

Compensation

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**INTERNAL REVENUE SERVICE
TAX EXEMPT AND GOVERNMENT ENTITIES**

Overview

Introduction Compensation is used for many different purposes in qualified retirement plans. In this chapter, we will describe and compare the different definitions of compensation that are required or permitted to be used for various plan purposes. The chapter will also provide helpful examples which will show how we apply these definitions and safe harbors during an audit or determination review.

Objectives At the end of this chapter, you will be able to determine whether a plan has properly defined the term compensation for each use.

Therefore, you will be able to:

- State the requirements for each use of compensation
 - Define Section 415(c) and Section 414(s) compensation
 - Identify non-safe harbor compensation definitions under Section 414(s)
 - Distinguish among Section 415(c), Section 414(s), and non-safe harbor compensation
 - Perform the nondiscrimination test on a plan which uses a non-safe harbor definition of compensation
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Overview, Continued

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Compensation

Introduction

In general, “compensation” includes any payment made by an employer to an employee for services rendered in the course of the employer’s business. Qualified plans use compensation in many different contexts. Qualified plans are permitted, within certain limits, to use different definitions for different plan purposes. For example, a plan sponsor may choose to exclude bonuses, overtime, or other types of payments from compensation for certain plan purposes, but not for others.

Statutory definitions

There are two definitions of compensation in the Internal Revenue Code, one in Section 415(c)(3) and the other in Section 414(s). Other code sections and regulations refer to one or the other of these definitions. Other code or regulation sections will specify which of the compensation definitions a plan can or must use for a particular purpose.

A Section 415 definition of compensation is one that satisfies all the requirements of Section 415(c)(3) and the regulations thereunder. A Section 414(s) definition of compensation is one that satisfies all the requirements of Section 414(s) and the regulations thereunder.

When a plan must use a Section 415 definition of compensation

A plan must use a Section 415 definition of compensation when:

- Determining compliance with the Section 415 limits on contributions and benefits
 - Determining which employees are highly compensated employees
 - Determining which employees are key employees
 - Calculating the top-heavy minimum contributions
 - Calculating the 5% minimum contributions for purposes of the gateway test under Section 401(a)(4)
 - Calculating the employer’s permitted deduction for contributions to the plan
-

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Compensation, Continued

Limitation year for Section 415 purposes

When compensation is used in a plan, it usually refers to compensation for some period of time, such as a plan year, calendar year, or a limitation year. Under Section 415 the limitation year can be defined by the plan as any 12-month period. Typically, the limitation year is defined as the plan year. If the limitation year is not defined in the plan, the limitation year is the calendar year. See Section 1.415(j)-1.

When a plan must use a 414(s) definition of compensation

A plan must use a definition of compensation which Section 414(s) when:

- Calculating the amount of contributions to be made to a design-based safe harbor plan or a safe harbor 401(k) plan
 - Determining a participant's actual deferral ratio and actual contribution ratio used in performing the ADP and ACP tests
 - Determining if contributions and benefits are nondiscriminatory under Section 401(a)(4) (other than the minimum contribution component of the gateway test)
 - Calculating contributions under a design-based safe harbor plan with permitted disparity provisions
-

When a plan can use any definition of compensation

Finally, a plan may use any definition of compensation when:

- Calculating allocations and accruals (if the plan is not a design-based safe harbor)
 - Calculating the maximum permitted deferrals within a 401(k) plan and,
 - Calculating the employer's matching contribution on behalf of each participant.
-

Section 415 Compensation

Overall definitions of 415 compensation

For employees who are not self-employed, Section 415(c)(3) defines a participant's compensation as compensation from the employer for the year. The details of the Section 415(c)(3) definition are fleshed out in the Section 415 regulations. Under the Section 415 regulations, sponsors can choose from four definitions of compensation:

1. Statutory definition,
 2. Simplified compensation,
 3. W-2 wages, and
 4. Wages for income tax withholding.
-

Types of compensation included in 415 definitions

Most types of compensation are included in all of these definitions, so the differences among them in any particular case will usually be small for most employees. See Exhibit 5-2 for a chart listing various types of compensation. This chart clearly indicates whether each type is included or excluded from each of the four definitions.

Tips

Tips are probably the most common type of compensation that is not treated the same under all definitions of Section 415 compensation. Under the statutory definition and the simplified compensation safe harbor definition, all tips are included in compensation, with the possible exception of allocated tips.

Under the W-2 Comp and Wages for Income Tax Withholding safe harbor definitions, allocated tips, noncash tips, and tips under \$20 per month are excluded from compensation.

Plan language

Exhibit 5-1 is an example of a Section 415 definition of compensation. A plan can incorporate a basic definition of compensation by reference to any one of four definitions found in Section 1.415(c)-2. However, some additional items must be specified in the plan, even if the basic definition is incorporated by reference.

Note: A definition of compensation for Section 414(s) purposes cannot be incorporated by reference.

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Section 415 Compensation, Continued

Self employed individuals

For a self-employed individual, Section 415 compensation includes the individual's earned income (as described in Section 401(c)(2) and regulations) plus amounts excluded because the individual deferred their receipt under a:

- Section 401(k) plan,
- Section 403(b) tax-sheltered annuity plan,
- Savings Incentive Match Plan for Employees (SIMPLE-IRA, Section 408(p)(2)(A)(i))
- Salary Reduction Simplified Employee Pension (SARSEP, Section 408(k)(6)), and
- Section 457(b) Eligible deferred compensation plan.

If the employer of a self-employed individual is a partnership or limited liability company, then compensation is calculated from the individual's distributive share of income as reported on the Schedule K-1.

415 compensation includes elective deferrals

All of the Section 415 definitions of compensation include elective deferrals or elective contributions made on a pre-tax basis, including catch-up contributions. Elective contributions are amounts which the participant could have received in cash, includible in gross income, but instead, were contributed to various benefit arrangements and therefore excluded from gross income. Elective contributions are contributions to the following arrangements:

- Cafeteria plans (Section 125(a))
 - Section 401(k) and Section 403(b) plans (Section 402(e)(3))
-

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Section 415 Compensation, Continued

**415
compensation
includes
elective
deferrals**
(continued)

- SARSEPs
 - SIMPLE-IRAs
 - Eligible deferred compensation plans maintained by a tax-exempt organization (Section 457(a)), state or local government
 - Qualified transportation fringe benefit arrangements (Section 132(f)(4))
-

**415
compensation
includes
differential
wage payments**

Differential wage payments are payments by an employer to an individual serving in the military on active duty for more than 30 days. These payments represent all or a portion of the compensation the employer would have paid if the individual had been performing services for the employer. Differential wage payments must be included in Section 415 compensation, even though the individual is not providing services to the employer.

**Affiliated
employers**

Section 1.415(a)-1(f) of the regulations provides that all employees of all corporations which are members of a controlled group of corporations are treated as employed by a single employer for purposes of Section 415. If the plan sponsor is in a controlled group of corporations, a group of trades or businesses under common control, or an affiliated service group, each participant's Section 415 compensation under its plan must include all of the compensation received from all employers in the group.

Under Section 415(h), for purposes of Section 415, Sections 414(b) and (c) are applied by using the phrase "more than 50%" instead of the phrase "at least 80%".

Any DB or DC plan maintained by any member of an affiliated service group (within the meaning of Section 414(n)(2)) is deemed maintained by all members of that affiliated service group.

Section 415- Post-Severance Compensation

Severance from employment

An employee has a severance from employment when the employee ceases to be an employee of the employer maintaining the plan. Whether an employee has a severance from employment with the employer that maintains a plan is determined in the same manner as Section 1.401(k)-1(d)(2) except, for purposes of determining the employer, the modifications of Section 415(h) (discussed above) apply.

An employee does not have a severance from employment if, in connection with the change of employment, the employee's new employer maintains such plan with respect to the employee. The determination of whether an employee ceases to be an employee of the employer maintaining the plan is based on all the relevant facts and circumstances. See Section 1.415(a)-1(f)(5).

Post-severance compensation-general rule

As a general rule, compensation may not be treated as Section 415 compensation unless it is paid (or treated as paid) before the employee's severance from employment. See Section 1.415(c)-2(e)(1)(ii). However, there are specific types of post-severance compensation that are included in Section 415 compensation.

Types of post-severance-compensation that must be included in 415 compensation

Compensation that would have been paid if the severance had not occurred that is paid after an employee's severance from service, but before the later of:

1. 2-1/2 months after severance from service, or
2. the end of the limitation year in which the severance occurs,

must be included in a plan's definition of compensation for Section 415 purposes.

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Section 415- Post-Severance Compensation, Continued

Types of post-severance compensation that may be included in 415 compensation

The following types of post-severance compensation **may** be included in Section 415 compensation at the sponsor's discretion:

- A cash-out of accrued but unused sick, vacation or other leave that could have been used if the severance had not occurred
- A distribution from a nonqualified deferred compensation plan that would have been payable at the time the distribution was made, whether or not there was a severance
- Salary continuation payments for disabled participants
- Salary continuation payments for participants in military service.

A cash-out of accrued leave or a distribution from a non-qualified plan can be included only if it is paid by the later of:

1. 2-1/2 months after severance from service, or
2. the end of the limitation year in which the severance occurs.

Salary continuation payments are not subject to any time limit.

Post-severance compensation not included in Section 415 compensation

Post-severance compensation not described as included or includible above (such as ordinary severance pay or a parachute payment) is not included in the definition of Section 415 compensation. Note that these payments are not included in Section 415 compensation even if the payments are made within the time period described above.

In addition, post-severance payments under a nonqualified unfunded deferred compensation plan are not included in Section 415 compensation unless the payments would have been paid at that time without regard to the severance from employment.

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Section 415- Post-Severance Compensation, Continued

Example 1- post-severance compensation

Zebu Co. maintains a profit-sharing plan. The plan's limitation year for Section 415 purposes is the calendar year. Jill terminates employment with Zebu Co. on September 2, 2012. She is paid a commission on September 20, 2012, that she would have received regardless of whether she had terminated employment.

Under Section 1.415(c)-2(e), the commission must be included when determining her Section 415 compensation because the commission was:

1. Regular compensation,
 2. Payable without regard to whether the severance occurred, and
 3. Paid within the later of 2-1/2 months or the end of the limitation year from the date of severance.
-

Example 2 – post-severance compensation

Same facts as Example 1, except that Jill's commission is not paid until December 20, 2012. Under Section 1.415(c)-2(e), the commission must be included when determining her Section 415 compensation because the commission was:

1. Regular compensation,
 2. Payable without regard to whether the severance occurred, and
 3. Paid before the end of the limitation year in which the severance from service occurred.
-

Example 3 – post-severance compensation

Same facts as Example 1, except that Jill's commission is not paid until January 5, 2013.

Under Section 1.415(c)-2(e), the commission must be excluded when determining her Section 415 compensation because the commission was not paid before the later of 2-1/2 months after her severance from service or the end of the limitation year in which the severance from service occurred.

Section 415 Compensation-Statutory Definition

**Statutory
Definition
(Section
1.415(c)-2(b))**

The statutory definition of Section 415 compensation is sometimes called “currently includible compensation.” Currently includible compensation includes wages, salaries, fees for professional services, and other amounts received for personal services actually rendered in the course of employment with the employer maintaining the plan. These compensation amounts are included, whether paid in cash or some other form. Thus, commissions, profit percentages, tips, bonuses, fringe benefits, and reimbursements or expense allowances under a non-accountable plan are all included in Section 415 compensation.

In addition, elective deferrals are included in the statutory definition of Section 415 compensation. Elective deferrals include deferrals made under a:

- Section 401(k) plan,
- Section 403(b) plan,
- SIMPLE IRA,
- SARSEP,
- Section 457(b) plan,
- A cafeteria plan, or
- Transportation benefit arrangement.

**Self-employed
individuals**

As stated above, for a self-employed individual, the statutory definition of 415 compensation includes the employee's earned income as described in Section 401(c)(2) and the regulations thereunder. Elective deferrals under Sections 402(e)(3), 402(h)(1)(B), 402(k) or 457(b) are also included for self-employed individuals.

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Section 415 Compensation-Statutory Definition, Continued

Additional items included in statutory definition

In addition to the items mentioned above, the statutory definition of compensation includes:

- Medical or disability benefits provided by an employer or provided under insurance paid for by the employer, but only to the extent that they are includible in gross income of the employee.
- Amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment, it is reasonable to believe that these amounts are not deductible by the employee under Section 217.
- The value of a non-qualified stock option granted to an employee by the employer, but only to the extent that the value of the option is includible in the gross income of the employee for the taxable year in which granted.
- Amounts that are includible in the gross income of an employee upon making the election described in Section 83(b) with respect to property received for services rendered.
- Amounts that are includible in the gross income of an employee because the amounts were constructively received by the employee or under the rules relating to non-qualified deferred compensation arrangements.

Items excluded from statutory definition (Section 1.415(c)-2(c))

The following items are specifically excluded from the statutory definition of Section 415 compensation:

- Employer contributions (other than elective deferrals) to a qualified or non-qualified deferred compensation plan that are not includible in the employee's gross income (before applying Section 415 limitations), including contributions to a Section 401(a) plan, a SIMPLE IRA plan, a SEP, or a rabbi trust maintained as part of a deferred compensation plan.
- Distributions from deferred compensation plans, regardless of whether the distribution is includible in gross income when distributed, except that a plan can choose to include distributions received by an employee from an unfunded non-qualified plan in compensation for Section 415 purposes in the year the amounts are includible in the gross income of the employee. *See Section 1.415(c)-2(c)(1).*

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Section 415 Compensation-Statutory Definition, Continued

Items excluded from statutory definition (Section 1.415(c)-2(c))
(continued)

- Amounts realized from the exercise of non-qualified stock options.
 - Amounts realized when restricted property becomes freely transferable or is no longer subject to a substantial risk of forfeiture.
 - Amounts realized from the sale or exchange of stock acquired under a qualified stock option.
 - Premiums for group term life insurance, to the extent the premiums are not includible in gross income (generally, the premium on the first \$50,000 of coverage).
 - Any other items of remuneration that are similar to any of the items listed above, such as employer contributions to a 403(b) plan, whether or not excludible from gross income.
-

Exercise 1

The Glendale Corporation Money Purchase Pension Plan defines compensation for all plan purposes as “current includible income excluding bonuses, commissions, and overtime.”

Does this definition of compensation meet the requirements of the statutory definition of Section 415 compensation?

Answer: No, bonuses, commissions and overtime must be included in the definition of compensation used for Section 415 purposes.

Safe Harbor Section 415 Definitions – Simplified Definition

Introduction

In addition to the statutory definition, there are three safe harbor definitions in the regulations that can be used to define compensation for Section 415 purposes.

Simplified compensation (Section 1.415(c)-2(d)(2))

The first safe harbor definition of Section 415 compensation is called “simplified compensation.” The simplified compensation definition is very similar to the statutory definition. This simplified definition includes wages, salaries, fees for professional services, and other amounts received for personal services actually rendered in the course of employment with the employer maintaining the plan, whether paid in cash or some other form. Compensation amounts are included to the extent that they are received and includable in the employee's gross income.

Elective deferrals

Elective deferrals are also included in the simplified definition of compensation. As stated above, these deferrals include deferrals under a Section 401(k) plan, a Section 403(b) tax shelter annuity plan, a Savings Incentive Match Plan for Employees (SIMPLE) IRA, or a Salary Reduction Simplified Employee Pension (SARSEP), a Section 457(b) eligible deferred compensation plan, a cafeteria plan, or a transportation benefit arrangement (under Section 132(f)).

Amounts not included in the simplified definition

Unlike the statutory compensation definition, simplified compensation does not include amounts that would have been included in the statutory definition under Section 1.415(c)-2(b)(3)-(7). These are amounts included in gross income derived from:

- Medical and disability benefits
 - Reimbursements of moving expenses
 - Stock options granted
 - A Section 83(b) election with respect to restricted property
 - Non-qualified deferred compensation
-

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Safe Harbor Section 415 Definitions – Simplified Definition, Continued

Other Exclusions

The items specifically excluded from the statutory definition are also excluded from the simplified definition:

- Employer contributions to a plan of deferred compensation
- Distributions from deferred compensation plans (*See Section 1.415(c)-2(c)(1)*).
- Amounts realized from the exercise of non-qualified stock options.
- Amounts realized when restricted property becomes freely transferable or is no longer subject to a substantial risk of forfeiture.
- Amounts realized from the sale or exchange of stock acquired under a qualified stock option.
- Premiums for group term life insurance, to the extent the premiums are not includible in gross income (generally, the premium on the first \$50,000 of coverage).
- Other items of remuneration similar to any of the items listed above, such as employer contributions to a 403(b) plan, whether or not excludible from gross income.

See Section 1.415(c)-2(c).

Impact of simplified definition

The items that are excluded from simplified compensation are more likely to be provided to highly compensated employees than to rank and file employees. Therefore the use of the simplified definition instead of the statutory definition for Section 415 purposes will tend to result in disproportionately reduced limits for highly compensated employees.

Safe Harbor Section 415 Definition – Wages For Income Tax Withholding

**Wages for
income tax
withholding
(Section
1.415(c)-2(d)(3)
)**

The second safe harbor definition of Section 415 compensation is often referred to as “wages for income tax withholding.” This definition includes all compensation subject to federal income tax withheld at the source, plus elective deferrals to:

- A cafeteria plan,
- A Section 401(k) plan
- A Section 403(b) plan
- A SARSEP
- A SIMPLE IRA
- An eligible deferred compensation plan maintained by a state or local government or by a tax-exempt organization
- A qualified transportation fringe benefit arrangement.

In contrast to the statutory and simplified definitions, this definition:

- Includes income from restricted property that is no longer subject to a substantial risk of forfeiture under Section 83
 - Includes income from the exercise of non-statutory stock options.
 - Excludes income from excess group term life insurance.
-

Safe Harbor Section 415 Definition – W-2 Wages

**W-2 Wages
(Section
1.415(c)-
2(d)(4))**

The third and final safe harbor definition of Section 415 compensation is “W-2 wages.” This definition includes the items included under wages for income tax withholding, above, **plus** any other payments of compensation to an employee by his employer for which the employer is required to furnish the employee with a Form W- 2 or a Form 1099.

The only significant difference between wages for income tax withholding and W-2 wages is that W-2 wages **includes** income from excess group term life insurance.

Exhibit 2

See Exhibit 5-2 at the end of the chapter for a chart listing various types of compensation. The chart clearly indicates whether each type is included or excluded from each of these definitions.

Examples Illustrating 415 Compensation

Example 4

Colby Corporation maintains a 401(k) plan. Tom's taxable wages for the year total \$46,000. During the year, Tom contributed \$3,000 through salary deferrals to the Colby Corporation 401(k) plan and the corporation made a matching contribution of \$1,500. Tom's Section 415 compensation under the any of the Section 415 compensation definitions is \$49,000. This includes his taxable wages and his salary deferral contribution, but does not include the employer matching contribution.

\$46,000 taxable wages
+ \$3,000 deferrals
\$49,000 compensation

Example 5

Same facts as in example 4; however, in addition Tom reduces his compensation by \$1,000 for qualified parking purchased through a cafeteria plan. Tom's Section 415 compensation would be \$50,000. As with salary deferrals, amounts paid for qualified parking through a cafeteria plan are part of elective deferrals that are included in Section 415 compensation.

\$46,000 taxable wages
\$3,000 deferrals
+ \$1,000 cafeteria plan
\$50,000 compensation

Example 6

Dalton Corporation maintains a profit sharing plan using the *wages for income tax withholding* definition of compensation for Section 415 purposes. During a year Ursula receives taxable wages of \$75,000, including \$1,000 of imputed income from group-term life insurance coverage purchased by Dalton. She also recognizes \$5,000 of income because the stock restrictions expired on certain Dalton stock she had received.

Ursula's Section 415 compensation (withholding definition) under the plan would be \$79,000. Income from group term life insurance is excluded, and the stock income is included. Using the statutory or simplified definition, her compensation would be \$75,000.

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Examples Illustrating 415 Compensation, Continued

**Example 6-
table**

Wages for Income Tax Withholding

\$75,000 taxable wages
- \$1,000 group term life insurance
+\$5,000 expired stock restrictions
\$79,000 compensation

Statutory or Simplified

\$75,000 taxable wages
+\$0 expired stock restrictions
\$75,000 compensation

Section 414(s) Compensation-Introduction

Overview

Section 414(s) compensation is often referred to as nondiscrimination compensation. A plan must use a definition of compensation that satisfies Section 414(s) in determining whether the plan has satisfied the nondiscrimination rules.

In this section of the chapter, we will discuss the different definitions and uses of Section 414(s) compensation.

Example 7- illustrating a discriminatory definition of compensation

The profit sharing plan maintained by Albion Corp. includes a definition of compensation for determining allocations that includes bonuses and excludes overtime. The plan provides an allocation of 3% of compensation.

Employees A and B both earn wages of \$60,000 and have total compensation of \$100,000 in the year being reviewed.

Employee A earns \$40,000 in overtime pay. Employee B earns \$40,000 in bonuses.

Example 7- analysis

$\$60,000 * 3\% =$

$\$100,000 * 3\% =$

\$1,800 allocation to A

\$3,000 allocation to B

Since bonuses are included and overtime is not, B's compensation for allocation purposes is \$40,000 higher than A's, resulting in a higher allocation for B even though their total compensation and percentage allocation were the same.

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Section 414(s) Compensation-Introduction, Continued

When the Section 414(s) definition of compensation must be used

The plan must use a compensation definition that satisfies Section 414(s) for the following purposes:

- Determining the contributions/benefits to a DC or DB safe harbor plan (including plans with permitted disparity).
 - Determining the contributions to a safe harbor 401(k) plan.
 - Determining a participant's actual deferral ratio and actual contribution ratio for the ADP and ACP tests.
 - Determining whether contributions and benefits are nondiscriminatory under Section 401(a)(4) (other than the 5% minimum contribution under the gateway test for cross tested plans).
 - Calculating the average benefit test if the plan document specifies Section 410(b) fail safe language that utilizes the average benefit test.
-

Situations in which a Section 414(s) definition of compensation is not required

Although many plans use a Section 414(s) definition of compensation for the following purposes, a Section 414(s) definition is not required for:

- Calculating allocations and accruals if the plan is not a design-based safe harbor plan,
 - Calculating the maximum deferral under the limit imposed within a 401(k) plan, and
 - Calculating the employer's matching contribution on behalf of each participant.
-

Different Section 414(s) Definitions

The different definitions of Section 414(s) compensation

There are several definitions of Section 414(s) compensation plan sponsors can choose from:

- The four definitions of Section 415 compensation described above
 - The safe harbor definitions under Section 414(s), which are the definitions of Section 415 compensation with certain specified adjustments
 - Any reasonable definition of compensation that does not favor highly compensated employees. *See*, 1.414(s)-1(d)
-

Section 415 definitions of compensation

A plan can use any of the four definitions of Section 415 compensation we discussed earlier in the chapter for all Section 414(s) purposes. Again, these four definitions are:

1. The statutory definition
 2. The simplified definition
 3. W-2 wages
 4. Wages for income tax withholding
-

Safe harbor 414(s) definition

A Section 414(s) safe harbor definition of compensation begins with one of the four definitions of Section 415 compensation. Any one of those definitions, modified by any one or more of the three modifications described below is a safe harbor compensation definition under Section 414(s). However, using any other modification creates an “alternative definition” of compensation that has to be tested under Section 1.414(s)-1(d).

First Modification Under Section 414(s)

First modification – excluding certain benefits

The first safe harbor modification to Section 415 compensation is to subtract certain benefits. A plan using this modification **MUST** exclude **ALL** of the following:

- Cash and/or non-cash fringe benefits-*these are any taxable “extras” such as the personal use of a company car, educational assistance, etc.,*
 - Reimbursements or other expense allowances-*amounts paid the employer to cover employees’ expenditures childcare, traveling expenses, etc.,*
 - Moving expenses,
 - Deferred compensation-*any income that is earned in the current year, but will be paid to the employee at a later date, and*
 - Welfare benefits-*certain benefits provided by the employer such as disability insurance, college scholarship funds, prepaid legal services, or unemployment benefits.*
-

Second Modification Under Section 414(s)-Elective Deferrals

415 compensation includes elective deferrals

The second safe harbor modification is to include elective deferrals. Elective deferrals were not included in Section 415 compensation before 1998. For 1998 and later years, the definition of compensation under Section 415 was amended to include specific elective deferrals. All of the Section 415 definitions of compensation now include certain elective deferrals or elective contributions made on a pre-tax basis, including catch-up contributions. These elective contributions are contributions to the following arrangements:

- Cafeteria plans
- Section 401(k) and Section 403(b) plans
- SARSEPs
- SIMPLE-IRA plans
- Eligible deferred compensation plans maintained by a state or local government or by a tax-exempt organization (Section 457(a))
- Qualified transportation fringe benefit arrangements

Second modification-elective deferrals

The second safe harbor modification is provided under 1.414(s)-1(c)(4) and changes the definition of compensation under 1.414(s)-1(c)(2) and (3) to include all of the following types of elective contributions and deferred compensation:

- Elective contributions that are not includable in gross income under Section 125, Section 402(e)(3), Section 402(h) and Section 403(b).
- Compensation deferred under an eligible deferred compensation plan within the meaning of Section 457(b).
- Employee contributions to governmental plans described in Section 414(h)(2) that are picked up by the employing unit and thus treated as employer contributions.

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Second Modification Under Section 414(s)-Elective Deferrals, Continued

415 compensation already includes elective deferrals

The second safe harbor modification allows a plan to include all the listed elective deferrals in compensation. As noted above, the Section 415 definitions of compensation already include those elective deferrals, **except for pickup contributions** under Section 414(h)(2). (The regulations under Section 414(s) have not been amended to reflect the inclusion of elective deferrals in Section 415 compensation) Thus, the second safe harbor modification only differs from the Section 415 definitions with respect to pickup contributions.

If an employer wants to exclude elective deferrals from the definition of compensation under 414(s), the definition would have to satisfy Section 414(s) as an “alternative definition” of compensation under Section 1.414(s)-1(d).

Excluding elective deferrals is reasonable

A definition of compensation that includes, on a consistent basis, all or any portion of the types of elective contributions listed under the second modification or deferred compensation can be a alternative definition. Thus the definition does not need to include all those types of elective contributions or deferred compensation as otherwise required under Section 1.414(s)-1(d)(2)(ii).

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Second Modification Under Section 414(s)-Elective Deferrals, Continued

**Example 8 –
excluding
elective
deferrals**

ABC Corporation has decided to include elective deferrals under a salary reduction 401(k) arrangement, and exclude the participant's deferrals to a Section 132(f)(4) qualified transportation fringe benefit arrangement, in its plan's definition of Section 414(s) compensation.

This definition would not be a safe-harbor definition of Section 414(s) compensation. The plan's definition of compensation will need to be tested annually in order to determine if it is nondiscriminatory. In order to be a safe harbor definition, the definition of compensation must include both of these kinds of deferrals .

Third Modification Under Section 414(s)

Excluding compensation only to HCEs

The last modification to Section 415 compensation a plan may make and still be a Section 414(s) safe harbor definition is to exclude any portion of compensation for some or all of the HCE's in the plan.

For example, a plan may include commissions in Section 414(s) compensation for NHCE's, but exclude commissions for all HCE's. This definition of compensation would be a safe harbor definition under Section 414(s).

Exercise 2

ABC Company provides the following compensation to all of their employees:

- relocation expenses to their Detroit location,
- disability insurance,
- salary deferrals in the 401(k) plan, up to 15% of pay,
- use of a company car while traveling,
- reimbursement of childcare expenses, and
- commissions based on quarterly sales

The plan document defines Section 414(s) compensation as statutory Section 415 compensation, modified only by the excluding the following items:

- welfare benefits,
- reimbursement or other expense allowances,
- deferred compensation,
- fringe benefits,
- moving expenses, and
- commissions paid to HCEs.

Would this be an acceptable safe harbor definition of compensation for Section 414(s) purposes?

Yes. This definition of compensation is a safe harbor definition since the exclusions of the listed amounts are safe harbor modifications that are allowed to be excluded.

Note that if the definition also excluded elective deferrals, the definition would have to satisfy Section 1.414(s)-1(d) as an alternative definition of compensation.

Non-Safe Harbor Compensation Definition

Alternative definition of compensation

The last definition that can be used for Section 414(s) purposes is a non-safe harbor definition of compensation. A non-safe harbor definition of compensation is one that:

- Does not by design favor highly compensated employees,
 - is reasonable, and
 - passes a nondiscrimination test. Section 1.414(s)-1(d)(1).
-

Defining reasonable

Section 1.414(s)-1(d)(2) provides the types of compensation definitions that are reasonable. A definition that starts with any of the Section 415 definitions or any of the alternative safe harbor definitions, and makes certain additional exclusions will be deemed reasonable.

A definition of compensation is reasonable if it excludes, on a consistent basis, all or any portion of irregular or additional compensation. These exclusions would be any type of additional compensation for employees working outside their regularly scheduled tour of duty. These exclusions would include:

- Overtime,
 - Bonuses,
 - Premiums for shift differential, and
 - Call-in premiums.
-

Continued on next page

Non-Safe Harbor Compensation Definition, Continued

Defining reasonable (continued)

Also, any one or more of the types of compensation excluded under the first safe harbor modification under 1.414(s)-1(c)(3) would also be considered reasonable:

- Cash and/or non-cash fringe benefits,
 - Reimbursements or other expense allowances,
 - Moving expenses,
 - Deferred compensation, and
 - Welfare benefits.
-

Reasonable definition can also exclude elective deferrals

A reasonable definition is also permitted to include, on a consistent basis, all or any portion of the types of elective contributions or deferred compensation under 1.414(s)-1(c)(4). Thus, the definition does not need to include all of the types of elective contributions or deferred compensation as otherwise required under Section 1.414(s)-1(c)(4).

Exclusion of compensation over a specified dollar amount

Additionally, a reasonable definition of compensation can exclude compensation over a specified dollar amount, such as the compensation limitation under Section 401(a)(17).

Not Acceptable “Reasonable” Definitions

There are two specific provisions that will make a definition unreasonable. . . Section 1.414(s)-1(d)(2)(iii).

First, compensation for Section 414(s) purposes cannot reasonably be defined as a percentage of the employee's compensation measured for the determination period under another definition. For example, it is not reasonable to define Section 414(s) compensation as “50% of the individual’s compensation as calculated under the simplified compensation rule.”

Continued on next page

Non-Safe Harbor Compensation Definition, Continued

**Not Acceptable
“Reasonable”
Definitions
(continued)**

Second, compensation for Section 414(s) purposes cannot be defined as the individual’s compensation during one month of the year. For example, it is not reasonable to define Section 414(s) compensation as “for each limitation year , the participant’s compensation earned in the month of June.”

**Exercise 3
excluding
overtime-
reasonable**

DEF Company employees work 40 hours a week with occasional overtime during the Christmas season. The plan defines compensation for Section 414(s) purposes as W-2 wages, but excludes overtime.

Would this definition be considered reasonable?

Yes. When employees work overtime that is outside of their regularly scheduled tour of duty, overtime pay is irregular compensation that can be excluded from compensation for Section 414(s) purposes. Section 1.414(s)-1(d)(2).

**Exercise 4-
excluding
overtime--
unreasonable**

GHI Company employees work 48 hours a week. Each employee consistently works 8 hours of overtime. Section 414(s) compensation is defined in the plan as wages for income tax withholding, excluding overtime.

Would this definition be considered reasonable?

No. Note that whether a type of compensation is irregular or additional is based on all of the relevant facts and circumstances. Overtime is provided on a regular basis to all of the employees. As a result, the compensation definition is not reasonable because it excludes overtime. Section 1.414(s)-1(d)(3).

Since the definition of Section 414(s) compensation is not reasonable, does not satisfy any safe harbor definition of compensation **AND** is not one of the four Section 415(c)(3) definitions of compensation, the plan would have to satisfy Section 401(a)(4) under the general nondiscrimination test if the definition is used to calculate benefits.

Continued on next page

Non-Safe Harbor Compensation Definition, Continued

Plan's definition of compensation may satisfy 414(s) in one year but not in another year

A non-safe harbor definition of compensation is only allowable if it passes a nondiscrimination test based on plan operations each year. Thus a plan's definition of compensation may meet the alternative definition requirements in one year, but may not meet such requirements for the following year, even if the compensation definition remains the same.

Example 9- illustrating the definition of compensation can be reasonable or unreasonable

The GHI plan defines Section 414(s) compensation as simplified compensation, excluding overtime. Assume this definition of compensation is used to determine benefits under the plan. On exam we find that GHI employees worked consistent overtime in 2011. However, these employees did not work consistent overtime in 2010 or 2012.

Since the employees did not work consistent overtime in 2010 or 2012, the compensation definition that excludes overtime is reasonable under Section 1.414(s)-1(d)(2)(ii). Assuming the compensation definition does not by design favor the HCEs and satisfies the nondiscriminatory test under Section 1.414 (s)-1(d)(3), such definition of compensation satisfies Section 414(s). As a result, the plan does not need to apply the general test if the plan meets the safe harbor requirements under the Section 401(a)(4) regulations.

Since the employees worked consistent overtime in 2011, excluding such overtime is not reasonable for that year. This definition of compensation does not satisfy the reasonable definition requirements under Section 1.414(s)-1(d) in 2011. Consequently, the plan must satisfy the general test for 2011.

Alternative Definition – Nondiscrimination Testing

Introduction

As previously discussed, if a plan's definition of compensation is not one of the Section 415 definitions, and does not satisfy any of the safe harbors under Section 414(s), a demonstration must be made that this definition of compensation:

- Is reasonable,
 - does not by design favor highly compensated employees, and
 - satisfies a nondiscrimination test.
-

Non-safe harbor definition of compensation under Section 414(s)

A definition that excludes any of the following categories from Section 414(s) compensation would result in a non-safe harbor definition of compensation:

- Compensation in excess of a certain dollar amount,
- Bonuses,
- Overtime,
- Reimbursements for expense allowances,
- Fringe benefits (cash and non-cash),
- Moving expenses,
- Commissions, or
- Elective deferrals.

If such a definition is reasonable, taking into account the facts and circumstances described above, and does not by design favor HCE's, the definition may satisfy the nondiscrimination test under Section 1.414(s)-1(d)(3). The plan should be tested annually to determine if the definition is nondiscriminatory.

Continued on next page

Alternative Definition – Nondiscrimination Testing, Continued

**The
nondiscrimination
test under Section
1.414(s)-1(d)(3)**

Treasury Regulation Section 1.414(s)-1(d)(3) provides that an alternative definition of compensation is nondiscriminatory for a determination period if the average percentage of Total Compensation (TC) included under the compensation definition for HCEs does not exceed the average percentage of TC included under the compensation definition for NHCEs by more than a de minimis amount.

The determination of whether the average percentage of TC included for the HCEs for a determination period exceeds the average percentage for the NHCEs by more than a de minimis amount is based on all the facts and circumstances. Section 1.414(s)-1(d)(3)(v).

**Employees
subject to the
nondiscrimination
test**

The employees taken into account in running the compensation test are all those who benefit under the plan or plans being tested. See Section 1.414(s)-1(d)(3)(iii).

Employees excluded are:

- (1) Self-employed individuals and
 - (2) Those employees whose total compensation for the year is zero.
-

**Total
compensation**

Total compensation for purposes of the nondiscrimination test is generally Section 415 compensation. Therefore total compensation must include any elective deferrals to a qualified plan, cafeteria plan, transportation benefit arrangement, Section 403(b) plan or Section 457 plan. See Section 1.414(s)-1(d)(3)(ii) which refers to Section 1.414(s)-1(c)(2).

Continued on next page

Alternative Definition – Nondiscrimination Testing, Continued

Modifying total compensation When defining total compensation, the employer has the option to modify a Section 415 compensation definition by including employee contributions picked up under section 414(h)(2). To modify the 415 definition, the employer has to choose the modification under Section 1.414(s)-1(c)(4). Otherwise, these pickup contributions are not included in total compensation. See Section 1.414(s)-1(d)(3)(ii)(A).

Special rules in determining total compensation If the alternative definition of compensation being tested contains exclusions from the definition of compensation under Section 414(s) that only apply to some HCEs, then the total compensation of the affected HCEs must be reduced by those exclusions. An exclusion that applies to all HCEs is not required to be reflected in total compensation. See Section 1.414(s)-1(d)(3)(ii)(B).

An alternative definition of compensation which uses a rate of compensation, compensation earned with a prior employer, or imputed compensation may result in an individual compensation percentage greater than 100 percent. The individual compensation percentages for individuals in that situation is limited to 100 percent. See Section 1.414(s)-1(d)(3)(vi)(A).

If the alternative definition of compensation being tested uses a rate of compensation, includes prior employer compensation or imputed compensation, each employee's total compensation must include all types of elective contributions and deferred compensation under Section 1.414(s)-1(c)(4). See Section 1.414(s)-1(d)(3)(vi)(B).

Nondiscrimination test As stated above, an alternative definition of compensation is nondiscriminatory for a determination period if the average percentage of total compensation included in the compensation definition for HCE's does not exceed the average percentage of total compensation included in the compensation definition for NHCE's by more than a de-minimis amount.

Continued on next page

Alternative Definition – Nondiscrimination Testing, Continued

Calculating the average percentage

An individual compensation percentage must be calculated for each employee.

The individual compensation percentage for an employee is calculated by dividing the amount of the employee's compensation that is included under the alternative definition being tested by the amount of the employee's total compensation. See Section 1.414(s)-1(d)(3)(iv)(A).

Individual compensation percentage

The individual compensation percentage is calculated as follows:

$$\frac{\text{Employee's compensation included under the definition being tested}}{\text{Employee's total compensation}}$$

Determining the average

Next, the average of the separately calculated compensation percentages for each employee in the group must be determined. For this step, the sum of the NHCE percentages are divided by the number of NHCEs included in the test. The same calculation is performed for the HCEs.

Additionally, the regulations allow the calculation of average percentages by "Other reasonable methods." Section 1.414(s)-1(d)(3)(iv)(B).

Demo 9

Determination letter applications filed before February 1, 2012, for plans under a 5-year remedial amendment cycle (other than terminating plans), and May 1, 2012, for terminating plans and plans under a 6-year remedial amendment cycle could include a Demo 9. Revenue Procedure 2012-6 eliminates the option for a Demo 9 request on the compensation definition used in a plan. See Announcement 2011-82.

The employer or plan administrator should run the nondiscrimination test to ensure that the plan still meets the nondiscrimination test for compensation in any year.

Nondiscrimination Testing Illustration

Introduction This illustration shows typical answers on a Demo 9 and how to run the nondiscrimination test.

The Plan, Inc. Employee Money Purchase Pension Plan

EIN 07-1234567; PLAN 001

Attachment to Form 5300

DEMONSTRATION 9 – NONDISCRIMINATORY COMPENSATION

- 1. State if the demonstration relates to a definition used to determine contributions or benefits, or a definition used in an IRC Section 401(k) and/or IRC Section 401(m) plan's ADP and/or ACP test.**

This demonstration relates to a definition of compensation that is used to determine pension benefits under a money purchase pension plan.

- 2. State the definition of compensation being tested (and cite the plan provision where applicable), and indicate whether the definition uses rate of compensation or includes prior employer compensation or imputed compensation.**

Compensation as defined in 1.415(c)-2(d)(2), excluding overtime and bonuses. This definition of compensation may be found in Plan section 2.1. This definition does not use rates of compensation or prior employer compensation.

- 3. Identify the period for which compensation data is given.**

January 1, 2012 to December 31, 2012.

- 4. State whether the test is based on the compensation of all employees benefiting under the plan or all employees benefiting under all plans of the employer for which the same alternative definition of compensation is used to determine that the plan satisfies IRC Section 401(a)(4). Also state whether all employees with zero total compensation have been excluded from the test and state the number of highly compensated and non-highly compensated employees whose compensation is taken into account in the demonstration.**

The test is based upon the compensation of all employees benefiting under the Plan, Inc. Employee Money Purchase Pension Plan. Employees with zero compensation have been excluded from the test. The numbers of highly compensated and non-highly compensated employees included in the test are 3 and 10, respectively.

For further explanation of this demonstration, see Section 1.414(s)-1(e) and (f) and Publication 6393, Explanation No.5 (relating to determination program worksheets).

Continued on next page

Nondiscrimination Testing Illustration, Continued

Data-HCEs

The Plan, Inc. Employee Money Purchase Pension Plan EIN 07-1234567; PLAN 001

Data

Participant	Total Comp	Plan Comp	Inclusion %
Grant F.	200,000	192,440	96.22
Claire B.	200,000	195,040	97.52
Drew E.	200,000	197,300	98.65
Average Compensation Percentage for HCE's			97.46%

Data-NHCEs

Participant	Total Comp	Plan Comp	Inclusion %
Emmett B	31,500	30,974	98.33
Carol D	32,000	31,498	98.43
Franklin H	55,000	54,725	99.50
Doug E	57,500	57,213	99.50
Harris G	58,000	57,710	99.50
Henry F	63,500	63,500	100
Harlan E	64,000	64,000	100
Alice G	65,000	65,000	100
Alan B	70,000	70,000	100
Craig E	70,000	70,000	100
Average Compensation Percentage for NHCE's			99.53%

Conclusion

The demonstration shows that the plan's definition of compensation is nondiscriminatory since the average compensation percentage for NHCE's is higher than the average compensation percentage for HCE's.

Nondiscrimination –Audit Steps

Processing Steps

Examine W-2s and payroll records to verify:

1. Compensation amounts used to calculate plan contribution/benefit, HCEs, ADP/ACP testing, etc., reconciles to amounts in source documents;
2. Definition of compensation used in operation is the same as the definition in the plan document; and
3. Compensation definition is not discriminatory in operation.

For the plan to be considered a safe harbor plan, the compensation definition must satisfy Section 414(s).

Additional steps for plans that are not a safe harbor under Section 414(s)

If the definition of compensation is not a safe harbor definition of Section 414(s):

1. Determine if the sponsor tested the definition for discrimination.
2. If the test was not run, have the sponsor run the test.
 - If the test is passed, then no further corrective action would be required. The failure to run the test would be mentioned in the closing letter and if no other issues were present, the case would be closed with a disposal code of 08, Correction of Operational Practice, Future Impact.
 - If the definition fails the test, the plan is not a safe harbor plan. The allocations must satisfy Section 401(a)(4).
 - Tip: If the plan sponsor does not want to have to test compensation for discrimination in the future, they could amend their plan prospectively to use a safe harbor definition of compensation.

See Exhibit 5-3 for a flow chart breaking down case processing steps for the compensation nondiscrimination test

If Plan Fails To Satisfy Section 401(a)(4)

Introduction

If, for a given year, a plan's definition of compensation does not satisfy 414(s) AND the plan fails the general test, the failure will have to be remedied using EPCRS. As a result, the employer will have to make corrections under Rev. Proc. 2013-12.

Generally, correction will involve providing benefits to NHCE's so that the employer can pass the general test.

In addition, steps will need to be taken to ensure that the employer's administrative procedures are adequate going forward.

Determine if defect is significant or insignificant

Talk with your manager and determine if the required corrections are insignificant or significant under the EPCRS Revenue Procedure (Rev. Proc. 2013-12).

- On examination, a significant defect can only be corrected via Audit CAP.
 - An insignificant defect can be corrected by the plan sponsor at any time, even during the audit, without entering into a closing agreement. However, to be eligible for correction under SCP, the plan sponsor must have had procedures in place to prevent the failure from occurring. This requirement could be difficult to satisfy, since the plan sponsor either did not have, or did not utilize procedures to test compensation for discrimination.
-

Approved correction is not provided in Rev. Proc. 2013-12

Since an approved correction for this type of failure is not provided in any of the Appendices to Rev. Proc. 2013-12, you, your manager and the Closing Agreement Coordinator will need to agree on the correction necessary.

- Normally, additional contributions will be required on behalf of the NHCEs to the extent necessary to pass the discrimination test.
 - In some cases, the plan sponsor may be allowed to retroactively amend the plan's definition of compensation to one that is not discriminatory. As part of an examination, a retroactive amendment will result in a closing agreement.
-

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If Plan Fails To Satisfy Section 401(a)(4), Continued

Example 10- illustrating an operational failure

Plan A provides that, for the purposes of the employer discretionary contribution, compensation is defined as the Participant's wages as defined in Code Section 3401(a) and all other payments of compensation by the Employer for a plan year for which the Employer is required to furnish the Participant a written statement under Code Sections 6041(d), 6051(a)(3) and 6052 (W-2 Compensation).

The employer provided a discretionary contribution of 3% of compensation during the year the year being tested. When calculating this contribution the employer incorrectly excluded compensation paid to Participants before they entered the plan. As a result, participants who entered the plan during the year received a lower allocation than the allocation they were entitled under the terms of the plan.

Under Section 6 of Revenue Procedure 2013-12, the correction method should restore the plan to the position it would have been in had the failure not occurred. In addition, the correction method should keep plan assets in the plan. Furthermore, the corrective contribution should be adjusted for earnings.

When encountering such a failure, the agent should determine the difference between what the affected participants actually received and what the affected participants would have received if the plan's terms had been followed. Then, the agent should develop possible remedies for the failure, keeping in mind the general correction principles under EPCRS, and present those suggestions to his group manager.

Exhibit 1 – Plan Language

Introduction The following is an example of a Section 415 definition of compensation, based on language included in the Defined Contribution Listing of Required Modifications and Information Package (LRM) provided to master and prototype sponsors (October 2011). A sponsor using this language would choose one of the three initial paragraphs, for W-2 wages, wages for income tax withholding purposes, and the statutory definition, respectively, and then use the rest of the definition with any of those.

W-2 definition Compensation is defined as wages, within the meaning of Section 3401(a), and all other payments of compensation to an employee by the employer (in the course of the employer's trade or business) for which the employer is required to furnish the employee a written statement under Sections 6041(d), 6051(a)(3), and 6052. Compensation shall be determined without regard to any rules under Section 3401(a) that limit the remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in Section 3401(a)(2)).

Withholding definition of compensation Compensation is defined as wages within the meaning of Section 3401(a) for the purposes of income tax withholding at the source but determined without regard to any rules that limit the remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in Section 3401(a)(2)).

Statutory definition of compensation-inclusions and exclusions Compensation is defined as wages, salaries, differential wage payments under Section 3401(h), and fees for professional services and other amounts received (without regard to whether or not an amount is paid in cash) for personal services actually rendered in the course of employment with the employer maintaining the plan to the extent that the amounts are includible in gross income (including, but not limited to, commissions paid salespersons, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses, fringe benefits, and reimbursements, or other expense allowances under a nonaccountable plan (as described in Section 1.62-2(c) of the Income Tax Regulations), and excluding the following:

Continued on next page

Exhibit 1 – Plan Language, Continued

**Statutory
definition of
compensation-
inclusions and
exclusions**
(continued)

- (i) Employer contributions (other than elective contributions described in Section 402(e)(3), Section 408(k)(6), Section 408(p)(2)(A)(i), or Section 457(b)) to a plan of deferred compensation (including a simplified employee pension described in Section 408(k) or a simple retirement account described in Section 408(p), and whether or not qualified) to the extent such contributions are not includible in the employee's gross income for the taxable year in which contributed, and any distributions (whether or not includible in gross income when distributed) from a plan of deferred compensation (whether or not qualified), other than, if the employer so elects in section _____ of the adoption agreement, amounts received during the year by an employee pursuant to a nonqualified unfunded deferred compensation plan to the extent includible in gross income;
- (ii) Amounts realized from the exercise of a nonstatutory stock option (that is, an option other than a statutory stock option as defined in Section 1.421-1(b) of the Income Tax Regulations), or when restricted stock (or property) held by the employee either becomes freely transferable or is no longer subject to a substantial risk of forfeiture;
- (iii) Amounts realized from the sale, exchange or other disposition of stock acquired under a statutory stock option;
- (iv) Other amounts that receive special tax benefits, such as premiums for group-term life insurance (but only to the extent that the premiums are not includible in the gross income of the employee and are not salary reduction amounts that are described in Section 125);
- (v) Other items of remuneration that are similar to any of the items listed in (i) through (iv).

**Compensation
for self
employed**

For any self-employed individual, compensation shall mean earned income.

Continued on next page

Exhibit 1 – Plan Language, Continued

Compensation is amount actually paid during the limitation year

Except as provided herein, compensation for a limitation year is the compensation actually paid or made available during such limitation year. If elected by the employer in section _____ of the adoption agreement, compensation for a limitation year shall include amounts earned but not paid during the limitation year solely because of the timing of pay periods and pay dates, provided the amounts are paid during the first few weeks of the next limitation year, the amounts are included on a uniform and consistent basis with respect to all similarly situated employees, and no compensation is included in more than one limitation year.

Compensation includes amounts paid after severance from employment

For limitation years beginning on or after July 1, 2007, or such earlier date as the employer specifies in section _____ of the adoption agreement, compensation for a limitation year shall also include compensation paid by the later of 2 ½ months after an employee's severance from employment with the employer maintaining the plan or the end of the limitation year that includes the date of the employee's severance from employment with the employer maintaining the plan, if:

- (a) the payment is regular compensation for services during the employee's regular working hours, or compensation for services outside the employee's regular working hours (such as overtime or shift differential), commissions, bonuses, or other similar payments, and, absent a severance from employment, the payments would have been paid to the employee while the employee continued in employment with the employer; or, if the employer so elects in section _____ of the adoption agreement,
-

Continued on next page

Exhibit 1 – Plan Language, Continued

Compensation includes amounts paid after severance from employment
(continued)

- (b) the payment is for unused accrued bona fide sick, vacation or other leave that the employee would have been able to use if employment had continued; or
- (c) the payment is received by the employee pursuant to a nonqualified unfunded deferred compensation plan and would have been paid at the same time if employment had continued, but only to the extent includible in gross income.

Any payments not described above shall not be considered compensation if paid after severance from employment, even if they are paid by the later of 2 ½ months after the date of severance from employment or the end of the limitation year that includes the date of severance from employment, except, if elected by the employer in section _____ of the adoption agreement, compensation paid to a participant who is permanently and totally disabled, as defined in Section 22(e)(3), provided, as elected by the employer in section _____ of the adoption agreement, salary continuation applies to all participants who are permanently and totally disabled for a fixed or determinable period, or the participant was not a highly compensated employee, as defined in Section 414(q), immediately before becoming disabled.

Back pay

Back pay, within the meaning of Section 1.415(c)-2(g)(8), shall be treated as compensation for the limitation year to which the back pay relates to the extent the back pay represents wages and compensation that would otherwise be included under this definition.

Compensation includes elective deferrals

Compensation paid or made available during a limitation year shall include amounts that would otherwise be included in compensation but for an election under Section 125(a), Section 132(f)(4), Section 402(e)(3), Section 402(h)(1)(B), Section 402(k), or Section 457(b).

Continued on next page

Exhibit 1 – Plan Language, Continued

Compensation includes deemed 125 compensation

Unless the employer elects otherwise in section _____ of the adoption agreement, compensation shall also include deemed Section 125 compensation. Deemed Section 125 compensation is an amount that is excludable under Section 106 that is not available to a participant in cash in lieu of group health coverage under a Section 125 arrangement solely because the participant is unable to certify that he or she has other health coverage. Amounts are deemed Section 125 compensation only if the employer does not request or otherwise collect information regarding the participant's other health coverage as part of the enrollment process for the health plan.

Compensation paid to nonresident aliens

If elected by the employer in section _____ of the adoption agreement, compensation shall not include amounts paid as compensation to a nonresident alien, as defined in section 7701(b)(1)(B), who is not a participant in the plan to the extent the compensation is excludable from gross income and is not effectively connected with the conduct of a trade or business within the United States.

Compensation does not include amounts exceeding 401(a)(17)

Compensation used to determine plan benefits will not exceed \$200,000, as adjusted for increases in the cost of living under Code Section 401(a)(17). A cost of living adjustment in effect for a calendar year applies to any period, not exceeding 12 months, over which compensation is determined (determination period) beginning in such calendar year. If a determination period is less than 12 months, the adjusted \$200,000 limitation will be multiplied by a fraction, the numerator of which is the number of months in the determination period, and the denominator of which is 12. Compensation of an owner-employee or self-employed individual will equal earned income up to the adjusted \$200,000 limitation.

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Exhibit 2 – Comparing Compensation Definitions

Comparison
Table

Item of compensation	Statutory definition (1.415(c)-2(a)--2(c))	Simplified comp. (1.415(c)-2(d)(2))	W-2 comp (1.415(c)-2(d)(4))	Section 3401(a) wages (1.415(c)-2(d)(3))
Salary	Included	Included	Included	Included
Overtime	Included	Included	Included	Included
Bonuses	Included	Included	Included	Included
Commissions	Included	Included	Included	Included
Tips	Included, but allocated tips are arguably excepted	Same as current includible compensation	Exclude allocated tips, noncash tips, tips under \$20 per month	Same as W-2
Elective deferrals	Included	Included	Included	Included
Differential wage payments to individuals in the military	Included	Included	Included	Included
Regular compensation paid after severance from service	Included	Included	Included	Included
Severance pay	Excluded	Excluded	Excluded	Excluded
Expense reimbursements - accountable plan	Excluded	Excluded	Excluded	Excluded
Expense reimbursements – non-accountable plan	Included	Included	Included	Included
"Qualified" moving expense reimbursements	Excluded	Excluded	Excluded	Excluded
"Nonqualified" moving expense reimbursements	Included	Excluded	Included	Included
Nontaxable fringe benefits	Excluded	Excluded	Excluded	Excluded
Taxable fringe benefits	Included	Included	Included	Included
"Excess" group term life insurance	Included	Included	Included	Excluded
Taxable medical or disability benefits	Included	Excluded	Included	Included

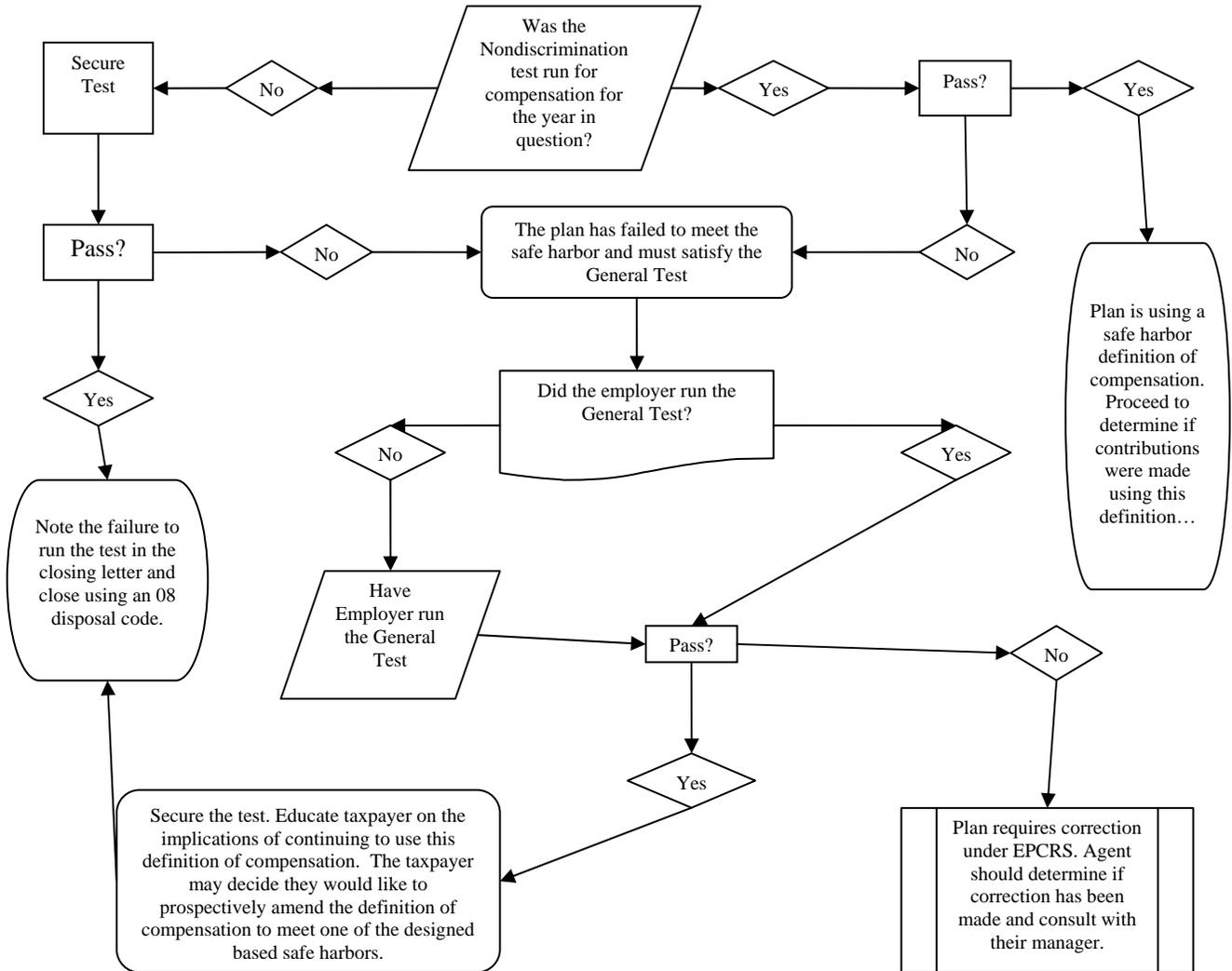
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Exhibit 2 – Comparing Compensation Definitions, Continued

Comparison
Table

Item of compensation	Statutory definition (1.415(c)-2(a)--2(c))	Simplified comp. (1.415(c)-2(d)(2))	W-2 comp (1.415(c)-2(d)(4))	Section 3401(a) wages (1.415(c)-2(d)(3))
Worker's compensation	Excluded	Excluded	Excluded	Excluded
Section 83 property that become freely transferable or no longer subject to substantial risk of forfeiture	Excluded	Excluded	Included	Included
Income attributable to Section 83(b) election	Included	Excluded	Included	Included
Nonqualified plan contributions excludable in year of contribution	Excluded	Excluded	Excluded	Excluded
Nonqualified plan distributions	Excluded unless plan provides otherwise	Excluded unless plan provides otherwise	Included	Included
Statutory stock options - grant or exercise	Excluded	Excluded	Excluded	Excluded
Non-statutory stock option includible in income in year granted	Included	Excluded	Included	Included
Non-statutory stock option - income includible in year of exercise	Excluded	Excluded	Included	Included

Exhibit 3 – Flow Chart For Case Processing



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