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# Employee Deferrals and Employer Contributions on Bonus Payments May Pose Challenges



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An issue that can arise when considering the potential qualified status of a tax-qualified retirement plan (a “plan”) (including related items such as IRS audits and internal Form 5500, *Annual Return/Report of Employee Benefit Plan*, reviews) is whether the definition of compensation under a plan is being properly implemented based on a participant's elective deferral election and corresponding employer contributions based on an employee's elective deferral election and the plan document. Specifically, a plan will sometimes provide a separate employee elective deferral election on bonuses when the plan already includes bonus payments in its definition of compensation. This article provides background on this issue and discusses the consequences of providing separate deferral elections on bonuses, the potential risks of permitting such separate elections, and related considerations that are important to maintain the tax-qualified status of a plan.

### BACKGROUND

A plan typically uses various definitions of compensation — importantly for purposes of employee deferrals and employer contributions.<sup>1</sup> Sometimes, a plan (either individually designed or a volume submitter plan) will permit a separate deferral election on bonus payments when the plan already includes bonuses in its definition of compensation. Depending on how the plan is administered, this approach can lead to errors where a bonus, absent an affirmative participant election, is excluded from the plan's definition of compensation and impermissibly excluded from a participant's existing elective deferral election and/or corresponding employer contributions. Where a separate bonus deferral election does not align with a plan's definition of compensation, potential plan qualification errors can occur, as the improper treatment of an item of pay may result in a missed deferral opportunity and/or corresponding employer contributions.

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<sup>1</sup> See §401(k); see also §401(m). All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

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Such an error may result in a plan needing to take corrective action under Rev. Proc. 2021-30 which

outlines the Employee Plans Compliance Resolution System (or future updated revenue procedures) (EPCRS), drafting participant communications, and coordinating with payroll, third-party administrators, recordkeepers, or volume submitter plan providers to correct the separate bonus deferral election issue prospectively. To avoid issues related to bonus payments and separate participant deferral elections, a plan sponsor should periodically review whether separate elections on bonus payments should be permitted under the plan.

## COMPENSATION UNDER A PLAN

Compensation as defined under a plan for purposes of employee deferrals and employer contributions will sometimes (more frequently in a pre-approved plan) track a Code definition such as “statutory” compensation,<sup>2</sup> “simplified” compensation,<sup>3</sup> or Form W-2 wages.<sup>4</sup> Of course, plans can narrow their definition of compensation, but, assuming a definition of compensation similar to the above is used, the plan will often capture bonus payments by default (excluding some instances, such as upon severance from employment).

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<sup>2</sup>See, e.g., Reg. §1.415(c)-2(a).

<sup>3</sup>See, e.g., Reg. §1.415(c)-2(d)(2).

<sup>4</sup>See Reg. §1.415(c)-2(d)(3)-§1.415(c)-2(d)(4).

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## CONSIDERATIONS

- **EPCRS (Corrective Contribution):** In the event a bonus payment is not deferred pursuant to a valid participant election (i.e., classified as not eligible for employee deferrals and/or employer contributions) when the amount should have been (i.e., should have been compensation under the plan), the plan sponsor will generally be required to contribute a qualified non-elective contribution (a “QNEC”) to the affected participant's plan account — typically 50% of the missed deferral amount, subject to certain EPCRS safe harbor rules. The QNEC should be adjusted for earnings. Any missed employer matching contribution and/or non-elective contributions should also be contributed to the affected participant's plan account, adjusted for earnings.
- **Correction of Bonus Deferral Error (Retroactive Amendments):** A plan should consider whether correcting a bonus deferral error may be done through a retroactive amendment under applicable EPCRS rules (i.e., retroactively amend the plan to permit separate deferrals on bonuses). One important point to consider is participant expectations — a plan should review its various participant communications, collective bargaining agreements, summary plan description, annual notices, etc. — to determine whether participants expected to be able to make separate deferral elections on bonus payments.
- **Correction of Bonus Deferral Error (Prospective Correction — Individually Designed Plans):** A plan should consider whether correcting a bonus deferral error may be done prospectively through a plan amendment to allow a separate deferral election.
- **Correction of Bonus Deferral Error (Prospective Correction — Volume Submitter Plans):** A plan should consider whether correcting a bonus deferral error may be done prospectively through a plan amendment. Often, this correction can be done by modifying the plan's definition of compensation in the adoption agreement (i.e., checking the “other” box under compensation) and

using language such as “Notwithstanding the foregoing, compensation will not include bonus payments unless the participant separately so elects pursuant to procedures adopted by the plan administrator.”

- **Correction Period:** A plan should consider the period for which the bonus deferral error occurred. Under EPCRS, generally most errors can be corrected using self-correction procedures if the error is identified and corrected within three years following the year in which the error occurred. If a bonus deferral error falls outside of that window, a plan will need to consider whether the errors were insignificant based on EPCRS factors (if not insignificant, the plan would need to utilize the voluntary correction program under EPCRS).

- **Participant Communications:** A plan should consider the need to communicate with participants regarding corrections. This consideration is especially important if a plan wishes to use a QNEC safe harbor approach under EPCRS.

- **Collectively Bargained Plans:** A plan should review any applicable collective bargaining agreement to ensure the plan and the agreement “sync” regarding separate deferral elections on bonus payments.

- **Disqualification:** Technically, the failure to properly implement employee deferral elections (and corresponding employer contributions, if applicable) is an operational failure that could result in the loss of a plan’s tax-qualified status.

## CONCLUSION

In short, ensuring a plan is properly administering employee deferrals and making corresponding employer contributions on bonus payments is important. Failing to do so could be costly — e.g., making QNECs, drafting employee contributions, amending the plan (either prospectively or retroactively), and risking disqualification. To avoid these issues, the plan definition (either in the individually-designed plan document or adoption agreement) should be reviewed periodically to ensure bonus payments are being properly treated as compensation under the plan.