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The Importance of Wage Code Reviews

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A key issue in an IRS audit and related internal Form 5500, *Annual Return/Report of Employee Benefit Plan*, auditor review is to ensure that the various definitions of compensation under a tax-qualified retirement plan (a "plan") are being properly implemented. This article provides background on this issue and discusses various definitions of compensation, the potential consequences of the mistreatment of compensation definitions, and related considerations that are important to maintain the tax qualified status of a plan.

BACKGROUND

A plan typically uses various definitions of compensation. For example, a plan may use one definition of compensation for purposes of determining employee deferrals, another definition of compensation for purposes of determining employer contributions, and other definitions of compensation for purposes of the Internal Revenue Code[1] rules (e.g., actual contribution percentage testing, actual deferral percentage testing, and top-heavy requirements). Varying definitions of plan compensation for different purposes often lead to a "disconnect" between a definition of compensation and how that item of compensation is treated by payroll for plan purposes (a "wage code").

Where a wage code does not properly "sync up" with a plan's definition of compensation, potential qualification errors can occur, as the improper treatment of a wage code may result in a missed deferral opportunity or an excess amount being contributed to a plan. These wage code errors may result in a plan needing to take certain corrective actions under Rev. Proc. 2021-30 (or future updated revenue procedures) (EPCRS), drafting participant communications, and coordinating with payroll to correct the wage code errors prospectively. To avoid wage code errors, a plan sponsor should periodically confirm with payroll that a plan's treatment of its wage codes align with the plan's potentially various definitions of compensation.

COMPENSATION DEFINITIONS

Compensation Under the Code

The Code and related Treasury regulations generally define compensation in several ways:

- A "statutory" definition which includes most items of gross pay but excludes amounts such as severance pay, reimbursements from accountable plans, moving expenses, non-taxable fringe benefits, worker's compensation, §83 property that is no longer subject to a substantial risk of forfeiture (including income attributable to a §83(b) election), non-qualified plan contributions and distributions, and certain non-statutory stock options.[2]
- A simplified definition which is generally the same as the above, though with different treat-

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[1] All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[2] *See* Reg. §1.415(c)-2(a)–§1.415(c)-2(c).

ments related to tips, taxable medical and disability benefits, and §83(b) income.[3]

- A ''Form W-2'' definition which is generally the same as the ''statutory'' definition but excludes tips under $20 per month but includes §83 property that is no long subject to a substantial risk of forfeiture, non-qualified plan distributions, and non-statutory stock options.[4]
- A §3401(a) definition which is generally the same as the Form W-2, *Wage and Tax Statement*, definition but excludes excess group term life insurance.

Section 414(s) also uses various definitions of compensation for testing purposes, which are generally amounts reported in box 1 of a Form W-2 (i.e., §6041, §6042, and §6051), amounts subject to federal withholding (i.e., §3401(a)), and §415(c)(3) compensation. Section 414(s) also includes a safe harbor which permits excluding reimbursements, expense allowances, fringe benefits (both cash and non-cash), moving expenses, deferred compensation, and welfare benefits. The Code definitions of compensation are complex and the above is only a very high-level discussion of compensation definitions.

Compensation for Purposes of Deferrals and Contributions

Compensation as defined under a plan for purposes of employee deferrals and employer contributions will sometimes (more frequently in a pre-approved plan) track one of the above Code definitions. However, a plan will often modify or narrow the Code's broad definitions of compensation to exclude certain amounts when determining employee deferrals and employer contributions. Such exclusions may vary as between employee deferrals and employer contributions, and will often depend on the line of business in which the plan sponsor participates (e.g., travel, securities, banking, etc.).

For example, where a plan uses a limited number of wage codes, compensation may be as narrow as base pay plus a restricted number of other wage codes (e.g., shift differentials, commissions, bonuses, and overtime). Alternatively, where a plan uses a large number of wage codes (most frequently occurring under a plan with a large and diverse participant base with a significant amount in total assets) there may be a broad definition of compensation but a correspondingly large number of exclusions — e.g., include bonuses for purposes of employee deferrals but exclude bonuses for purposes of employer contributions. More so, if the plan is collectively bargained, reviewing the collective bargaining agreement between the applicable union and plan sponsor will be important when determining how compensation should be defined for a particular represented group.

Common compensation exclusions (although, again, exclusions may vary as between employee deferrals and employer contributions) include moving expenses (or an industry equivalent — e.g., coterminal expenses for pilots or other more transient employees), plan sponsor-paid life insurance premiums, disability and worker's compensation pay, severance pay, vacation or sick time cash-outs, benefits provided to family members, reimbursements, tips, imputed income, bonuses, cost-of-living adjustments, or items specifically excluded under a collective bargaining agreement. Of course, the above list is not all-inclusive and the specific plan document should be reviewed for purposes of determining compensation ''carve outs.''

Compensation for Testing Purposes

As noted above, a plan's definition of compensation for purposes of testing (e.g., actual contribution percentage testing and actual deferral percentage testing) is often different than its definition for other purposes (e.g., employee deferrals and employer contributions). Testing compensation typically uses one of the §414 or §415 definitions, while compensation for other purposes may be more narrow.

CORRECTING WAGE CODE ERRORS RELATED TO COMPENSATION DEFINITIONS

The improper treatment of a wage code under a plan's definition of compensation is typically a qualification error. The correction of such an error can be done in multiple ways. Potential correction methods are discussed in more detail below:

- **EPCRS (Corrective Contribution):** In some instances, a wage code will be improperly classified as not eligible for employee deferrals and/or employer contributions when the amount should have been. Here, the plan sponsor will generally be required to contribute a qualified non-elective contribution (a ''QNEC'') to the affected individual's plan account — typically 50% of the missed deferral amount, subject to certain EPCRS safe harbor rules. The QNEC should be adjusted for earnings. Any missed employer matching contribution and/or non-elective contributions should

[3] Reg. §1.415(c)-2(d)(2).

[4] *See* Reg. §1.415(c)-2(d)(4).

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also be contributed to the affected individual's plan account, adjusted for earnings.

- **EPCRS (Corrective Distribution/ Forfeiture):** Alternatively, a wage code may be improperly classified as eligible for employee deferrals and/or employer contributions when the amount in fact should not have been. Here, the plan sponsor will generally be required to distribute the improper employee deferrals, adjusted for earnings, to the employee and report the distribution on a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc*. (including that the amount is not rollover eligible). Additionally, any improper employer contribution (i.e., match or nonelective), adjusted for earnings, should be moved to the plan's forfeiture account and used in accordance with the terms of the plan (typically, for QNECs and plan expenses).
- **EPCRS (Retroactive Plan Amendment):** EPCRS permits a plan to be retroactively amended in certain situations — specifically, where a retroactive amendment would result in an increase in a benefit, right, or feature to a group of plan participants (ideally, non-highly compensated employees), and such increase would be permitted under the Code and satisfies the correction principals of EPCRS.
- **Coordinate with Payroll:** Since payroll, either internal or external, typically facilitates how wage codes are treated for various definitions of plan compensation, coordinating with them to ensure wage code treatments ''sync up'' with a plan's various definitions of compensation is very important. If a wage code error is identified, a plan should coordinate with its payroll provider to ensure it is corrected prospectively.

CONSIDERATIONS WHEN ADDRESSING WAGE CODE ERRORS

Simply put, wage code errors — which are plan qualification errors — are fairly common but may not be reviewed frequently. A plan will often use or discontinue the use of a wage code without confirming on the back end (i.e., with payroll) that the wage code properly aligns with the plan or has properly been discontinued. Below are some general considerations for a plan to take into account when considering wage codes, compensation definitions, and wage code review.

Treatment of the Wage Code and Compensation Definitions

A plan should consider whether a wage code has been improperly included or excluded from a definition of compensation, including how a definition of compensation can vary — for instance, whether a wage code was improperly used for purposes of employee deferrals or employer contributions, or, alternatively, for testing.

Corrections

Correcting a wage code error varies based on the type of error but can generally include:

- **Correction of Wage Code Errors (Missed Deferrals/Contributions):** If a wage code was improperly excluded from a definition of plan compensation, a QNEC and corresponding employer contributions, adjusted for earnings, may be required. A plan should coordinate with its recordkeeper to the extent necessary to facilitate the corrective contributions.
- **Correction of Wage Code Errors (Excess Amounts):** If a wage code was improperly included in a definition of plan compensation, corrective distributions and forfeitures may be required. A plan should coordinate with its recordkeeper to the extent necessary to facilitate having Forms 1099-R distributed and moving improper employer contributions to the plan's forfeiture account.
- **Correction of Wage Code Errors (Retroactive Amendments):** A plan should consider whether correcting a wage code error may be done through a retroactive amendment under applicable EPCRS rules. One important consideration is whether a retroactive amendment would comply with the anti-cut back rules of §411(d)(6).
- **Coordinate with Payroll:** A plan should consider setting up a process whereby a new wage code will not be implemented until its treatment has been confirmed by the plan sponsor — this sort of confirmation process can help prevent wage codes from being improperly treated based on a plan's definitions of compensation.
- **Testing:** To the extent a plan identifies improperly treated wage codes, it should consider whether those wage codes could impact testing done for prior plan years.
- **Correction Period:** A plan should consider the period for which the wage code error occurred. Under EPCRS, any wage code error can generally be corrected using self-correction procedures if the error is identified and corrected within three years following the year in which

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the error occurred. If wage code errors fall outside of that window, a plan will need to consider whether the errors were insignificant based on EPCRS factors (if not insignificant, the plan would need to utilize the voluntary correction program under EPCRS).

- **Terminated Employees with No Plan Account Balance:** If a terminated employee with no plan account balance received an excess allocation, a plan must generally send a letter to the affected individual requesting a return of the excess amount, subject to certain EPCRS de minimis rules. If a terminated employee with no plan account balance is owed a corrective contribution, subject to certain EPCRS de minimis rules, a plan should consider missing participant issues.
- **Netting:** A plan should consider, when making corrections, whether an affected individual has wage codes which have both been improperly included and excluded from compensation. Amounts can typically be netted to make the correction more administratively feasible.
- **Expectations:** A plan should review its participant communications (e.g., annual notices, summary plan description, etc.) to confirm employee expectation as to how a specific wage code would be treated under the plan. Sometimes employee expectations can support treating a specific wage code differently than as provided for under the plan.

Specific Types of Pay

Certain types of pay should be taken into account when considering wage codes, including:

- **One-Time Payments:** A plan should consider whether ''one-off'' payments fall into a definition of compensation. For instance, whether one-time bonuses, retroactive pay, amounts paid pursuant to changes in federal law, etc., should be included in plan compensation (typically for purposes of employee deferrals and employer contributions). If amounts should not be included, the plan should be amended to exclude those amounts prior to payment.
- **Post-Severance Amounts:** A plan should consider whether post-severance payments should be included in compensation.

Participant Communications

A plan should consider the need to communicate with participants regarding corrections. This consideration is especially important if a plan wishes to use a QNEC safe harbor approach under EPCRS.

Collectively Bargained Plans

A plan should review any applicable collective bargaining agreement to ensure the plan and the agreement sync.

Disqualification

Technically, the failure to properly code wage codes as compensation for specific purposes under a plan is an operational failure that could result in a revocation of a plan's tax-qualified status. As such, periodically reviewing the treatment of wage codes under a plan is important to avoid potential disqualification — having procedures in place to review wage codes would be helpful in the event of an IRS audit.

CONCLUSION

When dealing with wage code errors, the options above should be considered carefully and, to the extent necessary, the advice of counsel should be sought, as correcting wage code errors can be potentially costly — e.g., QNECs, drafting participant communications, and using the voluntary correction program under ECPRS. More so, a plan's compensation definitions can be complex, making wage code reviews time consuming, depending on the number of wage codes used by payroll.

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