

## **What is Compensation? What difference does it make?**

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### **Overview**

- How is compensation defined?
- Where does it matter?
- What do the Code / regulations say?
- What about folks who don't get a Form W-2?
- Are S corporation shareholders self-employed or not?
- How can we help plan sponsors make this work?
- What do we do if the wrong definition was used?

## **Not Covering**

- 403(b) or 457 plans
- Ministers, clergy, etc.
- FICA/FUTA/withholding tax implications

## **Where does it matter?**

## What does it matter?

- Impacts benefit determination for nearly all defined benefit and defined contribution plans
  - Nearly all?
- Base for withholding salary deferrals for 401(k) plans
  - This is critical as many plan sponsors mess up here!
- Base for testing nondiscrimination
  - Highly Compensated
  - Non-discrimination

## What does the Code say?

**TOO MUCH!**

Becky Miller, anytime you ask.....

## What does the Code say?

- IRC Section 401(a)(5) – Nondiscrimination standard
- IRC Section 401(a)(17) – Limit on includible compensation
- IRC Section 401(c)(2) – Definition of *earned income* for self-employed persons
- IRC Section 401(l) – Permitted disparity

## What does the Code say?

- IRC Section 404(a)(12) – Definition for deductions
- IRC Section 409(b) – Archaic ESOP language
- IRC Section 414(q)(4) – For determining an HCE
- IRC Section 414(s) – For everything that says to look here!

## What does the Code say?

- IRC Section 414(u) – For veteran's reemployment privileges
- IRC Section 415(c)(3)
  - For limits on allocations,
  - ....but this is the fundamental one
- IRC Section 416 – For top heavy purposes

## What does the Code say?

**Not Enough,**

because now we have to go  
to the regulations.....

## Regulations

- Good News
- Two basic provisions
  - 414(s)
  - 415(c)
- One builds upon the other

## 414(s)

- Nondiscrimination standard
  1. Section 415(c)(3)
    - With or without salary deferrals
  2. Above reduced by ALL of the following:

## **414(s) Compensation**

- Reductions to 415(c)(3) compensation
  - Reimbursements or other expense allowances
  - Fringe benefits (cash and non-cash)
  - Moving expenses
  - Deferred compensation
  - Welfare benefits

## **414(s) Compensation**

- Nondiscrimination standard
  1. Section 415(c)(3)
    - With or without salary deferrals
  2. Above reduced by ALL of the adjustments
    - With or without salary deferrals
  3. Either of the above with exclusions for highly compensated employees only
    - With or without salary deferrals

## **PLANNING POINT**

Commission sales personnel  
and safe harbor:

Exclude commissions of  
HCEs, rather than all  
commissions.

## **414(s) Compensation**

- Apply consistently
  - Throughout the plan
  - Throughout the plan year
- Different definition permitted for actual allocations
- Different definition permitted for a different plan year
- Different definition permitted for a different plan of same employer.
- BUT watch aggregation rules!

## **414(s) Compensation**

- Other definitions are permissible:
  - Must be nondiscriminatory
  - Can't exclude a specific percentage of each participant's pay
  - Can set a different limit of pay, so \$100,000 rather than the 401(a)(17) limit.
  - Can use estimates in limited circumstances BUT
    - Estimated compensation must be used for testing AND for allocations

## **415(c)(3) Compensation**

- Finally – some real help
- Compensation includes:
  - Wages, salaries, etc. included in gross income
  - Employer contributions to a 403(b) or SEP
  - Elective deferrals
  - Taxable medical benefits
  - Non-deductible moving expense reimbursements
  - Certain options or restricted stock
  - Self-employment income

## 415(c)(3) Compensation

- Compensation does not include:
  - Distributions from a deferred compensation plan
    - **Other than an unfunded, nonqualified plan**
    - Even if included in gross income
    - What is this?
    - PS58 costs?
  - Certain options or income recognized under Section 83.
    - Wait.... wasn't that included in income above?

## 415(c)(3) Compensation

- Compensation does not include:
  - Amounts realized from sale, exchange; or other disposition of stock...
  - Premiums on group-term life insurance to the extent not includible in gross income
  - Accrued compensation
    - De Minimus rule for pay period cut-offs
    - Must be elected
    - Must be consistently applied

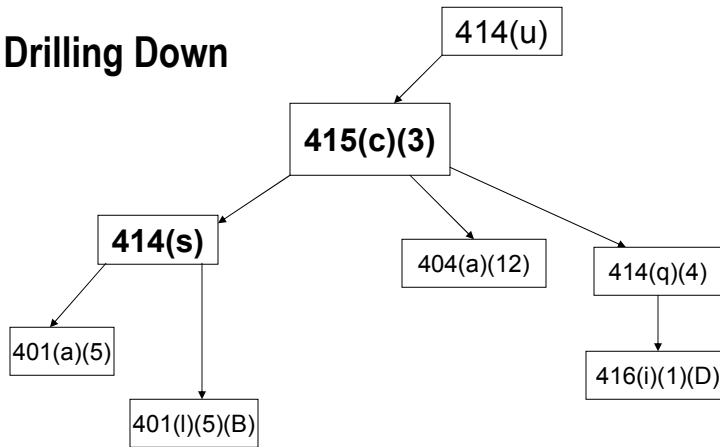
## **415(c)(3) Compensation**

- For 415 purposes only
  - Not to carry over to 414(s) and other sections
  - In a controlled or affiliated group, compensation includes compensation from other group members, even if not sponsoring the plan.

## **Alternate 415(c)(3) Definitions**

- Wages as defined for withholding – IRC Section 3401(a)
- Wages as defined for withholding plus ALL other compensation which must be included on Form W-2.
  - Permitted to exclude deductible portion of moving expenses.
- Plan may choose more than one 415 definition.
  - Where 415 is incorporated by reference, plan MUST specify which definition of compensation is to be used.

## Drilling Down



## Self-employed persons

- Net income from self-employment – IRC Section 401(c)(3)
  - Attributable to business for which plan is established
  - Reduced by employee contribution cost
  - Less one-half of SE taxes
  - Less any contributions made on behalf of self-employed person
    - Creates a simultaneous equation

## **Open Issues for Self-Employed**

- Is 401(k) a deduction or an exclusion?
- What if there are multiple sources of S/E income?
- What about expenses that a partner claims on his or her personal return as a deduction from partnership income?

## **Specific Issues on Partners**

- What is self-employment income?
  - General partners
  - Limited partners
  - Guaranteed payments
- Can you rely on the Form 1065, Schedule K-1?
- Can a partner get a Form W-2?

## What about S Corporations?

- IRC Section 1372
  - Partners for “fringe benefit purposes.”
  - This does not include retirement plans
- Use W-2 income, not S pass-through income
- Current IRS hot topic – too LOW of compensation paid to S corporation shareholders.

## Practical Advise

- Understand client’s compensation system
  - What kind of benefits do they offer?
- Understand client’s payroll system
  - What runs through payroll?
  - What has to be added at year-end?
  - Who prepares the W-2 forms?
  - Make sure they tell you of any changes in advance.
- Try to agree on a safe harbor

## What if they messed up?

- Where?
  - Allocations
    - EPCRS
  - Testing
    - Revise testing to correct definitions
      - Still wrong – EPCRS

## What if they messed up?

- Why?
  - Staff training
  - System failure
  - System change
- Response
  - Educate
  - Amend plan
  - Verify procedures

## **New EPCRS Ruling**

See [http://www.irs.gov/pub/irs-tege/cd\\_epcrs.pdf](http://www.irs.gov/pub/irs-tege/cd_epcrs.pdf)

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HAROLD T. SWARTZ

Assistant Commissioner (Technical)

Attention: Income Tax Division

In re: Armstrong, Anne L. & Tobin

Reference is made to a memorandum dated December 19, 1968 from the Refund Litigation Division to the Interpretative Division of this office (a copy of which is attached) pertaining to the case of Armstrong v. Phinney, 394 F.2d 661, (C.A. 5, 1968). This was a suit for refund of deficiencies paid by taxpayer, the managing partner of a ranch partnership resulting from the Service's inclusion in his gross income of the value of certain emoluments provided to him by the partnership, *i.e.*, a home at the ranch for himself and his family, most of his groceries, utilities, and insurance for the house, maid service, and entertainment of business guests at the ranch. Taxpayer did not report the value of these emoluments on the theory that he was an employee of the ranch and, as such, was entitled to exclude the value of these items from his gross income under section 119. In the court's view, the question to be determined was whether it is "legally possible for a partner to be an employee of his partnership for purposes of section 119 of the Code." The District Court answered this question in the negative and granted the government's motion for summary judgment.

In reversing the District Court, the Fifth Circuit concluded that in any situation not covered by section 707(b) and (c), where a partner renders services to the partnership and is not acting in his capacity as a partner, he is considered an "outsider" or "one who is not a partner"; that while the terms, "outsider" and "one who is not a partner," are not defined in the Code and the relationship between section 707 and the other Code sections is not explained, there is nothing to indicate "that Congress intended that this section is not to relate to section 119"; and consequently, that "it is now possible for a partner to stand in any one of a number of relationships with his partnership, including \* \* \* employee-employer." Accordingly, the case was remanded to the District Court for resolution of factual issues including whether taxpayer was, "in fact, an employee of the partnership." The government's petition for rehearing was denied.

By letter dated October 1, 1968 to the Department of Justice, this office recommended against filing a petition for a writ of certiorari, and, as indicated in a memorandum for the Solicitor General dated September 25, 1968 (a copy of which is attached), the Assistant Attorney General, Tax Division, made the same recommendation. It was the view of the Tax Division that "what is called for at this time is a thorough administrative study of the intended function of the entire section and its interrelationship with other portions of the Code and that further litigation at the appellate level, and certainly at the Supreme Court level, should be deferred until the results thereof have enabled us to formulate a comprehensive position that we can defend with a firmer and more informed posture than is now possible."

For the reasons hereinafter discussed, we believe that the Fifth Circuit's decision in Armstrong is erroneous and that the Court's reading of section 707 is incompatible not only with other provisions of Subchapter K but with other portions of the Internal Revenue Code as well. Consequently, it is recommended that you may wish to give consideration to the formulation of a publication with respect to the matter stating that the Service does not intend to follow the Armstrong decision to the extent that it conflicts with the views expressed therein.

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According to the record on appeal, taxpayer Tobin Armstrong during the period in question, was one of the five partners of a general partnership operating a cattle ranch under the name of Armstrong Ranch on 50,000 acres of land in Armstrong, Texas owned by the partners. Since cattle was the firm's only product, the entire partnership income was from the sale of livestock except for royalty income from the exploitation of mineral resources beneath the ranch property.

Under the terms of the partners' agreement (which presumably was oral), Tobin Armstrong had a 5% interest in the partnership profits. It was also agreed, in consideration of his services as managing partner in supervising the pastures, cattle, labor force and marketing of livestock, that he should occupy a house located on the ranch, and that he should have a salary of \$8,000 a year plus his personal living expenses. The record further states that the living expenses paid by the partnership included most of taxpayer's groceries, fire insurance on his belongings in the house, heating and lighting the house, his personal telephone calls, maid service for the house and the expenses of entertaining business guests at the ranch. The partners' agreement apparently contemplated that the \$8,000 salary and the amounts paid by the firm for taxpayer's personal living expenses should be subtracted from the partnership gross income and that his profit share would be 5% of the remaining partnership profits.

There is evidence in the record to the effect that taxpayer's wife kept the partnership's books and records, as well as the firm's checking account, and that she drew the checks on the partnership checking account in payment for the personal living expenses in question.

It also appears that each of the five partners contributed capital to the firm but that taxpayer, Tobin Armstrong, was the only partner who was bound, under the partners' agreement, to perform services for the firm (such services being those required in connection with management of the partnership enterprise).

In the light of these facts, it is apparent that the 5% net profit share, and the \$8000 annual payment plus personal living expenses all represented the consideration for taxpayer's contribution of capital and management services to the partnership enterprise. It is also apparent that the amounts paid out of the partnership's funds for his personal living expenses were the equivalent of cash in his hands. See for example, Koons v. United States (C.A. 9, 1963) 315 F.2d 542; Preston C. West (1928) 12 B.T.A. 725. <sup>1</sup>

But the question is, are these amounts gross income to Tobin Armstrong? We think they are.

We are not persuaded by taxpayer's argument that these amounts are not his gross income because his performance of services for the firm made him a partnership employee by virtue of section 707(a) and, as such, entitled him to the benefits of the section 119 exclusion with respect to the emoluments involved. Nor are we persuaded by his further argument that if the amounts in question are "guaranteed payments" within the scope of section 707(c), the section 61(a) treatment therein prescribed incorporates the exception provided in section 119, so that such amounts would therefore be excluded from his gross income.

Taxpayer acknowledges, however, that under the 1939 Code, the rule of exclusion regarding meals and lodging furnished to an employee for the convenience of the employer (now codified in section 119 of the 1954 Code) was inapplicable in the case of a partner living on the firm's business premises and performing services for the partnership there, because a partner could not be an employee of his partnership. See for example, Commissioner v. Robinson (C.A. 3, 1959) 273 F.2d 503; Commissioner v. Moran (C.A. 8, 1956) 236 F.2d 595; Commissioner v. Doak (C.A. 4, 1956) 234 F.2d 704. Cf., United States v. Briggs (C.A. 10, 1956) 238 F.2d 53.

The basis for the stated conclusion was summarized in the Doak case as follows:

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"Unincorporated businesses, unlike corporations, incur no income tax. The tax accrues against the partners or co-owners on their distributive shares of the profits. Sections 181, 182(c) of the 1939 Code. This fundamental principle is easily overlooked because for purposes of accounting convenience partnership records reflect the income and expenses of the venture as a separate and independent

business unit. But the income is taxable to the partners in their individual capacities, and each is entitled to his proportionate share of the expenses. For tax purposes, a partnership has no legal existence independent from the individual partners. The partnership and the partners are one and the same legal entity. \* \* \* In the eyes of the taxing statute, therefore, a partner cannot be an employee of the partnership. \* \* \* See Sections 183(a) of the Code and Section 29.183-1 of Treasury Regulations 111.’

As indicated in the foregoing discussion, the status of partners under the 1939 Code was unique. They were not regarded as sole proprietors separate from one another, each carrying on his own business for his sole account. Nor were they regarded as having established a business organization, like a corporation, with a legal identity of its own separate and distinct from each of its constituents. See 1939 Code Supplement F. sections 181-191; 1939 Code section 3797.

Instead, the 1939 Code conceived of partners as joint owners and joint entrepreneurs, that is, persons carrying on business together, jointly managing it, jointly assuming its risks, and dividing the profits from the operation among their number. Insofar as the joint business was concerned, each partner, therefore, had the status of a principal (i.e. one from whom those working for the enterprise derived their authority). Thus a partner could not be cast in the role of working for himself in the joint enterprise as his own employee any more than he could work for himself as his own employee if he were a sole proprietor. See for example, Estate of S.U. Tilton (1927) 8 B.T.A. 914 acq. C.B. VII-1, 17 where it was stated at page 917:

"A partner devoting his time and energies to the business of the firm is in fact working for himself and cannot be considered as an employee of the firm in the sense that he is in the service of another. \* \* \* In effect any allowances drawn by a partner from partnership assets are payments which he makes to himself and no man can be his own employer or employee.’

It is noteworthy that this fundamental tax design applicable to partnerships was not changed by the 1954 Code. On the contrary, partnerships under the 1954 Code are still regarded as business organizations having no legal status independent of the persons jointly owning and operating the business venture involved, who divide that jointly earned profits therefrom. In short, these persons under the 1954 Code, as under the 1939 Code, are joint entrepreneurs, and therefore principals, insofar as the jointly-owned business is concerned, with all the attending legal consequences noted above. Accordingly, the 1954 Code having made no change in the self-evident truth that a principal is incapable of being his own agent in his jointly or solely-owned business, it is apparent that the prevailing rule still is that a partner cannot be an employee of a partnership enterprise of which he is a member. 1954 Code sections 701-703, 761, 1402(a), 3121(d)(2), 3306(i), 7701(a)(2); Wilson v. United States (Ct. Cl. 1967) 376 F.2d 280.

In this regard, the stated rule for Federal tax purposes is identical with the law of partnership generally. See for example section 18 of the Uniform Partnership Act; Cook v. Lauten (Ill., 1948) 80 N.E. (2d) 280 and Rasmussen v. Trico Feed Mills (Neb., 1947) 29 N.W. (2d) 641, both to the effect that the status of partner and of partnership employee are inconsistent relationships and that one cannot at the same time, have such a dual relationship with his firm.

Furthermore, we do not think it can be said, as taxpayer maintains, that the prevailing rule has been changed by section 707(a), i.e. that the cited section has had the effect of making a partnership an entity capable of having a partner as its employee. Rather, we believe that section 707(a) merely gives statutory recognition to a well-established principle under the 1939 Code, prior Revenue Acts, and the law of partnerships generally, namely, that one may perform services for a partnership of which he is a member in a role other than that of a partner. See for example H.H. Wegener (1940) 41 B.T.A. 857, aff'd, 119 F.2d 49. There taxpayer was individually engaged in the business of drilling oil wells. He was also a member of a partnership owning oil leases under development. Inasmuch as he undertook a drilling operation on the partnership’s leasehold for an agreed consideration as an independent contractor, he could not be viewed as drilling wells for himself as to his own interest, and therefore, the full contract price received by him for the work done less the drilling costs was taxable income to him. Cf., Uniform Partnership Act, section 18(f) and Anno: 17 L.R.A. (NS) 389, L.R.A. 1917 F 575.

The fact remains, however, that while it has long been acknowledged that a person may perform services for his partnership in a capacity other than that of a partner, he has never been considered a partnership

employee when he does so. Instead, in such a situation, he has been regarded as an independent contractor acting individually for his own account. See H.H. Wegener, supra.

There is nothing in section 707(a), indicating that Congress sought to change this rule. On the contrary, that provision speaks in terms of a partner engaging in "a transaction other than in his capacity as a member of such partnership." Nowhere does the section characterize the partner as an employee in such a situation. Rather, section 707(a) simply says that in these circumstances (with exceptions not material here), the transaction shall be considered "as occurring between the partnership and one who is not a partner."

In this connection, the legislative history of subsection (c) of section 707 entitled "Guaranteed Payments" is particularly revealing of the apparent belief of the draftsmen that one can not at the same time be both a partnership employee and a member of the firm. The House initially viewed a partner receiving such payments "like any other employee who is not a partner." See H. Rept. 1337, 83d Cong. 2d Sess. A226-7 (1954). This characterization was abandoned, however, by the Senate which, in summarizing the import of section 707(c), made it clear that guaranteed payments were to be treated, not as amounts paid to a partner acting as an employee of the firm, but as amounts paid to a partner acting "as one who is not a partner." See S. Rept. 1622, 83d Cong. 2d Sess. 387 (1954).

Thus it is apparent that although the statute for the first time in section 707(a) makes specific reference to situations in which a partner in his individual capacity enters into a transaction with a partnership of which he is a member, no new rules concerning the tax consequences thereof were developed. On the contrary, section 707(a) is merely a codification of the existing principle that a partner dealing with his firm in that context is an outsider. Cf., Harvey M. Toy B.T.A. Memo. Dec. Dkt. Nos. 106024, 106025 (1942) (taxpayer member of a partnership engaged in the real estate brokerage business who purchased several properties through the firm for his individual account, was properly taxable on his distributive share of the partnership's commissions from these transactions); S. Rept. 1622, supra, 386.

In short, we found nothing in the legislative history of section 707(a), or elsewhere, indicating that this provision was intended to change the firmly-established rule that a partner performing services for his firm is incapable of being a partnership employee. Thus there is no justification at all for taxpayer's argument in his supplemental brief that "If a partner who performs services for his partnership is to be treated in the same manner as an outsider performing services for the partnership, and if an outsider performing such services is an employee of the partnership and entitled to the benefits of section 119 \* \* \*, the conclusion is inescapable that a partner is also to be treated as an employee entitled to the benefits provided by section 119."

There is only one case other than Armstrong involving the applicability of section 119 to the managing partner of a ranch operated in partnership form which has arisen since the enactment of the 1954 Code, i.e., Wilson v. United States, supra. There, it was concluded that the 1939 Code view (that a partner cannot be a partnership employee for purposes of the "convenience of the employer" rule) still has vitality under the 1954 Code. While the court in Armstrong indicated that the decision of the Court of Claims in Wilson was not controlling because no mention was made of the applicability of section 707, we find this unpersuasive. Since section 707 has had no impact on the "convenience of the employer" rule codified in section 119, there was no occasion for the Court of Claims to mention it. Certainly it cannot be inferred that a court is unaware of a particular section merely because it has not cited such section, if the provision is not relevant to its decision.

In addition to the section 707(a) issue, the Court in Armstrong considered and rejected the government's contention that section 707(c) governed the case and prevented taxpayer from claiming the benefits of the section 119 exclusion. In the first place, the Court said there was "no evidence in the record that the emoluments were "determined without regard to the income of the partnership," or that they consisted of "payments" rather than lodging and meals furnished in kind." As indicated in the foregoing discussion, the Court was either unpersuaded by, or unaware of, taxpayer's uncontroverted testimony that as part of the agreed consideration for his participation in the joint venture, he should receive a fixed annual salary in cash and his living expenses should be paid with partnership funds.

In view of this testimony, we think it is fair to say that taxpayer constructively received the amounts spent by the firm for his living expenses since, in effect, such amounts were paid to third parties at taxpayer's command. See Preston C. West, supra. Thus we think they are "payments" for purposes of section 707(c).

But we are not sure whether they can be said to be determined without regard to the income of the partnership. In other words, we can not tell from the record whether the partners' agreement contemplated that the amounts spent by the firm for the partner's living expenses should be payable only out of the partnership's gross income. If this were the case, the amounts could not be classified as section 707(c) guaranteed payments. In that event, because the amounts were based on partnership income, they would simply be reflected in the recipient partner's distributive share. See Willis, Handbook of Partnership Taxation, (1st ed., 1957) p. 130.

On the other hand, if the managing partner's living expenses were to be paid in all events (i.e. from contributions by taxpayer's co-partners to the extent that the partnership gross income was insufficient for that purpose), the amounts so paid (and constructively received by taxpayer), would be true guaranteed payments within the meaning of section 707(c). It is assumed for purposes of the instant discussion that these amounts were true guaranteed payments.

In any event, the Court in Armstrong maintained that even if the evidence on remand should establish that the amounts so expended were payments determined without regard to the income of the partnership within the meaning of section 707(c) such evidence could not affect the result reached. This is because section 707(c) payments must be "considered as made to one who is not a member of the partnership \* \* \* for the purposes of section 61(a) (relating to gross income)" and section 61(a) defines gross income as "all income from whatever source derived" but with the proviso "except as otherwise provided in this subtitle." Thus the Court reasoned that section 61(a) incorporates the other sections of the subtitle, including section 119, and requires that the other provisions of the subtitle be considered and utilized in determining gross income.

We do not agree. In the first place, as in the case of the statutory provision discussed above, section 707(c) made no substantial change in prior law which treated guaranteed payments merely as a part of the recipient-partner's distributive share. See Estate of S.U. Tilton, supra; Augustine M. Lloyd 15 B.T.A. 82 (1929) Acq. C.B. VIII-2, 27; Joe W. Stout 31 T.C. 1199 (1959) remanded sub nom. Rogers v. Commissioner (C.A. 4 1960) 281 F.2d 233. Certainly, that section does not authorize the Service to treat partners as employees of the partnership for any purpose whatever. See Willis, Handbook of Partnership Taxation, supra, where it is stated at page 131:<sup>2</sup>

"The guaranteed compensation paid to a partner is:

- (1) not subject to withholding at source for income tax (section 3402),
- (2) not subject to the employment taxes (Federal Insurance Contributions Act and Federal Unemployment Tax Act), frequently referred to as Social Security taxes, imposed by Chapters 21 and 23, Subtitle C,
- (3) not considered to be compensation paid to an employee for the purposes of a pension or profit-sharing plan under sections 401-404, inclusive,
- (4) not subject to any exclusion under section 101(b) for payment of death benefits to an employee, or under section 105(d) for payments under a wage continuation plan.

When it's all sifted down, the net effect of considering guaranteed compensation paid to a partner "as made to one who is not a partner" is quite innocuous and marks little change from prior law. The Senate Committee on Finance suggests that one significant effect is to clarify the tax status of the situation where the guaranteed compensation paid to a partner exceeds partnership net income, computed before deducting compensation to the partners.' (Emphasis supplied.)

Moreover, treating a partner as a firm employee for purposes of excluding from his gross income, under section 119, guaranteed payments received by him for services rendered would frustrate the general objectives of Subchapter K and would nullify several statutory provisions; there and elsewhere, specifically applicable with respect to partners and partnerships. In other words, such treatment would completely undermine the structure established by Congress for the taxation of partnership income.

In general, partners are liable for income tax on the partnership income in their separate and individual capacities. The partnership, as such, is not subject to income tax but is required to make returns of income, computing the taxable income of the partnership in the same manner as the taxable income of an individual, with certain exceptions not material here. See sections 701, 703.

Nevertheless, the partnership return is informational only, and each partner, in determining his income tax, is required to take down separately into his individual return his distributive share of the various partnership items reflected in the partnership taxable income, in accordance with the provisions of section 702(a). And the identity of these various partnership items is preserved in each individual partner's hands. See section 702(b).

It is readily apparent that Subchapter K which taxes partnership income to the partners separately would not function in the manner intended if the various partnership items were not traceable into the individual partners' returns and identifiable there. Stated another way, the constituent elements of the results of the partnership's operations must all be retained in the portion thereof to which an individual partner is entitled, whether such portion is a "distributive share" or a "guaranteed payment" in his hands. Otherwise it would be impossible to correctly apply a multitude of code provisions to a taxpayer receiving income from a partnership of which he is a member.

More specifically, several Code sections impose fixed dollar limitations upon the amount of an item to be taken into account in computing taxable income, as for example, section 270 (limiting hobby losses to \$50,000) and section 615 (limiting exploration expenditures to \$100,000). Other such limitations are stated in terms of a percentage of gross income, viz., section 175 (limiting deductible soil and water conservation expenditures to 25% of gross income from farming). In a number of other provisions, the limitation is a percentage of taxpayer's taxable income, like section 613 (limiting the deduction for depletion to 50% of the taxpayer's taxable income from the property) and section 1211(b) (limiting the deduction for capital losses to capital gains plus taxable income of taxpayer or \$1000 whichever is smaller). Still other limitations are expressed in the form of a percentage of adjusted gross income such as section 170(b) (limiting charitable contributions to 20% or 30% of taxpayer's adjusted gross income). And finally there are limitations correlated with similar or related items of income, gain, loss, deduction, or credit, such as section 165(d) (limiting wagering losses of wagering gains) and section 111 (limiting the inclusion of bad debt recoveries, prior taxes and the like to the amount of tax benefit from the same item).

The tenor of these provisions makes it obvious that if the characteristics of the partnership's realization experience were lost in guaranteed payments and that if the making of such a payment somehow transformed it into mere section 61(a) "compensation for services," the cited provisions would have a completely different impact than they would if the various partnership items were preserved therein so as to retain their identity in the recipient-partner's hands.

This, of course, is the reason why the regulations provide that guaranteed payments are considered as made to one who is not a member of the partnership "only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses)." That is, they are so considered only for initial computational purposes to insure that the benefit is correctly reported in toto by the recipient partner and that the burden is correctly allocated among his copartners. The regulations emphasize that "For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income." See section 1.701-1(c), and cf., E. Y. Mallary Jr. et ux v. United States (D.C. Ga. 1965) 238 F. Supp. 87 (Gov'ts appeal discussed, C.A. 5, 1965); Thomas Browne Foster (1964) 42 T.C. 974; Foster v. United States (C.A. 1964) 329 F. (2d) 717 aff'g. (D.C. N.Y. 1963) 221 F. Supp. 291.

There is still another reason why a section 707(c) guaranteed payment may not be considered mere section 61(a) "compensation for services" retaining none of the characteristics of the partnership items from which it was derived. Such treatment would be completely incompatible with section 702(c) which provides that in any case where it is necessary to determine the gross income of a partner for purposes of the Internal Revenue Code, such amount shall include "his distributive share of the gross income of the partnership." Gross income of the partnership, of course, cannot be reduced by any guaranteed payments made by the firm to a partner. Accordingly, if a guaranteed payment were simply section 61(a) "compensation for services" in the hands of the recipient, his gross income would include the amount of the guaranteed payment as well as his "distributive share of the gross income of the partnership" from which it originated. Stated another way, if a guaranteed payment were true compensation for services, section 702(c) would, in effect, require inclusion of the amount of such payment in the recipient's gross income twice, once as a portion of his distributive share of the partnership gross income and once directly as guaranteed payments.

A parallel problem is inherent in two separate enumerations within section 61(a) itself. Gross income is defined therein to mean all income from whatever source derived, including "(1) Compensation for services \* \* \*" and "(13) Distributive share of partnership gross income." Since guaranteed payments are not a deduction of partnership gross income, the same possibility for double inclusion noted above in connection with section 702(c) would exist in section 61(a) if such payments were considered true compensation for services. That is, the same amount would be subject to inclusion twice, once, as a portion of the recipient's distributive share of the partnership gross income and once, directly as a guaranteed payment.

There is an additional reason why guaranteed payments, in the hands of the recipient partners, are not simply compensation for services which have lost the identity of the various partnership items from which they were derived. If they were true compensation for services, they would be reported by the recipient in the year received or accrued. They are not so treated, however. By statute, guaranteed payments must be reported by the recipient as distributive share income. See section 706(a).

Furthermore, treatment of section 707(c) guaranteed payments for services rendered as mere compensation paid to an employee, as taxpayer in Armstrong urged, would result in double inclusions in the administration of the employment taxes provided for in Subtitle C and the self-employment tax provided for in Subtitle A. Obviously, subjecting a guaranteed payment to both taxes at the same time would be contrary to Congressional intent and totally incompatible with the structure of these statutes. Under long established principles, the income of an individual arising from a partnership of which he is a member is not subject to employment taxes. Rather, one who realizes such income from participating as a partner in the trade or business of the partnership, or in providing services to the partnership as an independent contractor, is, in either event, a self-employed individual rather than an individual who has the status of an employee. See sections 1402(a) and 3121(d)(2); G.C.M. 3401 (December 23, 1968) \*\*\* I-3179, I-3178.

In summary then, we think the court in Armstrong v. Phinney was in error in holding that the value of the emoluments received by taxpayer-partner for his services to the firm was excludable from his gross income under section 119. It is our recommendation, therefore, that you may wish to give consideration to the preparation of a publication to the effect that the Service does not intend to follow this decision, but will adhere to the view that cash amounts paid out of a partnership's funds, in the circumstances of the Armstrong case, on account of a partner's own personal living expenses, can not be regarded as compensation to him within the scope of the section 119 exclusion.

We would further suggest, as a simplifying measure, that any such publication omit a discussion of the value of the lodging involving in Armstrong, (i.e. taxpayer's use of the house located on the ranch.) In the first place, this was the only item of the agreed consideration furnished to him in kind. The rest were in the form of cash equivalents, that is, cash amounts paid out of the partnership's funds to third parties, at his order, for his own living expenses.

Any discussion of the tax consequences resulting from taxpayer's occupancy of the house on the ranch will necessarily add complexity to the publication, since the house, as well as the entire ranch property on

which it was located, apparently was co-owned by all the partners including taxpayer. Stated another way, it appears that taxpayer occupied a house which he himself owned in co-tenancy with his fellow partners. Attention is also invited to the fact that if taxpayer, as an independent contractor, had been engaged in farming the land of another under an arrangement entitling him to occupy a dwelling on the land, the Service would not consider that he had realized gross income as a result of his occupancy of the dwelling. See G.C.M. 33316, (January 8, 1968, September 12, 1966 and August 23, 1966) \*\*\* I-2257.

In any event, this office will be glad to assist you in the preparation of a publication regarding the Armstrong case if you would like to have us do so.

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1 The Court of Appeals viewed these emoluments as an "in kind" receipt rather than as a cash equivalent, apparently not taking into account the taxpayer's uncontroverted testimony to the effect that he had control of the funds used for this purpose (i.e. he had agreed that part of the consideration for the services he rendered should be via payment of his living expenses with partnership funds).

2 Section 1.707-1(c) of the Regulations is to the same effect.

# What is Compensation?

What difference does it make?

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This session will focus on tax qualified retirement plans under IRC Section 401(a). Any special rules associated with 403(b) or 457 plans are outside the scope of this session.

- I. Where is the definition of compensation relevant in a benefit plan?
  - A. Definition of benefits in a defined benefit plan.
  - B. Allocation of contributions and forfeitures in a defined contribution plan.
  - C. Base for withholding salary deferrals in a 401(k) plan.
  - D. Testing of benefits / allocations for non-discrimination under IRC Section 401(a)(4).
- II. Where is compensation defined in the Code? More like, where isn't it defined?
  - A. IRC Section 401(a)(5) – Benefits may bear a uniform relationship to compensation
  - B. IRC Section 401(a)(17) – Limit on Compensation for determining benefits
  - C. IRC Section 401(c)(2) – Earned income is the concept of compensation used for self-employed persons
  - D. IRC Section 401(l) – Permitted disparity relies on IRC Section 414(s).
  - E. IRC Section 404(a)(12) – Definition of compensation for deduction purposes – cross references to IRC Section 415
  - F. IRC Section 409(b) – This is generally archaic language that limits tax-credit ESOPs on counting only the first \$100,000 of compensation. This rule is not required for other ESOPs.
  - G. IRC Section 414(q)(4) – Definition of compensation to define a *highly compensated employee*.
  - H. IRC Section 414(s) – Definition of compensation for purposes of *any applicable provision*. An *applicable provision* is defined as any provision that refers to this section....
  - I. IRC Section 414(u) – Definition of compensation for purposes of veteran's re-employment rights.

- J. **IRC Section 415(c)(3) – Definition of compensation for limits on benefits.** This definition is *home base*. Many of the other definitions are grounded here.
- K. IRC Section 416(i)(1)(D) – Definition of compensation for top heavy plan purposes. This is one of those *applicable provisions*.

III. How are these concepts developed in the regulations?

A. For W-2 employees

- 1. Compensation paid, not accrued – see both 404 and 415 regulations
- 2. Safe harbor definitions of compensation for non-discrimination purposes – IRC Reg. Section 1.414(s)-1. This is a critical regulation to this discussion. The regulation provides the following summary of its' content:

*Overview.* --Paragraph (b) of this section provides rules of general application that govern a definition of compensation that satisfies section 414(s). Paragraph (c) of this section contains specific definitions of compensation that satisfy section 414(s) without satisfying any additional nondiscrimination requirement under section 414(s). Paragraph (d) of this section provides rules permitting the use of alternative definitions of compensation that satisfy section 414(s) as long as the nondiscrimination requirement and other requirements described in paragraph (d) of this section are satisfied. Paragraphs (e) and (f) of this section provide special rules permitting the use of rate of compensation, or prior-employer compensation or imputed compensation, rather than actual compensation, under a definition of compensation that satisfies section 414(s). Paragraph (g) of this section provides other special rules, including a special rule for determining the compensation of a self-employed individual under an alternative definition of compensation. Paragraph (h) of this section provides definitions for certain terms used in this section.

- a. Definition used must be applied consistently through out the plan for testing purposes for a particular period. This does not mean that a different definition cannot be used for allocation purposes. Also, a different definition may be used in a different period or by a different plan of the same employer.
- b. Section 415(c)(3) compensation, see below, is the first choice. This can be calculated before or after **all** employee salary deferrals.
- c. Second choice is the above definition reduced by **all** of the following items (even if includible in gross income): reimbursements or other expense allowances, fringe benefits (cash and noncash), moving expenses, deferred compensation, and welfare benefits.
- d. The third choice starts with either b. or c. above, and then excludes elements of compensation **only** for highly compensated employees.

- e. Other definitions can be used, but the sponsor must demonstrate that such definitions do not discriminate to the benefit of HCEs. For example, a definition of compensation that includes all bonuses and excludes all overtime is likely to be discriminatory in most companies.
  - i. An alternative definition of compensation is nondiscriminatory under section 414(s) for a determination period if the average percentage of total compensation included under the alternative definition of compensation for an employer's highly compensated employees as a group for the determination period does not exceed by more than a de minimis amount the average percentage of total compensation included under the alternative definition for the employer's nonhighly compensated employees as a group.
  - ii. This is calculated taking into account the limit on compensation under IRC Section 401(a)(17). Thus, for very high paid employees, the exclusion of their bonus may have no effect since their net pay exceeds the limit. Thus, 100 percent of their eligible pay is still covered.
  - iii. A definition is not reasonable if it specifies that each employee's compensation is a specific percentage of that employee's total compensation. IRC Reg. Section 1.414(s)-1(d)(2)(ii). But limiting compensation to a specific dollar amount is not unreasonable.
  - iv. Note that unexpected events in an otherwise nondiscriminatory definition will not invalidate the definition. For example, a large amount of overtime pay due to an emergency. See IRC Reg. Section 1.414(s)-1(d)(3)(v).
  - v. For example, an employer can estimate compensation based upon hours plus the employees regular rate of pay or such estimate plus known amounts of irregular pay.
    - (a) But, such method may not be used for testing salary deferrals or matching contributions.
    - (b) Such definition must be used for determining benefits, not just testing them.
  - vi. Special rules are provided for imputing prior compensation in a defined benefit plan.
- f. IRC Reg. Section 1.415-2(d) defines contribution under Section 415 and for the starting point for Section 414(s).
  - i. Under the basic definition of compensation, part (2) of the regulation, the following items are included:
    - (a) Wages, salaries, fees for professional service and other amounts received (in cash or kind) to the extent includible in the employee's gross income.

This category includes, but is not limited to, commissions paid to salespersons, compensation based on a percentage of profits, commissions on insurance premiums, tips, bonuses, fringe benefits, reimbursements, and expense allowances under nonaccountable plans.

- (b) Employer contributions to a Code Sec. 403(b) tax sheltered annuity, whether or not the amounts are excludable from an employee's gross income.
  - (c) Employer contributions to a simplified employee pension plan (SEP) that are excludable from an employee's gross income.
  - (d) Elective deferrals to a 401(k) plan (including contributions to a SIMPLE 401(k) plan) that are not includible in the employee's income in the year of contribution, a SIMPLE IRA or a Code Sec. 457(b) eligible deferred compensation plan.
  - (e) Elective or salary reduction contributions made to a cafeteria plan. Watch out for special rules regarding automatic 125 deferrals.
  - (f) Salary reduction contributions made to a qualified transportation plan.
  - (g) Amounts received through employer-provided accident and health insurance or self-insured plans to the extent included in gross income.
  - (h) Reimbursed moving expenses to the extent that it is reasonable to believe that they are not deductible.
  - (i) The value of a nonstatutory stock option to the extent includible in the gross income of the employee for the tax year in which granted.
  - (j) The amount includible in the gross income of an employee who has property transferred to him or her in connection with the performance of services upon making an 83(b) election.
  - (k) Earned income of a self-employed individual.
- ii. Note this compensation does **not** include, part (3) of the regulation:
- (a) Distributions from a deferred compensation plan (other than an unfunded, nonqualified plan), even if the amounts are includible in the gross income of the employee when distributed;
  - (b) Amounts realized from the exercise of a nonqualified stock option, or when restricted stock (or property) held by an employee becomes freely transferable or is no longer subject to a substantial risk of forfeiture; and

- (c) Amounts realized from the sale, exchange, or other disposition of stock acquired under a qualified stock option; and premiums for group-term life insurance, to the extent the premiums are not includible in an employee's gross income.
- iii. SPECIAL RULE – part (5) of the regulations, for 415 purposes only, though this is to be compensation **paid** there is a *de minimus* rule for accrued compensation associated with the timing of wages due to pay period cut-offs. Such inclusion must be elected and be consistently applied across plan years.
- iv. SPECIAL RULE, for 415 purposes only – Part (6) of this regulations, where an employee earns wages from 2 or more members of a controlled group, affiliated group, 414(o) group or group of businesses under common control, that employees total salary from all members is counted for 415 purposes, regardless of whether all employers sponsor the plan.
- v. If the plan uses the above definition of compensation with no exceptions, it satisfies the *safe harbor* standard of part (10) of the regulation.
- vi. Alternative definitions to this basic rule:
  - (a) Part 11 of the regulation: Wages as defined for purposes of income tax withholding IRC Section 3401(a). Withholding wages are determined without regard to any rules that limit remuneration included in wages on the basis of the nature or location of the employment or the services performed (e.g., the exception for agricultural labor).
  - (b) Wages as defined in (a) plus all other payments of compensation to an employee by his employer (in the course of the employer's business) for which the employer is required to furnish the employee Form W-2. This definition may be modified to exclude amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that it is reasonable to believe that these amounts are deductible by the employee.
- vii. A plan can choose from more than one definition of compensation for 415 purposes, but incorporates the provisions of the law by reference must specify which definition is intends to use in the plan document.

B. Self-employed persons

1. The 414(s) regulations contain special language for self-employed persons. See IRC Reg. Section 1.414(s)-1(g).
2. Net earnings from self-employment in defined in IRC Reg. Section 1.401-10, but watch out – a lot of this is archaic.
  - a. Attributable to business for which the plan is established.

- b. Reportable earnings for self-employment tax. IRC Section 1402(a)
  - i. Less  $\frac{1}{2}$  of the self-employment tax
  - ii. Less any contributions made on behalf of the self-employed person that are attributable to an IRC Section 401(a) plan.
  - iii. Creates a simultaneous equation for calculating the maximum for persons whose net earnings from self-employment after deduction for plan contributions are less than \$200,000.
  - iv. How do you apportion the S/E tax if the individual has more than one business venture – per IRS oral comment – reasonable.
  - v. What about expenses that a partner claims against Schedule E partnership earnings (above the line) on his or her personal income tax return?
- c. Limited partners typically do not generate self-employment income. See IRC Section 1402(a)(13). But guaranteed payments made to limited partners, as compensation for services performed would be self-employment income. To distinguish a limited partner from a general partner see Proposed regulation 1.1402(a)-2 and the instructions for Form 1065.
  - i. An individual will *not* be classified as a limited partner and will thus be subject to self-employment tax on ordinary income distributions from the LLC, if the member:
    - (a) has personal liability for the debts of the LLC by reason of being a member;
    - (b) has agency authority for the LLC, and can contract on its behalf; or
    - (c) participates in the business more than 500 hours during the tax year.
  - ii. A member who does not qualify as a limited partner because they violated (c) above, who owns only one class of interest and whose interest is otherwise identical to those owned by members who are classified as limited partners may still be classified as a limited partner. If that makes sense to you, call me. See –2(h)(4) of the proposed reg.
  - iii. An LLC member (such as a manager) who owns more than one class of interest in the LLC may be able to split the distributions between those attributable to limited partner status and those treated as self-employment income, under the proposed rules.
  - iv. Partners should not have W-2 earnings from any partnership in which he or she is an active partner. See GCM 34173.

(a) What are the ramifications of violating this rule?

1. Impact of payroll taxes
2. Impact of partnership expenses
3. Impact of simultaneous equation for plan expenses.
4. Less severe if difference is just between guaranteed payment and wages.

(b) Are all such inconsistencies violations?

For example, a former partner of an accounting firm who has been reclassified as an employee. He or she may still be receiving distributions of partnership income over a period of time, but use of W-2 wages may be appropriate in the plan.

(c) But, what if the partner is performing in a non-partner capacity?

Deciding on whether a partner is acting in a partner or nonpartner capacity when performing services depends on the facts and circumstances of that case. The dominant factor will be partnership agreement.

1. In cases involving services performed by a partner for a partnership, the form of the transaction is respected when there is no ambiguity in the partnership agreement and the clear intent of the parties is that the partner is acting in a nonpartner capacity. *H.H. Wegener v Commr*, CA-5, 119 F2d 49, cert. denied, 314 US 643; *L.J. Sverdup v Commr*, 14 TC 859, (1950) (Acq.); *G.A. Heggstad v Commr*, 91 TC 778, (1988).
2. Where the partnership agreement is ambiguous, it gets more complicated.
  - a. For example, a general partner of a limited partnership who managed a partnership-owned shopping center acted in his partner capacity because the services rendered were essential to the partnership activities. See *E.T. Pratt v Commr*, 64 TC 203, (1975), rev'd on other issues, CA-5, 550 F2d 1023.
  - b. Performing continuous services alone does not cause a partner to be acting in a partner capacity if he performs similar services for other persons, he could be terminated upon 60-days notice, and he is not liable for partnership losses caused by his services. See Revenue Rulings 81-300 and 301 and PLR 8642003.

(d) Even if it is determined that the partner is performing in a non-partner capacity, you don't automatically get employee treatment.

1. Two court cases have considered this issue and arrived at different conclusions. See *A.L. Armstrong v Phinney*, CA-5, 394 F2d 661 and compare it to *C.C. Wilson v US*, CtCls, 179 CtCls 725.
  2. As noted above, the IRS's position is that a partner is not an employee because state law does not allow a partner to have a dual relationship with his partnership. GCM 34173. Thus, payments to a partner are not wages for social security, unemployment or withholding tax purposes – Revenue Ruling 69-184.
3. What about an S corporation shareholder?
- a. S Corporation shareholders are common-law employees. In spite of their treatment as self-employed for certain fringe benefits (IRC Section 1372), S corporation shareholders get W-2 income and should be subject to the same standards as other common law employees.
  - b. Further, S distributions are not earned income for plan purposes. This is in spite of the series of cases discussed below where the IRS succeeded in recharacterizing such distributions as compensation. For a comprehensive discussion of this matter see, *Paul B. Ding, Jane C. Ding v. Comm.* (CA-9), U.S. Court of Appeals, 9th Circuit, 98-70848, 12/30/99, 200 F3d 587. Affirming the Tax Court, 74 TCM 708, TC Memo. 1997-435.
  - c. There has been a lot of recent controversy on inadequate compensation, as opposed to excess compensation for S shareholders.
    - i. In a case involving a veterinarian (*Veterinary Surgical Consultants, P.C.*), and one involving an accountant (*Joseph M. Grey Public Accountant, P.C.*), the Tax Court found that payments classified by the corporations as dividends were, in fact, compensation for services and held that the taxpayers were liable for the employment taxes.
    - ii. In another case, involving a CPA (*Wiley L. Barron CPA, Ltd.*), the Tax Court reached the same conclusion.

Characterizations of distributions to owners of S corporation stock as dividends, where less than reasonable compensation has been paid to owners and where the amount of the reported dividend exceeds a reasonable return on the owners' invested capital, will probably not withstand scrutiny by the Internal Revenue Service or the courts. **Design impact:** Where plan sponsors wish to be aggressive in this regard, care must be taken to define compensation properly within the plan document. Language that specifies that compensation for allocation purposes be based upon the W-2 filed for the year, without regard to any subsequent adjustments may be appropriate.

- d. This is not a new position. In Rev. Rul. 74-44 the "dividends" paid to two shareholders were held to be in lieu of reasonable compensation for their services.

4. In some cases, the Social Security Administration has had success in recharacterizing S Corporation distributions as wages for purposes of determining excess earnings for recipients of Social Security benefits. See *Owens* [*Charles B. Owens, Jr.*, 790 F. Supp. 195 (W.D. Ark. 1991) and *Esser* [*Fred R. Esser*, 750 F. Supp. 421 (Ariz. 1990)].
5. The IRS's recharacterization argument was reaffirmed in *Fred R. Esser*, P.C. 750 F Supp 421 (DC, Ariz., 1990).
6. The IRS prevailed on the recharacterization argument in *Spicer Accounting, Inc.* 918 F2d 90 (CA-9, 1990).
7. See also In *Joseph Radke*, 712 F. Supp. 143 (E.D. Wis. 1989), *aff'd per curiam*, 895 F.2d 1196 (7th Cir. 1990).
8. In *Paula Construction Company* [58 TC 1055, 1058 (1972), *aff'd* by unpub. op. 474 F 2d 1345 (5th Cir. 1973)], the Tax Court stated the standard as follows: "It is now settled law that only if payment is made with the intent to compensate is it deductible as compensation. Whether such intent has been demonstrated is a factual question to be decided on the basis of the particular facts and circumstances of the case."

#### IV. What are the practical approaches?

- A. Try to agree on a safe harbor definition.
- B. Think about what is easily available through the payroll system.
- C. Think about the nature of the client's normal and nonstandard payments in contrast to plan design. For example, what about 401(k) salary deferrals? Can they come from non-periodic pay? What about taxable benefits?

#### V. What are the client's options if they have messed up?

- A. Not much case law or other guidance to look at.
  1. *T. Sam Scipio, Jr., v. National Bankshares, Inc.* Civil Action No. 1:01CV175, UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF WEST VIRGINIA ENTERED Sept. 25, 2003. Dealing with the recognition of wages associated with the exercise of options in measuring pension benefits.  
  
Similarly see, *NYSA-ILA MEDICAL AND CLINICAL SERVICES FUND, By Its Trustees, John BOWERS, James Capo, Frank Lonardo, William P. Lynch, M. Brian Maher, James P. Melia, Gerald Owens, and Peter Vickers, Plaintiffs-Appellants, v. David AXELROD, M.D., US-CT-APP-2, June 01, 1994*
  2. *Flanaghan Leiberman Hoffman & Swaim, et al., Plaintiffs, vs. TRANSAMERICA LIFE AND ANNUITY COMPANY*, Defendant Case No. C-3-98-255 UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF OHIO, WESTERN DIVISION, August 26, 2002 on the measurement of compensation for partners in a law firm.

- a. An important note in the case with respect to the definition of net self-employment income is included below:

.....As it turns out, the self-employed individual compensation figures were excessive. They did not take into account all of the necessary factors, **including deductions** [emphasis added], which need to be considered in the calculus.

- b. The settlement of this case included:

The Plaintiff settled with the IRS by paying a negotiated sanction of \$ 34,701 and making a back-contribution to the Plan of \$ 16,309.20 on behalf of its common law employees.

- B. Look at the Summary on EPCRS solutions on this issue as prepared by Seth Tievsky of Ernst & Young. The BNA Pension & Benefits Reporter publishes this summary annually.

Issue	Negotiated Resolution
Plan identified HCEs using reduced compensation (i.e., less than 414(s)). Certain HCEs were misclassified as NHCEs for the years of 1996-1999. Revised testing resulted in ADP/ACP failures.	Retroactively amend the definition of compensation for purposes of ADP/ACP testing to total compensation. As a result, ADP/ACP passed without correction. Monetary sanction of \$16,000 (covering multiple violations).
Incorrect definition of compensation used for ADP testing.	Distribute excess amounts plus earnings to highly compensated employees. Contribute amount equal to amount distributed (including earnings) and allocate on a per capita basis to current active nonhighly compensated employees who were eligible to receive contributions in the affected years.
Recordkeeper refunded Section 415 excess contributions instead of placing in suspense as required by plan. Improperly calculated Section 415 excess amounts by basing refund on compensation including Section 415 excess amounts.	Amend plan to provide for refund of excess annual additions. Make corrective refunds of remaining excess annual additions plus earnings computed on an aggregate plan basis.
Failed to take participant elective deferrals from vacation pay paid separately from the regular payroll check.	Recalculate participant deferrals based on proper compensation including vacation pay and make corrective qualified nonelective contribution. Earnings will be calculated based on an aggregate plan earnings in accordance with Rev. Proc. 94-62, Section 5.01.

Issue	Negotiated Resolution
<p>For 4 plan years, compensation on which elective deferrals were based was calculated based on the first and last weekly pay dates falling closest to the beginning and end of the plan year without regard to whether the pay dates were before or after each affected plan year. Plan operation was nondiscriminatory.</p>	<p>Retroactive plan amendment to use the pay dates closest to the beginning and end of the plan year. Thereafter, amendment ceases to be effective; administer plan under current provisions based only on compensation earned during plan year. Monetary sanction of \$15,000.</p>
<p>Compensation for purposes of ratably allocating discretionary contributions was calculated based on only the amounts paid for a 6 month period (April—September) for each plan year instead of the entire plan year as provided by the plan document. Operation was nondiscriminatory.</p>	<p>Retroactive plan amendment to provide for 6-month compensation reference point. Monetary sanction of \$15,000.</p>
<p>Bonuses were excluded from the base compensation on which elective deferrals could be made for 4 plan years.</p>	<p>Corrective QNECs in the amount of the affected participants' bonuses multiplied by the ADP for the NHCE group for the particular year (excluding QNECs for separated participants of less than \$50). Earnings computed on aggregate plan basis: Form 5500 earnings divided by beginning balance plus one-half of year's contributions minus one-half of year's benefit payments. Monetary sanction of \$15,000.</p>
<p>Discretionary contributions were allocated based on individual compensation as a percentage of divisional compensation for 5 plan years, but plan provided that the allocation should have been made as a percentage of total compensation.</p>	<p>Retroactive plan amendment to provide for divisional compensation allocation. Monetary sanction of \$15,000.</p>
<p>Plan defined compensation as W-2 wages during the plan year, including elective deferrals and cafeteria plan contributions. In violation of plan terms, cap on matching contributions, elective deferrals, and nonelective contributions were based upon compensation earned once an employee became a participant and not on compensation for the full plan year. In addition, compensation was calculated based on certain pay dates without regard to whether or not compensation for those pay dates was compensation earned within the plan year in violation of plan terms.</p>	<p>Make a corrective contribution on behalf of each affected participant. Earnings computed on aggregate plan basis: Form 5500 earnings divided by beginning balance plus one-half of year's contributions minus one-half of year's benefit payments. Pay monetary sanction of \$1,250 (covering multiple violations).</p>

Issue	Negotiated Resolution
<p>Plan defined compensation for purposes of determining contributions as Code §415 compensation. Violated plan terms by excluding certain types of compensation, including overtime, shift differential, bonuses and other supplemental compensation, in calculating discretionary matching contribution. The undermatch impacted 39 participants in 1998 and 269 participants in 1999.</p>	<p>Recalculate matching contributions using the correct definition of compensation. Contribute the additional matching contributions, including earnings (based on a weighted average of the percentage of trust assets invested in each available investment fund).</p>
<p>Plan's pre-1993 document excluded profit sharing and bonus payments from the definition of compensation. Effective 1/1/93, the plan was restated and did not specifically exclude profit sharing and bonus payments from the definition of compensation. Taxpayer clearly demonstrated that this was an unintended error in restating the prior plan version. Violated plan terms from 1993 through 1999 by excluding profit sharing and bonus payments in computing employee before-tax and after-tax contributions and matching contributions.</p>	<p>Retroactively amend plan to 1/1/93 to adjust the definition of compensation to exclude profit sharing and bonus payments. Monetary sanction of \$15,000.</p>
<p>Plan defined compensation for calculating deferrals and matching contributions as W-2 compensation plus certain excludable amounts (e.g., cafeteria plan contributions). Violated plan by calculating deferrals and matching contributions on compensation excluding taxable expense allowances.</p>	<p>Retroactively amend plan to adjust definition of compensation to exclude taxable expense allowances. Monetary sanction of \$50,000 (covering multiple violations).</p>
<p>Deferrals, made as a fixed dollar amount, by employees who separated from service or reduced their work schedule exceeded the plan's percentage-of-compensation limit. No deferrals exceeded §415 or §402(g) and all affected participants were nonhighly compensated.</p>	<p>Refund excess deferrals plus earnings calculated on an aggregate plan basis.</p>
<p>Plan allocates profit-sharing contributions based on compensation earned as a participant. Violated plan terms by making profit-sharing allocations based on compensation earned prior to satisfying definition of participant (age 21).</p>	<p>No correction because affected participants are non-highly compensated and there will be no future employer contributions against which to apply amounts if suspended because plan has been frozen.</p>
<p>Incorrect calculation of matching contributions. Failed to base matching contributions on pay including §125 plan contributions as required by the plan.</p>	<p>Make corrective matching contribution to accounts of affected participants. No correction for participants with de minimis amounts. Interest on the corrective contributions will be calculated based on the annual rate earned by the trust as reported on the Form 5500.</p>

Issue	Negotiated Resolution
Plan defines compensation as gross compensation. Violated terms by making elective deferrals from base pay.	Corrective QNEC based on deferrals using the correct definition of compensation plus earnings calculated on an aggregate plan basis. Make distribution to terminated participants. Modify payroll system prospectively to compute deferrals using the correct definition of compensation and revise participant election forms.
The plan is a 401(k) plan with a definition of compensation that includes bonuses. Failed to properly include bonuses.	Employer will make qualified nonelective contributions (QNECs) on behalf of the affected employees. QNECs will equal (a) the amount of deferral that was not made to the plan based on the employee deferral percentage due to the exclusion of the bonus, (b) and related match, and (c) any imputed earnings (based on plan's rate of return).
Contribution exceeded plan formula. Miscalculated "earned income" for determining regular contributions for self-employed participants.	Reallocate excess allocations to accounts of non-highly compensated employees in year contributions were deposited.
Plan provides that terminated participants eligible to receive allocation regardless of hours of service on last day of plan year. Failed to make matching contribution for final paycheck of terminated participants.	Employer will make corrective matching contribution and distribute to terminated employees. Earnings based on actual investment activity, or if not administratively feasible, the highest rate earned by plan.

- C. Revise payroll system.
- D. Amend the plan for future periods to avoid the problem.
- E. Verify data transmission issues with TPA.

***WARNING – This document was issued in 1995. Thus, the concepts described for compensation remain fundamentally accurate, but the treatment of salary deferrals is archaic and the wrong 415 limits are described.***

#### **V. COMPENSATION LIMITATION FOR DEFINED CONTRIBUTION PLANS**

If 25 percent of a participant's compensation for a limitation year is less than the dollar limit for that limitation year, then annual additions allocated to a participant's account for the limitation year cannot exceed such 25 percent of compensation. "Compensation" is defined in Reg. §1.415-2(d), as amended by regulations published in the Federal Register on September 19, 1991, and corrected by the Federal Register on March 31, 1992.<sup>4</sup> (For years beginning before September 19, 1991, employers are permitted, in defining compensation for purposes of IRC §415(c)(3), to comply with either the provisions of Reg. §1.415-2(d), as amended, or with the prior regulation provisions before amendment.)

While the terms of a plan may provide a different definition of compensation for purposes of calculating the rate of employer contributions or the benefit accrual, a definition of compensation within the meaning of IRC §415(c)(3) must be used to determine whether the maximum permissible contributions or benefits have been exceeded. A plan that incorporates IRC §415 by reference must specify which definition of compensation is incorporated.

##### **A. Compensation Within The Meaning Of §415(c)(3)**

Compensation within the meaning of IRC §415(c)(3) can be defined in one of three possible ways: the "traditional" IRC §415(c)(3) definition of compensation which includes all remuneration found in Reg. §1.415-2(d)(2) and all other forms of remuneration, including exclusions listed in Reg. §1.415-2(d)(3); and two "alternative definitions" used for wage reporting purposes, as modified, which will be considered automatically to satisfy IRC §415(c)(3).

##### **1. "Traditional" IRC §415(c)(3) compensation**

For purposes of applying the limitations of IRC §415, the term compensation includes all of the following inclusions and does not include any other form of remuneration.

The **inclusions** are:

- (i) wages, salaries, fees for professional services, and other amounts received (without regard to whether or not an amount is paid in cash) for personal services actually rendered in the course of employment with the employer maintaining the plan to the extent that the amounts are includible in gross income (including, but not limited to, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses, fringe benefits, and reimbursements or other expense allowances under a nonaccountable plan (as described in Reg. §1.62-2(c));
- (ii) earned income in the case of a self-employed individual (see IRC §401(c)(1) and (2) for definitions);

- (iii) amounts described in IRC §§104(a)(3), 105(a), and 105(h), but only to the extent that these amounts are includible in the gross income of the employee;
- (iv) amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are not deductible by the employee under IRC §217;
- (v) the value of a non-qualified stock option granted to an employee by the employer, but only to the extent that the value of the option is includible in the gross income of the employee for the taxable year in which granted; and
- (vi) the amount includible in the gross income of an employee upon making the election described in IRC §83(b).

In determining amounts under (i) and (ii) above, foreign earned income (as defined in IRC §911(b)), whether or not excludible from gross income under IRC §911, is included. Compensation under (i) above is to be determined without regard to the exclusions from gross income in IRC §§931 and 933. (See Reg. §1.415-2(d)(2).)

Examples of remuneration **not included** in compensation are:

- (i) contributions made by the employer to a plan of deferred compensation to the extent that, before the application of the IRC §415 limitations to that plan, the contributions are not includible in the gross income of the employee for the taxable year in which contributed;
- (ii) employer contributions made on behalf of an employee to a simplified employee pension described in IRC §408(k);
- (iii) any distributions from a plan of deferred compensation, regardless of whether such amounts are includible in the gross income of the employee when distributed, although amounts received from an unfunded nonqualified plan are permitted to be considered as compensation for IRC §415 purposes in the year the amounts are includible in the employee's gross income;
- (iv) amounts realized from the exercise of a non-qualified stock option or when restricted stock (or property) held by an employee either becomes freely transferable or is no longer subject to a substantial risk of forfeiture (see IRC §83 and the regulations thereunder);
- (v) amounts realized from the sale, exchange or other disposition of stock acquired under a qualified stock option; and
- (vi) other amounts which receive special tax benefits, such as premiums for group-term life insurance (but only to the extent that the premiums are not includible in the gross income of the employee), or contributions made by an employer (whether or not under a salary reduction agreement) towards the purchase of an annuity contract described in IRC §403(b) (whether or not the contributions are excludible from the gross income of the employee).

**Safe Harbor Definition.** If a plan defines compensation for purposes of applying the limitations of IRC §415 to include only those items specified in Reg. §1.415-2(d)(2)(i) and to exclude all those items listed in Reg.

§1.415-2(d)(3), if applicable, the plan will automatically be considered to be using a definition of compensation which satisfies IRC §415(c)(3).

Alternatively, for employees other than self-employed individuals treated as employees within the meaning of IRC §401(c)(1), a plan may define compensation using definitions (2) and (3) below, used for wage reporting purposes, as modified herein, and the definition will be considered automatically to satisfy IRC §415(c)(3).

## **2. IRC §3401(a) wages**

Compensation is defined as wages within the meaning of IRC §3401(a) (for purposes of income tax withholding at the source) but determined without regard to any rules that limit the remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in IRC §3401(a)(2)).

## **3. Information required to be reported under IRC §§6041, 6051, and 6052**

Compensation is defined as wages within the meaning of IRC §3401(a) and all other payments of compensation to an employee by his employer (in the course of the employer's trade or business) for which the employer is required to furnish the employee a written statement under IRC §§6041(d), 6051(a)(3), and 6052. (See Reg. §§1.6041-1(a), 1.6041-2(a)(1), 1.6052-1, and 1.6052-2, and also Reg. §31.6051-1(a)(1)(i)(C).) This definition of compensation may be modified to exclude amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are deductible by the employee under IRC §217. Under this alternative definition, compensation must be determined without regard to any rules under IRC §3401(a) that limit the remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in IRC §3401(a)(2)).

## **B. General Comments**

The plan must provide a definition of compensation actually paid or includible in gross income in the year. For limitation years beginning before January 1, 1992, the employer may elect to use compensation accrued for the limitation year, but all members of a controlled group of corporations or an affiliated service group (within the meaning of IRC §§414(b), 414(c), or 414(m) as modified by §415(h)) must make the same election.

If an employee is employed by two or more members of a controlled group of corporations, members of commonly controlled trades or businesses or an affiliated service group, compensation for such employee includes compensation from all of the employers in the group, whether or not they maintain the plan.

### **Example 5**

Employer Y maintains a profit sharing plan with an IRC §401(k) cash or deferred arrangement for a group of employees. For the 1993 plan year, Employee Smith received a \$500 allocation under the profit sharing plan and elected to defer \$3,500 under the IRC §401(k) cash or deferred arrangement, of which \$2,000 was matched by the employer. Smith's salary for the year (including the \$3,500 elective deferral) was \$35,000, and Smith received no other remuneration includible in compensation under Reg. §1.415-2(d).

For purposes of applying the limitations of IRC §415(c), compensation of \$31,500 (\$35,000 \$3,500) would be used for Smith. Therefore, the 1993 compensation limitation applicable to Smith would be

\$7,875 (25 percent of \$31,500). This is because elective IRC §401(k) contributions are not treated as compensation under any of the allowable definitions of compensation under IRC §415. Smith's total annual addition of \$6,000 (\$500 + \$3,500 + \$2,000) under the profit sharing plan did not exceed the dollar limitation (\$30,000) or the percentage of compensation limitation (\$7,875) applicable to Smith.

TRA '86 added IRC §401(a)(17) which imposes an annual compensation limit on the amount of compensation a qualified plan can take into account in determining allocations, in a defined contribution plan, or benefit accruals, in the case of a defined benefit plan. You should note that for purposes of applying the percentage of compensation limitations of IRC §415, compensation is not limited by the IRC §401(a)(17) compensation limit. However, the plan must satisfy the IRC §401(a)(17) compensation limit. Therefore, the plan provisions for determining contributions or allocations may not be based upon compensation in excess of the IRC §401(a)(17) limit.

*[RJM Note: For a 2004 plan year, the deferral percentage limit becomes 100 percent of pay and the dollar limit is \$41,000. Salary deferrals no longer reduce wages for 415 purposes. Thus, the individual described in the above example could have deferred the full limit of \$13,000. If we assume that Smith did defer the maximum, the limits for the above benefits would yield the following results:*

*For purposes of applying the limitations of IRC §415(c), compensation of \$35,000 would be used for Smith. Therefore, the 1993 compensation limitation applicable to Smith would be \$35,000 (100 percent of \$35,000, since it is less than \$41,000). This is because elective IRC §401(k) contributions are not treated as **reducing** compensation under any of the allowable definitions of compensation under IRC §415. Smith's total annual addition of \$15,500 (\$500 + \$13,000 + \$2,000) under the profit sharing plan did not exceed the dollar limitation (\$41,000) or the percentage of compensation limitation (\$35,000) applicable to Smith.*

*Clearly, this greatly benefited Smith in contrast to the prior rules.]*

### **Examination steps**

1. (a) Is an IRC §415 definition of compensation used under the plan for purposes of determining whether the limitations of IRC §415 have been exceeded?  
  
(b) Does the plan specify which definition is used for purposes of determining §415(c)(3) compensation?
2. Are amounts which are deferred and not includible in gross income under §125 plans, §401(k) plans, §403(b) plans, §408(k) plans, and §457 plans from compensation for §415 testing?
3. Is the employee's compensation from all members of a controlled group taken into account?

**AIDE FOR COMPUTING 2003 RETIREMENT PLAN  
CONTRIBUTIONS FOR SOLE PROPRIETORS AND PARTNERS**

This is a basic tool for a person whose sole earned income arises from a single self-employed arrangement. Modifications must be made if that person also has wages, has multiple sources of net self-employment income, etc.

- |   |    |             |
|---|----|-------------|
| 1. <b>Sole Proprietors</b> - Net Profit from Schedule C or F  |    |             |
| <b>Partners</b> - Self-employment income from Form 1065, Schedule K-1, line 15a   | \$ | _____       |
| 2. <b>Partners Only</b> - Other deductions - Section 179 expense, oil or gas depletion, or unreimbursed partnership expenses        |    | ( _____ )   |
| 3. Earnings from self-employment (subtract line 2 from line 1)  |    | _____       |
| 4. Section 1402(a)(12) deduction factor   | X  | _____ .9235 |
| 5. Net earnings from self-employment (line 3 times line 4)  |    | _____       |
| 6. OASDI tax (12.4% times lesser of line 5 or \$87,000)   |    | _____       |
| 7. HI tax (2.9% times line 5)   |    | _____       |
| 8. Total tax (add lines 6 and 7)  |    | _____       |
| 9. Section 164(f) self-employment tax deduction (line 8 times 0.5)  |    | _____       |
| 10. Plan earnings from self-employment (line 3 minus line 9)  |    | _____       |
| 11. Self-employed person's contribution rate (see attached rate table or worksheet)   |    | _____       |
| <b>Note: This rate does not reflect Social Security Integration</b>   |    | _____       |
| 12. Multiply line 10 by line 11 and enter the result  |    | _____       |
| 13. Multiply \$200,000 by the <u>plan</u> contribution rate ( <u>not</u> the self-employed person's contribution rate)              |    | _____       |
| 14. Enter the smaller of line 12 or line 13   |    | _____       |
| 15. 415 (c) limit for plan limitation years ending in 2003  |    | \$40,000    |
| 16. 401(k) elective deferrals made by the self-employed person to this plan for 2003 (not to exceed \$12,000) [if none, enter zero] |    | _____       |
| 17. Subtract line 16 from line 15 and enter the result  |    | _____       |
| 18. Enter the smaller of line 14 or line 17   |    | _____       |
| 19. Add lines 16 and 18 and enter the result  |    | _____       |
| 20. Catch-up contribution made if age 50 or over (not to exceed \$2,000)  |    | _____       |
| 21. Total plan contribution for the self-employed person (add lines 19 and 20)  |    | _____       |

- Note 1: The plan contribution is to be based only upon the net self-employment income, including related expenses, of the trades or businesses for which the plan was established. Refer to the plan document to determine which trades or businesses are covered by the plan. The self-employment tax deduction from line 9 will need to be prorated if any of the trades or businesses are not covered by the plan.
- Note 2: Adjustments will need to be made to this form if the client maintains more than one plan or if the plan does not define compensation for self-employed persons as earned income within the meaning of IRC Section 401(c)(2).
- Note 3: As noted on the form, if the taxpayer also has statutory employee income, skip lines 4 through 8 and insert in line 9 the actual SECA tax imposed from line 13 of the taxpayer's Long Schedule SE.
- Note 4: See IRS Announcement 94-101 for more information.

**SELF-EMPLOYED PERSON'S RATE TABLE  
SELF-EMPLOYED PERSON'S RATE WORKSHEET**

Compute the self-employed person's rate using the worksheet below.

- |    |   |       |
|----|---|-------|
| 1) | Plan contribution rate as a decimal.<br><i>(for example, 10½ percent would be 0.105)</i>  | _____ |
| 2) | Rate in line 1 as a decimal plus 1.0<br><i>(for example, 0.105 plus 1 would be 1.105)</i> | _____ |
| 3) | Divide line 1 by line 2.<br><i>This is the self-employed person's rate as a decimal.</i>  | _____ |