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Tax Reform Makes Now a Good Time for a 401(k) Plan Compensation Definition Audit

It is always a good idea to periodically perform an internal self-audit of a 401(k) plan's definition of compensation, to verify that the definition matches the administration in the plan sponsor's payroll and reporting system and, consequently, the correct deferral and matching contributions are being made.

Compensation definitions specify remuneration elements that are either included or excluded when making contribution calculations. Improper treatment of various elements is a common operational error of 401(k) plan administration, and a common focus of both the Internal Revenue Service's and U.S. Department of Labor's audit programs. If the plan documents and payroll system do not match, it can be a time-consuming and expensive error to correct. But in the wake of major tax reform legislation, a compensation self-audit can be vital to avoiding costly administrative errors and corrections.

The Tax Cuts and Jobs Act ("TCJA") signed into law late in 2017 made several changes to the tax code that eliminated the ability for employers to deduct and employees to exclude from income certain fringe benefits received by the employee. For example, before 2018, the Internal Revenue Code (the "Code") allowed an above-the-line deduction (meaning the amount is excluded from adjusted gross income rather than being an itemized deduction) for employees who incurred moving expenses.

The pre-2018 Code also allowed employers to reimburse employee-incurred moving expenses without including those amounts in the employee's income. Beginning with the 2018 tax year through 2025, the deduction and exclusion for moving expenses is suspended under new Code Sections 132(g)(2) and 217(k).

Some 401(k) plans' definitions of compensation distinguish between fringe benefits that are includable in or excludable from gross income, and will either be included or excluded from the plan's definition of compensation depending on which tax category the fringe amount falls into. As a result, plan administrators will need to review their plan's definition of compensation and may need to change the payroll system to reflect whether the moving expense element of remuneration is included or excluded for 401(k) plan purposes if it is no longer excludable from taxable income. Through this process, it is a good idea to check the other elements of remuneration identified in the plan's compensation definition as well, and verify they are all properly coded in the employer's payroll system.

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