401(k) Compensation – be Audit Ready

Working Together

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By Zachary Schurin

Failure to follow the 401(k) Plan Compensation definition for determining contributions is one of the top ten plan qualification failures and an area of IRS scrutiny during plan audits. This time of year, as you are gathering information for your plan's Form 5500 filing, is a good time for a plan checkup.

Begin by checking whether your payroll practices match your plan's compensation definition. Unfortunately this is not as straight forward as it may sound. Your plan's compensation definition may not be quite what it seems. Plans often define compensation as W-2 compensation. However W-2 compensation usually means box 1 of Form W-2, which includes non-cash compensation such as the taxable portion of the premium for group term life insurance. This means that a participant can defer against such non-cash compensation. In addition, a plan may have different definitions of compensation for different types of contributions. The compensation definition for salary deferral purposes may include bonuses while compensation for employer contributions may exclude bonuses. For plan operations to be consistent with plan provisions, payroll practices must address the plan's various compensation definitions. Failure to follow the proper plan definition can result in contributions that are greater or less than those provided for under the plan, thereby causing what the IRS refers to as an operational failure. Such failures can be costly to correct and result in substantial penalties, especially if repeated over several years.

Determining your plan's compensation definition often requires examining several different provisions of your plan document. For example the plan document (or adoption agreement) may provide that "participants may defer up to 75% of their Compensation …". You then need to review the definition section to find the Compensation definition applicable to deferrals. Keep in mind that bonuses, overtime pay, commissions, car allowance and expense reimbursements, that may or may not be included in the definition, add an additional layer of complexity.

After comparing applicable definitions to your payroll practices you should also spot check a variety of participants, both as to deferrals and allocations to confirm that the compensation definitions are being properly applied. Taking these steps enables you to be prepared in the event an IRS audit letter appears in your mail.

The IRS is particularly interested in (1) plans having processes in place to insure compliance with plan terms; and (2) early correction if the plan's operations are not consistent with the plan terms. While taking the above steps may reveal a problem, the sooner the problem is uncovered, the easier it is to correct. The IRS has programs in place to assist you in correcting errors. Depending on the circumstances, the error may be eligible for self correction. Taking the initiative to uncover and correct errors (whether through self correction or applying to an IRS correction program) places your plan in a better position in the event of an audit. If the IRS discovers the error(s) on audit the penalties imposed can be substantial. So be proactive, review your plan provisions and payroll practices, correct when necessary and decrease both the possibility that errors may be uncovered on audit and the anxiety that results when an audit notice is received.

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