

# Definition of Compensation

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## *A Segment in Our Retirement Rescue Series*

*One of the most common errors submitted to the IRS Voluntary Correction Program (VCP) involves the Plan's Definition of Compensation. If the definition used in operation does not match the definition stated in the Plan Document, a failure has occurred.*

*Does your Plan need to be rescued?*

### **Utilizing the Incorrect Definition of Compensation**

The Definition of Compensation is integral to a Plan's design because it provides a basis for the calculation of employee deferrals and employer contributions. Definition of Compensation errors are so common because they can occur for a variety of reasons. If a Plan Amendment has changed the definition, but Plan operations have not changed, this failure can occur. An erroneously marked box on the Plan's Adoption Agreement can also cause the incorrect Definition of Compensation to be used, as could not fully understanding the Plan Document or Adoption Agreement prior to signing.

In short, any time the Definition of Compensation used in Plan operations does not match what is dictated by the Plan Document, an error has occurred. Because of this failure, types of compensation may have been incorrectly excluded or included which could require corrective contributions or distributions.

### **Correction Methods**

Plan Sponsors have multiple correction methods to consider depending on the specific situation. If the Definition of Compensation used was the definition conveyed to Plan participants, a retroactive amendment may remedy the error by changing the written Definition of Compensation to match the definition used in operation. Because Participants were expecting deferrals and contributions to be handled as they were, corrective contributions and/or distributions would not be appropriate. For this method, the Plan Sponsor must propose the retroactive amendment to the IRS and submit validation of participant expectations along with a VCP submission.

If the Definition of Compensation used was not reflective of the Plan Document or what participants were anticipating, corrective contributions or distributions are likely required to put affected participants in the situation they would be in had the failure not occurred. These corrections should include earnings. For example, if bonuses are not included in the Plan's Definition of Compensation but elective deferrals are made from bonus wages, correction under this method would include restoring this money, plus earnings, back to participants.

Plan Compensation Errors - How to Correct When Your Plan Definition of Compensation is Different from Plan Operations. Internal Revenue Service. 19 September 2016.

401(k) Plan Fix-It Guide - You didn't use the plan definition of compensation correctly for all deferrals and allocations. Internal Revenue Service. 23 August 2016.