Do We Have to Consider Pay Before a Participant is Eligible When Calculating Matching Contributions?

Facts

Each year, after our last payroll in December, I submit my census information to the TPA for our 401(k) plan. Even though I've looked at each participant's total deferrals for the year to determine the matching contributions, the TPA almost always has true-up contributions for me to make. Taking a closer look, it seems like these true-ups are always related to newly eligible participants and the part of the year before they became eligible.

Question

Do I really have to calculate contributions for participants before they were eligible for the plan?

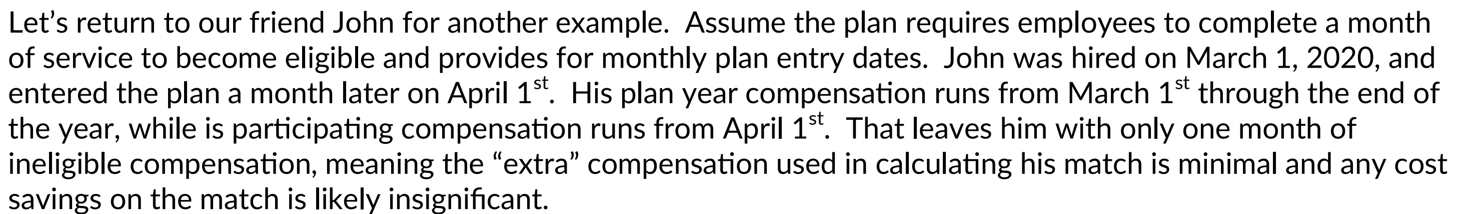
Answer

Maybe so. The plan document, with all its nuances, spells out the compensation you must use to calculate employer contributions. For this question, we're going to focus on the definition of compensation rather than the method of calculating matching contributions. Granted, both of these things are important to ensuring you accurately calculate contributions; so if you have any questions on the difference between "payroll period" and "entire plan year" calculations, we've got you covered here.

Let's start with the basics. There are really two ways to define the period of compensation for contributions. The first is plan year compensation which, for this purpose, is as straight forward as it sounds: it is the compensation earned by the participant during the full plan year. The second is participating compensation, which is the compensation paid to the participant from the date he or she first enters the plan through the end of the year. Let's look at a quick example:

- John becomes eligible to enter your plan on April 1, 2020.
- If the plan uses plan year compensation, you'll use the compensation you paid to John from January 1, 2020 through December 31, 2020 to calculate contributions and perform nondiscrimination testing.
- If, instead, the plan uses participating compensation, you'll look at John's compensation from April 1st through December 31, 2020.

With an understanding of these two options, you might be asking why anyone would choose plan year compensation over participating compensation. Although it's quite common for plan sponsors to choose participating compensation, there are circumstances where plan year compensation is preferable. One such circumstance is when a plan provides for a very short service requirement and/or frequent plan entry dates. Frequent plan entry dates (think monthly or even each pay period) mean that you would be stuck looking at different compensation periods for each new participant, while short service requirements mean that there is minimal cost savings from using participating compensation.



Let's return to our friend John for another example. Assume the plan requires employees to complete a month of service to become eligible and provides for monthly plan entry dates. John was hired on March 1, 2020, and entered the plan a month later on April 1st. His plan year compensation runs from March 1st through the end of the year, while is participating compensation runs from April 1st. That leaves him with only one month of ineligible compensation, meaning the "extra" compensation used in calculating his match is minimal and any cost savings on the match is likely insignificant.

Using plan year compensation for all participants is much more streamlined, which leads to time savings as well as fewer opportunities for miscalculations due to manual data entry. Both of these translate into cost savings which may even outweigh any added cost related to the matching contributions.

The other scenario where a plan sponsor may prefer plan year compensation is when the plan is top heavy. If a plan is top heavy, you must calculate the minimum required employer contribution using plan year compensation *even if the plan otherwise calls for participating compensation*. We provide additional details here, but if a plan is ultimately going to have to look at full year compensation for contributions anyway, a sponsor may not find the participating compensation exercise worth the while.

There's a potential "gotcha" that is worth mentioning here. Participating compensation is based on when the employee becomes a participant in the plan. That is, a participant by ERISA definitions, meaning the date he or she is first eligible to contribute and not the date he or she actually starts contributing. John became a participant on April 1, 2020. If John chooses to wait until July 1, 2020 to being making contributions, his participating compensation is still the amount he was paid from April 1st through December 31, 2020. The fact that John does not begin making contributions to the plan until some time after April 1st is not relevant.

By no means are these the only items to consider when designing your plan and selecting the period of compensation. The period of compensation is an important determination that is used for the ADP/ACP tests, cross testing for profit sharing contributions, and other nondiscrimination tests. Carefully designing the definition of compensation can be a strategic component to creating a plan that efficiently and effectively meets company objectives year after year. It is typically allowable to amend your plan to expand the definition of compensation at any time; however, any change that restricts the definition can usually only be made prospectively at the start of subsequent plan year.

Questions about how your plan document defines the period of compensation? Wondering if there are changes that can improve the ease of administration or annual test results? Reach out to the DWC Team and we can review your specific plan provisions and discuss your unique needs to ensure you avoid year-end surprises with a plan that works the way you want.

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