
Compensation Nondiscrimination Requirement And Testing (IRC §414(s))

The definition of compensation used in a qualified plan must be nondiscriminatory. Any definition of compensation satisfying Internal Revenue Code (IRC) §415(c)(3) automatically satisfies the nondiscriminatory requirement of IRC Section 414(s), subject to certain limitations in amount. As an alternative, a plan may rely on a safe harbor by defining compensation that satisfies IRC §415(c)(3) and then reduced by certain items.

The table in this section outlines the definitions of compensation automatically satisfying IRC §414(s). However, if the plan's definition of compensation does not automatically satisfy IRC §414(s), it must prove it is not using a discriminatory definition. To do so, its definition (i) must not favor Highly Compensated Employees (HCEs) by design, and (ii) must be reasonable.

Usually, compensation is considered reasonable if it would automatically satisfy IRC §414(s) except for the exclusion of certain types of irregular or additional compensation - for example, bonuses or overtime.

A definition of compensation is considered nondiscriminatory if under its definition the average percentage of total HCE compensation does not exceed by more than a de minimis amount the average percentage of total NHCE compensation calculated in the same way.

Averages are calculated by first determining the compensation percentage for each employee in the group by dividing that employee's compensation, as defined in the plan, by the employee's total compensation, as defined by IRC Section 145(c)(3). The average of the individual compensation percentages is the average percentage for the group. If the average of the NHCE group is greater than the average of the HCE group, the compensation definition is nondiscriminatory. If the HCE group average is slightly less than the HCE group average, the compensation definition may be considered nondiscriminatory, but it would depend on the facts and circumstances.

In general, there are four possible definitions for compensation, plus a fifth safe harbor for nondiscrimination testing purposes:

1. IRC §415 Long List: All compensation includable in gross income
2. IRC §415 Short List: Only items usually considered wages
3. IRC §3401(a) Wages: All wages considered for tax withholding purposes
4. W-2 Wages: Wages reportable in Box 1 of Form W-2¹
5. §414(s) Safe Harbor: safe harbor definition for nondiscrimination testing²

	Long List	Short List	§3401(a)	W-2	§414(s)
Direct pay: salary, over-time, holiday and vacation pay, bonuses, commissions, shift differential	yes	yes	yes	yes	
Direct-type pay: unusual vacation time payments, employer-paid FICA / FUTA	yes	yes	yes	yes	
Professional fees	yes	yes	yes	yes	
Reimbursements, expense allowance and taxable fringe benefits	yes	yes	yes	yes	exclude ^a
Expenses under a "non-accountable" plan ^b	yes	yes	yes	yes	
Earned income under §911	yes	yes	yes	yes	
Flexible benefits or credits received as cash	yes	yes	yes	yes	
Unallocated tips	yes	yes	yes	yes	
Allocated (pooled) tips	yes	yes	yes	yes	

1. Reg. 1.414(s)-1(c)(2), and Reg. 1.415-2(d)(11). Some practitioners suggest defining compensation as W-2 income when Controlled Group or Affiliated Service Group status is present. In that way, it is argued, even if the groups are combined for qualification purposes, nevertheless the second employer's employees will receive no benefits because they receive no W-2 income from the first employer. Such an approach is based in part on the fact that Controlled Groups and Affiliated Service Groups are defined by federal tax law rather than federal labor law. However, new court cases are tending to be based on labor law issues, presumably as the path of least resistance. Thus, some argue that the lack of an explicit standard on the labor law side allows for a looser interpretation on such issues.
2. Reg. 1.414(s)-1(c)(3)

	Long List	Short List	§3401(a)	W-2	§414(s)
Unfunded deferred compensation payouts while employed, if allowed by plan	yes	yes	yes	yes	exclude
Non-taxable elective contributions or deferrals to §125 (Cafeteria), §401(k), §403(b), SEP, SARSEP and §457 plans. Also, §414(h)(2) "pick-up" contributions	Note 1 ^c	Note 1	Note 1	Note 1	
Taxable group term life insurance for coverage in excess of \$50,000	yes	yes	no	yes	exclude
Includible §105(h) short-term disability pay (sick pay)	yes	no	yes	yes	exclude
Long term disability pay	yes	no	yes	yes	exclude
Moving expense if:					
(i) deductible	no	no	no	no	
(ii) nondeductible	yes	no	yes	yes	exclude
Nonqualified stock option at time of grant, if taxable:					
(i) on option privilege	yes	no	yes	yes	
(ii) on exercise	no	no	yes	yes	
§83(b) elections	yes	no	yes	yes	
§83 property vesting	no	no	yes	yes	
§83 property when received	no	no	no	no	
Disqualifying disposition of qualified stock option	no	no	no	no	

	Long List	Short List	§3401(a)	W-2	§414(s)
Nontaxable employer-provided education assistance (§127), employer-provided dependent care (§129), service provided under group legal services plan (§120), certain employee awards or prizes (§74(c)), fringe benefits (§132)	no	no	no	no	
Meals or lodging under §119	no	no	no	no	
Severance pay	Note 2 ^d	Note 2	Note 2	Note 2	Note 2

- a. That is, §415(c)(3) compensation, reduced by certain items shown as "exclude" under the safe harbor alternative.
- b. An "accountable plan" is one complying with Reg. 1.62-2(c) by properly providing for substantiation of expenses; for example, most Section 125 or Cafeteria Plans. A "non-accountable plan" is any other expense allowance or reimbursement arrangement.
- c. **Note 1:** The answer is "yes" for some purposes, while the employer has a choice for other purposes. Beginning in 1998, the answer became "yes" for purposes of determining Highly Compensated Employees (HCEs) and Key Employees, for determining the maximum benefit limit under IRC §415, and for doing Top-Heavy testing.
- d. **Note 2:** Generally, the answer is "yes", and severance is included in compensation. However, the issues involved are broader in scope and depend on facts and circumstances as well as the period of compensation considered. For this reason, employers should consider consulting their attorney for a final determination. An issue commonly addressed is whether any severance pay is attributable to prior years.