Code 401(a)(17) Compensation Limit Simplify 401(k) Plan Administration and Increase Permitted HCE Deferrals with a Simple Drafting Technique

PRACTICE AREAS

Benefits & Compensation

Retirement Plans

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With careful drafting, a 401(k) plan generally can permit all employees, even HCEs, to continue to defer compensation under the plan until they hit the full 402(g) limit of $16,500 (indexed) plus any catch-ups, without regard to the employee's compensation. The payroll department need not track cumulative compensation during the year.

Under Code 401(a)(17), the compensation that can be taken into account under a qualified retirement plan is limited to $245,000 in 2010 (indexed). Under most 401(k) plans, this limit is applied by adding up the compensation earned by highly-compensated employees during the year and cutting off deferrals once an employee's cumulative compensation for the year has reached $245,000 (indexed). For example, assume an elects to defer 4% of compensation under a 401(k) plan. If the employee's monthly compensation is $50,000, the employee would be permitted to defer $2,000 in each of January through April, and another $1,800 in May, for a total of $10,800. No further deferrals would be permitted after May.

Applying the 401(a)(17) limit in this manner is administratively burdensome - someone, typically the payroll department, must track cumulative compensation (which might include bonuses and other irregular pay) and hit the "off" switch when the compensation limit is reached. It also restricts employee deferrals in a way that is not required under the Code. With careful drafting, the employee in the example above could continue to defer 4% of her compensation each month until she hit the 402(g) limit of $16,500 (indexed) plus any catch-ups. And the payroll department need not track cumulative compensation during the year.