One Cent, Two Cents, Red Cents, Blue Cents
What Counts as Plan Compensation?

By Alison J. Cohen, Esq.

Before we start, FBLC would like to give a big shout out to all of the amazing, hard-working third-party administrators out there who have been working long, hard hours these past few months on 2021 testing. We see the hour at which you send us emails (And Saturdays. And Sundays.). This year's testing season has been like a very bad COVID hangover. Everyone we've spoken to has been struggling (and that includes plan sponsors, too) and we want you to know that you're not alone. We're here for you. This Solution is dedicated to all the fantastic pension administrators out there helping Americans save for retirement.

Once Upon a Time….

Little Cindy Lou, who was a pension administrator in year two, receives census data from her client, Whoville, LLC, that simply doesn't make sense to her. She notices that the owner's compensation for 2020 has somehow doubled since last year. "But, Why? Why, Mr. Claus, has your compensation jumped up so much?" she asks. "You'll have to talk to my CPA, Mr. Grinch, to figure it out. He puts the data together, that he does, without a doubt." So, off to Mr. Grinch, Little Cindy Lou goes, ambitious and true, to figure out why one plus one doesn't seem to equal two.

"Why, you see, Cindy Lou, dear, I take the K-1 information from there and put it down here," said Mr. Grinch. "But aren't you an LLC taxed as an S-Corp?" asked Cindy Lou. (Yes, there is no good way to rhyme that and there is no way that Cindy Lou would understand that.)

'C' is for Compensation

It is amazingly common for folks to lose track of where compensation for plan purposes should come from. Between the different possible entity types, there are different ways that companies should treat compensation and pull the data for census purposes.

Compensation for a corporate employee or owner is based entirely on payroll and is reflected on Form W-2. S Corporation dividends (K-1) income is not compensation for plan purposes. Ever. "Can I count the K-1 Comp?" "No, please toss it in the swamp."

Compensation for an unincorporated business (sole proprietorship, partnership, LLC taxed as a partnership, etc.) is based on earned income. Earned income is net earnings from self-employment from a trade or business in which the owner's services are a material income producing factor. It includes both guaranteed payments for services and the partner's share of profit (or reduced by the partner's share of loss). It is adjusted for SE tax and retirement plan contributions.

Below is a handy chart as a reminder:

Entity Type	Plan Compensation Source	Relevant Tax Document	Timing of Deferrals
C-Corp S-Corp LLC, taxed as S-Corp Professional Corp	W-2 wages only	W-2	With each payroll
Limited Partnership Partnership LLC, taxed as Partnership	Self-employed Income	Schedule K-1 (self-employment income)	Prior to tax filing deadline (deferral must be elected before the last of the partnership tax year for which income is earned)
Limited Partnership Partnership LLC, taxed as Partnership	Guaranteed payments	Schedule K-1	Taken with each guaranteed payment (see note below)
Single Member LLC Sole Prop	Self-employed Income	Schedule C	Prior to tax filing deadline (deferral must be elected before 12/31 of calendar year for which income is earned)

What Do You Do with a Whoops?

Fortunately, Little Cindy Lou caught the problems with Whoville, LLC before testing went through, but maybe not soon enough to catch some operational failures. What if Mr. Claus deposited deferrals into the Whoville Plan from the company coffers in December at Mr. Grinch's instructions, instead of having them taken from his W-2 wages? Are they valid deferrals?

No. Since Little Cindy Lou has done her homework and knows that Whoville, LLC is taxed as an S-Corp, per the above chart, all deferrals must be taken from W-2 compensation on a per payroll basis. Taking the 'deferrals' from the company's general accounts, and theoretically from Mr. Claus' Schedule K-1, was impermissible. The contribution would then need to be considered a profit sharing contribution, which may trigger the need to fund additional amounts for other participants. Mr. Grinch will need to fix the tax filings and ensure that the amounts are not considered deferrals on the Schedule K-1. Since it is not a deferral, it is an employer contribution, to be allocated as a match or nonelective contribution. Hopefully, Mr. Grinch hasn't filed the Whoville taxes yet.

The typical question that we get asked next is: can Mr. Grinch simply amend the Form W-2 to reflect the deferrals instead and modify their internal records? Sadly, that's not a bell that can really be unrung. The deferrals are required to be taken on a per payroll basis. In reality, that wasn't done. Even if the paycheck in December was large enough to cover the entire year's deferral contribution, to tamper with the Form W-2 would impact federal and state withholding figures. There is no doubt that the IRS would frown on such a practice.

Now, let's change our facts just a bit. What would we have if Whoville was an LLC taxed as a partnership? In that instance, what Mr. Grinch did when he had Mr. Claus contribute the deferrals from the company coffers in December was correct. It would be the Schedule K-1 that would count as income and, as Mr. Claus' election was made prior to December 31, so long as the funds were deposited before his tax filing deadline, it would be a permissible deferral contribution. Mr. Claus would also have the option to have his deferrals taken from his periodic guaranteed payments throughout the year. There could still be an operational failure if Mr. Claus failed to make his deferral election by December 31, even if it was funded in a timely manner. (BTW – when the IRS looks to see if an election was made timely, it wants to see it in writing and not be told that it was just a verbal understanding.)

Guaranteed payments are part of earned income, but they don't stand alone. Earned income includes both guaranteed payments and, in the case of a general partner, the partner's distributive share of profits and losses. If the K-1 is reflected properly, that figure is line 14 (Code A) on the K-1. What happens if the guaranteed payments were $100,000, but the partner had a $95,000 business loss? Then the partner's earned income is only $5,000 (adjusted for SE Tax and retirement plan contributions).

Another common mistake that we've seen is to issue a W-2 to a partner that is part of a partnership or an LLC taxed as a partnership. That's a no-no. Per the chart above, partnership and LLC/partnership folks should just have the Schedule K-1 income. It is important that the TPA receive information from the client, or its CPA, that is accurate. Don't be afraid to ask questions and challenge what doesn't seem right.

Conclusion

Entire books are written regarding compensation – the whole tax code, in fact – so it is not a slight on anyone who doesn't fully understand this topic. It is important to at least understand the basic information presented above and to know when to ask the right questions. If you are a TPA, and you see something that doesn't make sense, make sure you document your questions in an email to the client and suggest that they consult with their legal counsel and tax professional. Aspire to be Little Cindy Lou and never be afraid to ask questions. Good luck with testing season!!

Pensions on Peachtree 2021 is coming up next month!

April 26-27, 2021

Registration is open for the 2021 Pensions on Peachtree Conference, co-sponsored by Ferenczy Benefits Law Center and FIS. It is virtual again this year (social distancing at its finest y'all). All of our friends can join us from wherever you are. We look forward to "seeing" you all online with us!

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