 or \$1,904.76, leaving safe harbor compensation of \$38,095.24.
35. See Treas. Reg. § 1.401(k)-3(c)(4).
36. See Treas. Reg. § 1.401(k)-3(c)(6)(iv).
37. See Treas. Reg. § 1.401(k)-3(c)(3).
38. See Treas. Reg. § 1.401(k)-3(c)(7), Example 3.
39. Under the assumptions of the example, a participant's overtime would have to be more than 73 and 1/3 percent of the participant's total compensation for the participant not to be able to make elective deferrals equal to at least 4 percent of the employee's safe harbor compensation.
40. See Treas. Reg. §§ 1.401(k)-3(c) and 1.401(m)-3(d).