Plan Sponsor’s Guide to Compensation

A Resource for Plans Utilizing Fidelity’s Volume Submitter Plan Document

The material contained in this guide is provided for informational purposes only and is not intended to constitute tax or legal advice. This resource is intended for plans that utilize the 2014 Fidelity Volume Submitter Defined Contribution Plan document; however, this guide is not applicable to the 403(b) Volume Submitter Plan document.

Generally, three types of compensation are used for qualified defined contribution plans.

- Gross compensation (415)
- Test compensation (414(s))
- Compensation for determining contributions

The plan is required to use a gross definition for certain plan purposes. That gross definition may be used for testing and/or for determining contributions, but it is not required.

**Gross (415) Compensation – Required Information**

Because gross compensation is required for determining a plan’s HCEs (highly compensated employees), Fidelity’s Testing & Reporting Services requires gross compensation data for nondiscrimination testing.

Gross compensation is also used for the following:

- Determining key employee status (top heavy testing)
- Top heavy contributions (if the plan is top heavy)
- Determining 415 limits
- The 5% minimum allocation gateway (if the plan is cross-testing a non-uniform nonelective contribution)

The plan document provides the definition for gross compensation.

**TIP:** Review the Compensation Resource Guide for additional information regarding gross compensation.
Test (414s) Compensation – Only Required for Startup Plans, Optional Otherwise

Test (414s) Compensation is often referred to as a nondiscriminatory definition of compensation. The compensation used in nondiscrimination testing must satisfy this requirement. Gross compensation satisfies the requirements of 414(s) and may be used in nondiscrimination testing. Therefore, if a plan sponsor supplies gross compensation only, it will be used as test compensation as well.

However, since the regulations provide for additional safe harbor definitions of test compensation, a plan sponsor may supply another form of test compensation. Although supplying an additional form of test compensation will require additional data compilation on behalf of the plan sponsor, it may provide a better result. If a plan sponsor supplies an additional form of test compensation, Fidelity will provide the test results based on whichever compensation provided the best results. If supplying test compensation for one employee, it must be supplied for all.

For a startup plan, test compensation should be from the effective date of the plan through the last day of the plan year.

Compensation for Determining Contributions

Gross, test or another type of compensation may be used to determine a plan’s contributions. The plan’s Adoption Agreement will specify the compensation used for determining contributions.

**NOTE:** Using another type of compensation, may subject the plan to additional compensation testing.

The compensation for determining contributions is required only if the plan sponsor has engaged Fidelity to calculate an employer contribution at the conclusion of the plan’s nondiscrimination testing or additional compensation testing is required.
Frequently Asked Questions

When is 414(s) Compensation Testing required?

A plan is required to use a 414(s) definition for nondiscrimination testing and for certain contributions. When the plan is required to use a 414(s) definition, if the plan does not utilize a safe harbor compensation, it must ensure the compensation used is nondiscriminatory through the 414(s) Compensation Test.

The Compensation Test is required in the below scenarios.

- The plan does not use a 414(s) safe harbor definition of compensation for nondiscrimination testing.
- The plan does not use a 414(s) safe harbor definition of compensation for determining contributions to a safe harbor 401(k) plan.
- The plan does not use a 414(s) safe harbor definition of compensation for a design-based nonelective contribution (i.e. a uniform percentage contribution or an integrated allocation).
- The plan does not use a 414(s) safe harbor definition of compensation for the 1/3 minimum allocation gateway (if the plan is cross-testing a non-uniform nonelective contribution).

What are the 414(s) safe harbor definitions of compensation?

Gross compensation is a 414(s) safe harbor. Other types of 414(s) safe harbor compensation include:

1. Gross compensation less pre-tax deferrals (see the Compensation Chart for further details of what is excluded)
2. Gross compensation less fringe benefits (cash and noncash), reimbursements or other expense allowances, moving expenses, deferred compensation, and welfare benefits. All of these items have to be excluded for it to be considered a safe harbor definition. For purposes of determining contributions, these are all excluded by the Adoption Agreement unless a selection was made to add some or all of them back.
3. Compensation from when a participant becomes eligible. Per the plan document, if the plan sponsor has elected different eligibility requirements for deferral and matching contributions, then testing compensation shall be based on compensation for the full year.
4. Any compensation exclusion that is applied only to HCEs

What compensation following a severance of employment is included in gross compensation?

The final 415 regulations effective for plan (limitation) years beginning after 7/1/07 provide specific rules regarding when amounts received following severance from employment are considered compensation for purposes of gross compensation. These regulations state that amounts received
following severance from employment are generally not considered to be compensation for purposes of gross compensation with a few exceptions. The following are the exceptions (i.e. to include in gross compensation) for certain payments made by the later of 2\(\frac{1}{2}\) months following severance from employment or the end of the year in which the severance occurs:

1. Payments that, absent a severance from employment, would have been paid to the employee while the employee continued in employment with the employer and are regular compensation for services during the employee’s regular working hours, compensation for services outside the employee’s regular working hours (such as overtime or shift differential), commissions, bonuses, or other similar compensation; and

2. Payments for accrued *bona fide* sick, vacation, or other leave, but only if the employee would have been able to use the leave if employment had continued

3. Payments pursuant to a nonqualified unfunded deferred compensation plan, but only if the payment would have been paid to the participant at the same time if the participant had not severed employment and only to the extent that the payment is includible in the participant’s gross income

4. Differential Wages - Compensation paid to an employee by the Employer with regard to military service meeting the definition of differential wage payment found in Code Section 3401(h)(2)

Compensation from severance agreements (often called severance packages), to the extent they do not include any of the compensation listed in the 4 criteria above, are generally not included in gross compensation.

The following are a few examples of how to apply the later of 2.5 months following severance of employment or the end of the year the severance occurred. All the examples below assume the compensation paid meet one of the 4 criteria listed above.

1. Limitation year is 01/01/16 – 12/31/16
   Employee’s termination date is 05/05/16 and compensation was paid on 09/01/16

   The employee was paid on 09/01/16 which is by the end of the limitation year of the severance, so the amount paid on 09/01/16 should be included in the gross compensation supplied to Fidelity for the 2016 limitation year.

2. Limitation Year is 01/01/16 – 12/31/16
   Employee termination date is 12/01/15 and compensation was paid on 09/01/16

   The employee was paid on 09/01/16 which is after the end of the limitation year, so the 2.5 month timeframe needs to be assessed. The compensation paid on 09/01/16 should not be included in gross compensation because the 09/01/16 check date is after the end of the limitation year of the severance and exceeds the 2.5 month timeframe for inclusion.

3. Limitation Year is 01/01/16 – 12/31/16
   Employee termination date is 12/01/15 and compensation was paid on 01/15/16
The employee was paid on 01/15/16 which is after the end of the limitation year, so the 2.5 month timeframe needs to be assessed. The compensation paid on 01/15/16 should be included in gross compensation because, while the check date is after the end of the limitation year of the severance, it is within the 2.5 month timeframe for inclusion.

**Can an employee defer from a final paycheck?**

As long as the compensation meets the criteria to be included in gross compensation as explained above in severance compensation and the plan does not choose to exclude the compensation, an eligible employee should be able to defer to the 401(k) arrangement.

**What is look-back compensation? When is it required?**

Look-back compensation is generally defined as gross compensation for the twelve-month period preceding the plan year being tested. That twelve-month period is known as the look-back year. Look-back compensation is primarily used to determine the plan’s highly compensated employees (HCEs) for the plan year being tested.

An employee is considered an HCE if their compensation in the look-back year exceeds an IRS threshold. If Fidelity performed testing for the plan in prior year, the look-back year compensation should already be available to Fidelity. If Fidelity did not perform testing for the plan in the prior year, then the look-back year’s compensation would need to be supplied. If the plan has experienced an employer change or plan merger, then lookback compensation may need to be supplied. Since the HCE determination is applied on an employer wide basis (including “related” employers), if the plan uses the top-paid group election to determine HCEs, additional look-back compensation may be needed to properly determine HCEs. The look-back year is generally the 12 months preceding the current plan year. However, plans that do not have a plan year end of 12/31 may elect to use a calendar year period to determine HCEs which would require supplying the additional calendar year look-back compensation.

**Is Compensation Prorated For Short Plan Years and Terminated Plans?**

If the plan determines compensation over a period that contains fewer than 12 months (i.e. short plan years and generally terminated plans), then the compensation limit for such short determination period shall be prorated based on the number of full months in the short determination period divided by 12.

**What is a Startup Plan? How is Testing Done?**

Startup plans, or newly-created plans, have effective dates in the plan year being tested. The following rules detail the type of compensation that should be used for testing in the first plan year.
1. If the initial plan year consists of fewer than 12 months, gross compensation shall be the 12-month period ending on the last day of the plan year.
2. For purposes of determining HCEs, the look-back year shall be the 12 months immediately prior to the 12 months ending on the last day of the plan year.
3. Test compensation should be from the effective date of the plan through the last day of the plan year.

**IMPORTANT:** Compensation should only be accounted to the extent the sponsoring employer was in existence. If the sponsoring employer commenced its business on 7/1/15, gross compensation would be supplied from 7/1/15 – 12/31/15 and look-back compensation would not be applicable.
COMPENSATION RESOURCE GUIDE

This guide covers the common treatment of certain items of compensation; your specific treatment of compensation may vary. Please consult your accountant or attorney to ensure you are correctly defining your compensation.

Gross Compensation

<table>
<thead>
<tr>
<th>Definition of Gross Compensation</th>
<th>Gross Compensation is typically all compensation earned by an employee, minus the following exclusions:</th>
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<tbody>
<tr>
<td></td>
<td>• Non-Taxable Expense Reimbursement</td>
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<td></td>
<td>• Long-Term disability pay paid by third party</td>
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<td>• Severance pay as part of severance package or separation payout (paid after termination).</td>
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<td></td>
<td>• Regular wages paid more than 2 ½ months after termination or after the plan year end date, whichever is longer. Regular wages can be wages, unused time off pay, commissions, bonuses and other similar pay.</td>
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<tr>
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<td>• Severance pay part of Welfare Benefit Plan</td>
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<tr>
<td></td>
<td>• Severance pay related to Military/Uniformed Service that exceeds employees expected regular wages.</td>
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<td></td>
<td>• Short-Term disability pay (including sick pay) part of a Welfare Benefit Plan</td>
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</tbody>
</table>

When to use Gross Compensation?

All plans must submit Gross Compensation for all employees. For new plans, Gross Compensation should be based upon the entire year of compensation.

Test Compensation

<table>
<thead>
<tr>
<th>Definition of Test Compensation</th>
<th>Test Compensation is Gross Compensation minus ALL pre-tax deferrals, sometimes available on Box 1 of an employee’s W-2. Test Compensation can also be provided from an employee’s date of eligibility during the plan year through the end of the year. See below for common exclusions:</th>
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<tbody>
<tr>
<td></td>
<td>• Elective pre-tax contributions to IRC Section 401(k), 403(b)</td>
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When to use Test Compensation?

Test Compensation may be used optionally to test your plan as an alternative to Gross Compensation. However, Gross Compensation is still required of all plans. For a NEW plan (startup plan during the year), Test Compensation is REQUIRED from the plan original effective date through the end of the first plan year.

Look Back Compensation

<table>
<thead>
<tr>
<th>Definition of Look Back Compensation</th>
<th>Look Back Compensation is used to determine the Highly Compensated Employees. Therefore, it is Gross Compensation for the year prior to the year you are testing. If you are testing plan year 2016, then it is Gross compensation for 2015.</th>
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</thead>
</table>

When to use Look Back Compensation?

Look Back Compensation is only needed in the first year a plan is tested by Fidelity, or if a new population is added to an existing plan. Some situations that will require Look Back Compensation:

• The plan moved to Fidelity (1st year of testing).
• The plan experienced a Merger that brought in a new population that has never been tested by Fidelity.
• The plan has populations being tested by Fidelity but not record kept by Fidelity.

Compensation to be considered when Determining Gross and Test Compensation:

- Elective pre-tax contributions to IRC Section 401(k), 403(b) Tax-Sheltered Annuities, 125 Cafeteria Plan, and SEPs (to be used for Gross Comp Only).
- Salary
- Overtime
- Bonuses
- Commissions
- Amounts paid to HCEs under IRC Section 105(h) Plan
- Fringe benefits under IRC Section 132
- Educational assistance dependent care under IRC Sec 127 & 129
- Taxable Expense allowance
- Long-term disability pay paid by employer
- Long-term disability pay paid by a third party
- Moving expense or allowance
- Unfunded deferred compensation payouts while employed
- Differential Pay for employees called to active duty (Military/Uniformed Services)
- Severance pay of regular wages and not part of a Welfare Benefit Plan— if paid within the plan year or 2 ½ months following the termination date, whichever is longer.
- Severance pay of regular wages and not part of Welfare Benefit Plan— if paid on or before the termination date
- Severance pay related to Military/Uniformed Service that does not exceed employees expected regular wages
- Short-Term disability pay (including sick pay) not part of a Welfare Benefit Plan
- Taxable value of employer qualified or non-qualified stock option
- Taxable value of group-term life insurance
- Taxable value of meals or lodging allowance