Proceedings from the 1984 Tax Institute Symposium: Cash or Deferred Arrangements Under I.R.C. Section 401(k)

John H. Appel
WHAT'S THE REAL REASON that employers might consider a cash or deferred profit sharing or stock bonus plan? To understand the answer we have to go back to the basics. Employers offer employees a total compensation package. Part of that package is always straight salary or wages; part may be overtime pay; part is welfare benefits such as medical insurance; and often part is employer contributions to a qualified plan such as a profit sharing or stock bonus plan.

Consider the tax benefits of qualified plans. As contributions are made to the plan, the employer gets immediate deductions, but the employee is not taxed immediately on such. As you know, the employee is not taxed on the contributions or their earnings until he or she actually receives them under the plan. Thus, these monies are deferred until retirement or at least until the employee separates from service with the employer. Further, when the employee receives distributions, they often are eligible for favorable income tax treatment.

But there's an important rule with qualified plans. They have to be non-discriminatory. What does that mean? It means in very general terms that we have to provide the same deferral as a percent of compensation for all employees. In the past we could not individually design these programs to benefit various employees who may have wanted different portions of their total compensation package put in qualified plans. Generally, the employer had to designate a certain overall percentage of compensation as a contribution, even though some of its employees may have wanted more cash and less compensation in the form of qualified plan contributions.

Even more importantly perhaps, some of the employees, and oftentimes the very ones you want to benefit most, want to put more of their compensation package into the qualified plan but cannot due to the designated percentage imposed on them by the employer. The employer needs to impose a deferral that meets the bulk of all employees' desires. You often hear the employee complain, "I can't put more into the plan." And the employer apologizes, "I cannot afford to put more in for you because I would have to do the same for all my other employees." What happens? The employer must try to develop

*John H. Appel, a member of the Ohio Bar, is a partner in the Cincinnati, Ohio law firm of Frost & Jacobs. Mr. Appel received his J.D. from Harvard Law School.
an individually designed nonqualified deferred compensation arrangement with the employee, which never works as well as a qualified plan, or the employee is forced into what often is a horrible tax shelter.

The cash or deferred plan, which is permitted under Section 401(k) of the Internal Revenue Code, allows, within certain limitations, an individual employee the choice between receiving immediate cash or a contribution being made on the employee's behalf to a qualified plan. If the employee chooses the plan contribution instead of receiving immediate cash, the contribution is treated as an employer contribution. Thus, the employer gets the immediate deduction; the employee defers tax until retirement or separation from service; and the employee obtains the favorable income tax treatment.

If we are to use a CODA (cash or deferred arrangement) in a qualified plan, we must meet certain extra requirements pertaining to this type of plan. These extra requirements are designed mainly to insure that the elective contributions will be used to provide retirement security, as opposed to serving as a type of savings account that permits withdrawals at will. Furthermore, the rules are intended to prevent the plan from being a device that merely allows highly compensated employees to escape current taxation.

Now let’s get into the detail of the Section 401(k) plan. I want to cover four primary requirements and then get to the big one, nondiscrimination, which is the fifth requirement.

First, we need an employee election involving a choice between cash or a plan contribution. That’s the whole basis of the cash or deferred plan. Now despite some statutory ambiguity, the proposed regulations permit both a salary reduction cash or deferred arrangement (whereby the employee elects to reduce salary or wages or forego a raise in return for a plan contribution) and a bonus, or profit, cash or deferred arrangement (whereby the employee elects to forego a bonus or share of profits above his regular compensation in return for a plan contribution). Either the salary reduction or the bonus cash or deferred arrangement can qualify for the special treatment we are going to examine. Even though a Section 401(k) plan demands elective contributions, both regular deductible employer contributions and regular, non-deductible or deductible employee contributions are also permitted.

In addition to an employee election, we need a qualified plan. What type of qualified plan are we allowed? The rules indicate that only a profit sharing or stock bonus plan will be eligible for Section 401(k) treatment.

Consider for a moment the definition of a profit sharing plan. As the name implies, profit sharing plans involve plan contributions that can only be made, obviously, out of profits. But this means not only current profits but also accumulated profits, which can be any fruits of the enterprise available for distribution. Thus, most employers that have operated for some period of time should
There are certain companies, however, that may have difficulty in this regard, such as "high-tech" companies that depend upon the future profitability of their products. For these and similar companies to use a cash or deferred arrangement, they must either establish a stock bonus plan, which need not be based on profits, or hope that the Internal Revenue Service ultimately rules (as I doubt they will) that salary reduction contributions are automatically deemed made out of "profits" without regard to the traditional concept of profits, or pray that Congress eventually rules that salary reduction money purchase pension plans are allowed.

Money purchase pension plans operate almost exactly like profit sharing plans, except that the contributions are not dependent upon profits. To be honest, I see no reason why money purchase pension plans should not be allowed under Section 401(k). At this time, the only proposed legislation respecting this is contained in the Tax Reform Act of 1984 as passed by the House, which merely grandfathered the legality of salary reduction money purchase pension plans in existence on June 27, 1974, at contribution levels then in effect. The 1974 date arises from ERISA, which put a halt to cash and deferred plans until Congress had time to consider them in detail, which they did in the Revenue Act of 1978. Except for the possibility of grandfathered salary reduction money purchase pension plans, it does appear that we are going to be limited to using a profit sharing or stock bonus plan.

There is an indication in some recent private letter rulings that partnerships, sole proprietorships, and tax exempt organizations should, in certain circumstances, be able to establish a Section 401(k) plan. There is still some controversy as to these organizations, particularly tax exempt organizations. Can a tax exempt entity set up such a plan and still meet its tax exempt purpose? I think tax exempt employers may become eligible to set up Section 401(k) plans. If so, "profits" for such an organization would simply be revenue over cost.

A third requirement for Section 401(k) plans is that the contributions elected by employees must be 100% vested at all times. Since elective contributions are really the employees' own money, I think this requirement is noncontroversial. After all, the employer was ready to give each such employee immediate cash. Simply because employees elect plan contributions doesn't mean the employer is no longer willing to give them a 100% right to that money. There may be some controversy as to the application of the nonforfeiture requirements to "regular" employer contributions sometimes made in this type of plan, as we will discuss later, but 100% vesting for all elective contributions is quite understandable.

The fourth requirement involves distribution limitations. The employee elective monies will be treated as employer monies only if they're not
distributable at will, that is, only if they're going for retirement, or akin to retirement, purposes. Section 401(k) requires that elective contributions may not be distributed other than for retirement, death, disability, separation from service, hardship, or attainment of age 59 1/2. Almost all of these triggering events have some issues or ambiguities involved with them. In fact, the only one that maybe doesn’t is death, but that’s just such a hell of a way to get your money out. With new technological advancements, maybe there’s even going to be issues as to death. I’ve heard that the next issue of the New England Journal of Medicine is going to cover “death, lack of brainwaves, and the Section 401(k) problem.” For a pension plan attorney that’s the only type of article that makes any sense.

The triggering event I do want to mention is hardship, since it generates the greatest confusion. Allowing a hardship distribution does cause some tough administrative decisions at times, and many employers are thus going to avoid allowing such distributions. There are two important points here. One, when it is necessary to determine when a hardship has occurred, the plan administrator cannot simply be a rubber stamp. If the plan administrator accepts any reason at all for making a distribution, then at a later time the IRS can justifiably determine that distributions are simply at will and not pursuant to a standard of hardship. The IRS would thus find that the plan violates the Section 401(k) distribution limitations and that all of the employees’ elected monies have suddenly become immediately taxable. A scramble to be first to sue the plan administrator would result. Do not get in the habit of giving distributions just for any reason simply because we have no cases yet on this point. It may be prudent, until we get better guidance, to allow distributions only for medical emergency or casualty losses. It is possible final regulations will expand the hardship definition to include the college education of a child or purchase of a house, but in the meanwhile I advise caution.

Further, right now the proposed regulations say one must consider the outside resources of the employee in determining whether a hardship situation is present. Consideration of outside resources amounts to a built-in bias against management or highly compensated employees. Such employees will rarely be able to meet the hardship criteria so defined. Until we get better guidance, you may want to use hardship distributions only to help lower compensated employees in extreme situations. Pay attention to final regulations and future cases in this area.

Distribution limitations may make some employees afraid to participate in a Section 401(k) plan. They may be afraid of locking in their money for a long period of time and not being able to get it out when they feel they want the money. In other words, although the employer may determine no hardship situation exists, the employee may feel he or she has a hardship situation. This hurts all employees to the extent distribution limitations result in not implementing the plan. Even if the plan can be implemented, if the distribution
limitations scare off the lower compensated employees, the employer may not be able to allow full deferrals for those people it's trying to benefit, the highly compensated work force, as a result of application of the deferral percentage rules to which we'll soon turn.

How do we alleviate or minimize the effect of the distribution limitations? Aside from using hardship distributions, the employer can allow employees access to their elective contributions through plan loans. Plan loans do not have to be used with the Section 401(k) plan or any plan. However, they often are very appropriate for this type of plan because of the distribution limitations and very often are used in Section 401(k) plans.

Plan loans are basically subject to three sets of rules: prohibitive transaction rules, the “bona fide loan” rules, and the TEFRA rules. These rules govern both the type of loans permitted and when the loans will be treated as taxable distributions to the employee.

Any time the employer has a plan loan program, it has extra administrative costs, so I do not try to oversell a loan feature. One must analyze whether the benefits of loans are worth the extra cost. Often they are, but too many people do not fully consider the cost factor. A loan program requires documentation, determination of interest rates, and administration of payments, including enforcement problems.

I also want to point out that loans must truly be loans and not effective distributions from the employees' account balances. If a loan is deemed a distribution, then Section 401(k) distribution limitations will be violated, and the loan program put in to minimize the fear of those limitations will have caused definite disqualification of the cash or deferred arrangement. Thus, for all employees, those receiving loans and those not receiving loans, the elected monies in the plan become immediately taxable.

When does a plan loan become a plan distribution? One example is when the interest rate for the loan is too low, or below market. I fear for plans that use an interest rate for loans at 5% or 6%. Not only might the plan have a prohibited transaction problem, since the prohibited transaction rules require a "reasonable" interest rate, but the plan might also have made a distribution of plan property in violation of the Section 401(k) limitation. That "property" is the right to use money for a period of time without paying a fair return.

Now I don't have any direct authority on point, but there are some analogies I think I can draw to support such a distribution theory. For instance, in the recent Dickman case the Supreme Court held that a no-interest loan in a family context was a valuable property distribution for gift tax purposes. And, look at the new proposed Tax Reform Act of 1984 as passed by the House. It would treat certain family loans or loans between employers and employees having an interest rate below the average yield of U.S. marketable
obligations of appropriate length, as distributions. I think the movement is clear. If we use too low an interest rate in our plan loans, we may create distributions for plan purposes.

Distributions may also result from the loan enforcement problems. The form of security for almost all plan loans is the vested account balance of the employee. But there's a dilemma here. What if the plan is not being repaid and the plan trustees try immediately to foreclose upon the security of the account balance? The use of an account balance for paying an old debt of the employee is a distribution in violation of the Section 401(k) distribution limitations if the employee is not yet age 59½ and still working for the employer. But, if the plan fails to foreclose immediately, and does not otherwise enforce the payment, there arguably can be a finding that the loan is not bona fide. In reality, the loan may be seen as an advanced distribution of the account balance. Once again, the Section 401(k) limitations are violated. It may be prudent, because of this problem, to require an irrevocable agreement at the time the loan is made to allow the loan to be repaid, if necessary, from payroll deductions. This insures a source of payment while the employee is working for the employer. If the employee separates from service, that's a triggering event for distribution anyway under Section 401(k), so deducting the loan from the account balance should be fine in that situation.

Finally, I think distributions may result when there is constant rollover of loans. One loan is replaced with another until finally a triggering event is reached. Too much of such activity can easily lead to an IRS finding that a distribution has transpired at some point. So aside from the extra administrative costs of plan loans, care must be exercised to avoid constructive distributions. Loans are used a great deal in Section 401(k) plans, but to the extent possible, try to make sure the clients know how to use them.

I want to turn now to one additional basic requirement for a Section 401(k) plan, the nondiscrimination rules. These rules are very complex for someone not emersed in the area. People not familiar with Section 401(k) often believe that if all employees are allowed to defer the same percentage of compensation, discrimination is avoided. Unfortunately, as reasonable as that position sounds, Section 401(k) goes farther. The overriding philosophy is that there must be no more than a limited difference between the deferrals or benefits allowed for highly compensated employees and the deferrals or benefits allowed for lower compensated employees. The Code and the IRS prohibit special tax breaks for highly compensated employees unless society's purpose is being fulfilled respecting retirement coverage for a broad-based class of employees. Section 401(k) plans, more so than other qualified plans, must conform with that philosophy. Thus, very strict nondiscrimination rules have resulted, but it is easy to tell when these rules have or have not been met.

There are three basic requirements of meeting the special nondiscrimination
The first of these is that the right to make elective contributions must meet one of the general coverage tests that apply to all qualified plans under Section 410(b) of the Code. Section 410(b) encompasses both a percentage test and a classification test.

The percentage test involves two alternative sub-tests, but the one most often used requires coverage for 70% or more of all employees, excluding, among certain others, union employees and those not meeting minimum age and service requirements. The classification test requires generally that the plan not discriminate in favor of those employees who are also shareholders, officers, or highly compensated. In applying the classification test, we can exclude union members, but we still have to consider those not meeting minimum age and service requirements. Closely-held employers will most often use the percentage test. In the Section 401(k) context, the percentage test will require that 70% or more of all employees, excluding union employees and those not meeting minimum age and service requirements, must be eligible to make elective contributions to the plan. In most cases, this test can be easily met.

A second general requirement under Section 401(k) is that elective contributions must meet one of two actual deferral percentage tests, or as I call them, ADP tests. To understand the ADP tests, we must know the definition of a “top ½ employee.” Such an employee is one eligible to participate in the plan who has more compensation for the subject year than 2/3 of all eligible employees. A “lower ⅔ employee” is simply the corollary; he or she is an eligible employee who is not a top ½ employee. In line with the general philosophy that a plan cannot inordinately benefit highly compensated employees, the definition of a highly compensated employee is thus established to mean a top ½ employee.

We must determined for both the top ½ employee group and the lower ⅔ employee group an actual deferral percentage. For either group, the actual deferral percentage for any year is the average of the deferral percentages for each employee in that group. The deferral percentage for any one employee is simply the amount of elective contributions made by the employee for the year divided by the employee's compensation for the year.

For example, consider an employee with regular compensation of $20,000 per year. Assume he or she can elect to defer as much as $3,000, or 15% of his or her regular compensation, as a bonus. The employee can elect to receive all of the $3,000 as cash, he or she can elect to have the whole $3,000 go into the plan, or he or she can elect to receive part of it in cash and have part go to the plan. Let us say he or she elects to receive $1500 in cash while putting $1500 into the plan. The deferral percentage for the employee is simply the $1500 that goes into the plan divided by his or her regular compensation before the election ($20,000). The deferral percentage is 7.5%.

Assume the employee is a lower ⅔ employee and that a second lower ⅔
employee has a deferral percentage of 5%. The actual deferral percentage for
the lower ⅔ group consisting of the two employees is merely the total of all
deferral percentages, here 7.5% plus 5%, divided by the number of employees
in the group. The actual deferral percentage for the lower ⅔ group is thus
6.25 percent. We must also determine an actual deferral percentage for the
top ⅓ employees.

Given these numbers, we must now meet one of the two ADP tests. Under
the first test, the actual deferral percentage of the top ⅓ employees can be
up to but not beyond 1½ times the actual deferral percentage for the lower
⅔ employees. Under the second test, the actual deferral percentage for the
top ⅓ employees can be up to but not beyond 2½ times the actual deferral
percentage of the lower ⅔ employees but the actual deferral percentage of the
top ⅓ employees must be within three percentage points of the actual deferral
percentage of the lower ⅔ employees. Working this out; if the actual deferral
as a percent of compensation of your lower ⅔ employees is less than 2%, then
the top ⅓ employees can defer as an average percent of their compensation
2½ times as much. If the actual deferral percentage for the lower ⅔ employees
is 2% through 6%, the top ⅓ employees can defer on average up to 3 peren-
tage points more. If the actual deferral percentage for the lower ⅔ employees
is above 6%, the actual deferral percentage for the top ⅓ employees can be
1½ times as much.

Let's now return to our original example. We already determined the ac-
tual deferral percentage for our lower ⅔ employee group. It was 6.25%. Since
the figure is above 6%, the top ⅓ employees can defer on average 1½ times
as much. 1½ times 6.25% is 9.375%. Consider a higher-paid employee with
$100,000 compensation who elects to put $10,000 into the plan. His or her defer-
ral percentage is 10%. Thus, the test is failed, since 9.375% is exceeded. If
we don't do something we've made all of the elective contributions immediately
taxable to our employees. We have to reduce the higher-paid employee's con-
tribution to $9,375. At the point, we've met the first actual deferral percentage
test.

I want to take one look at a salary reduction example. The proposed regul-
ations give specific examples of how to determine deferral percentages for a bonus
or profit, cash or deferred arrangement, but they do not give specific examples
for a salary reduction plan. Presumably we should use compensation before
an election is made as a basis for applying the deferral percentage tests, and
my example will show how I interpret the tests for salary reduction plans.

Assume an employee with $150,000 of regular compensation wishes to
reduce his salary by $25,000, which goes into the plan. The way I read the
proposed regulations, his or her deferral percentage is determined by dividing
the 25,000 by his or her compensation before the election, or $150,000. We get
a deferral rate of 16.67%. But if a salary reduction plan is to operate the same
as a profit or bonus cash or deferred arrangement, the deferral percentage should be determined by dividing the $25,000 by reduced compensation of $125,000. Doing so produces a deferral rate of 20%, making it harder in most cases to meet the special nondiscrimination rules. We should be prepared to look at final regulations or other authorities closely to make sure our salary reduction arrangements meet the special nondiscrimination rules.

Another point I want to make is that the Section 401(k) plan is a qualified plan subject to other contribution limitation. We have annual addition limitations that restrict the amount of money that can be allocated for any one employee in any one year, and we have deduction limitations that directly affect the employer’s tax posture. Since elective contributions are employer contributions for tax purposes, both of these limitations apply, and it appears they apply to compensation net of (and not including) the elective contributions to the plan. So make sure you pay attention to these restrictions.

A third basic nondiscrimination requirement for Section 401(k) plans is that the permitted amounts subject to deferral on behalf of all employees must be nondiscriminatory. Thus, the top $1/2$ employees cannot be allowed to put $15\%$ of compensation into the plan while the lower $1/2$ employees are limited to $10\%$. Do not confuse this point with the actual deferral percentage tests. Just because $15\%$ is no more that $1\frac{1}{2}$ times $10\%$ does not mean that the $3/2$ employees can be limited to a potential benefit of $10\%$ while the top $1/2$ employees are permitted $15\%$.

At this point we have covered the basic tests and must consider how to make sure we have enough participation of the lower compensated participants in order to meet the actual deferral percentage tests. The main purpose of the plan is to allow extra deferrals, especially for the highly compensated employees or at least for those who want them. But if we don’t have sufficient deferrals and good participation for the lower $1/2$ employees, we are going to limit severely the deferrals that can be allowed for those people we are trying to benefit. If the lower $3/2$ employees put in zero, I don’t care if you multiply $1\frac{1}{2}$ times zero or $2\frac{1}{2}$ times zero, the top $1/2$ employees will be limited to zero deferrals. The costs of the plan far outweigh the benefits if there isn’t good participation for the lower paid employees. So, how do we promote that participation?

I want to mention three methods. First is one too often overlooked. Simply sell the plan to the lower $3/2$ employees. Clients are often amazed at the good participation they can get from the lower $3/2$ employees once that group understands the advantages of this type of plan. Consider a comparison of your plan to an Individual Retirement Account, an alternative for your client’s employees, and you may find that the Section 401(k) advantages, if properly explained, help sell the plan.

A second method to encourage employee contributions is by use of matching employer contributions. This is a device that uses regular employer
contributions in the plan design. The employer can say to its employees, "If you put in an elective contribution, we'll match it with regular employer contributions at a designated rate." The employer can thus explain that, if for example there is a 50% matching rate, the employee who puts in an elective contribution will have an immediate 50% return on his or her money even before it is invested. A very attractive selling point thus results.

Most tax advisors are already familiar with what we call thrift or savings-type plans. These plans also use matching employer contributions, but instead of matching Section 401(k) contributions, in the past they matched nondeductible employee contributions. Changing a thrift or savings plan to a Section 401(k) plan while retaining the matching feature does not change the operation of the plan at all, except to transform those prior nondeductible employee monies contributed with after-tax dollars into employee elected monies that are treated as employer contributions for tax purposes.

One problem with this device is that matching employer contributions must meet the general nondiscrimination rules, and we cannot rely on the special rules I just mentioned. I want to point out one of these nondiscrimination rules. In the past, matching contributions were approved automatically if employee contributions eligible for a match did not exceed 6% of the employee’s compensation. However, a 1980 Revenue Ruling eliminated the 6% safe harbor and there’s been no guidance from the IRS since then as to what constitutes discriminatory contributions. Are the matching employer contributions prohibited if they are made to any greater extent, measured as a percentage of compensation for highly paid employees than for the lower paid? Or can they, as I sincerely hope, be made in the same proportion as the elective contributions if the elective contributions meet one of the special Section 401(k) contribution rules. Thus, if the lower ⅔ employees end up in operation putting in 10% of compensation and the top ⅓ employees 15%, can I put my matching contributions on the same ratio and be deemed to meet the general rules? I hope so, I pray so, and I think so, but I can’t say for sure. So I advise all thrift plan clients, whether their plans are being converted to Section 401(k) status or not, to apply for a new determination letter, provide the coverage information needed, and get a new determination letter from the IRS indicating that the plan remains qualified.

A third method to assist with employee contributions involves nonelective employer contributions. The proposed regulations allow nonelective employer contributions to be counted in determining each employee’s deferral percentage, if the nonelective contributions are nonforfeitable when made and at all times thereafter and they are subject to the Section 401(k) distribution limitations. The distributions limitations rarely cause much difficulty. Most regular employer contributions are not distributed until the employee separates from service or retires. However, the 100% vesting requirement bothers some employers. They like vesting schedules for regular contributions and they like
forfeitures that go to others or reduce contributions. Thus, using employer contributions in the manner I am going to explain does have a cost, but you have to see whether the benefits are worth the cost. Since many closely-held employers will be under the new "top heavy" rules of TEFRA, their vesting schedules may have to be drastically altered anyway. I think that in many cases the presumed cost of 100% vesting is somewhat overrated.

If nonelective employer contributions are 100% vested at all times, subject to the Section 401(k) distribution limitations, and allocated to participants on a clearly nondiscriminatory basis (such as in direct proportion to each employee's compensation), then they can form a base actual deferral percentage for the lower ⅔ employee group so as to allow greater elective contributions for the top ⅓ employee group. Such nonelective contributions thus operate almost like a straight profit sharing plan, but, most importantly, they assure that the top ⅓ employees can make elective contributions sufficient to justify the cost of the plan.

For example, if the employer makes a 10% of compensation contribution, it can permit its employees to put an extra 5% of compensation in the plan. Even if the lower ⅔ employees put nothing into the plan, their actual deferral percentage would be 10% and one of the ADP tests would be met, since 15%, the maximum top ⅓ percentage, is no more than 1 ½ times 10%. In this example I limit the elective contributions to 5%. I could increase the plan's flexibility by allowing the employees to put in any elective contributions, subject only to the regular annual addition and deduction limitations. So what happens if the lower ⅔ employees put in an extra 1% on their own for a total of 11%? The top ⅓ employees could contribute up to an additional 6⅔% above their 10% base. If the lower compensated employees put in an extra 2%, we can go from 5% to 8% for the higher compensated employees. You can play with the numbers yourself to suit your clients. Also, note that even if our base is 10% and the lower ⅔ employees put in nothing, it is the average limit for our top ⅓ employees that is an extra 5%. If someone puts in only 2% in the top ⅓ group, another top ⅓ employee can go above 5% to make up the difference. It is the average that has to be limited to the 5%.

It must be noted that the base level cannot be computed with reference to Social Security contributions; because they cannot be deemed employer contributions in determining the deferral percentages. A couple of extra points should also be stressed. Since it is possible for a Section 401(k) plan inadvertently to violate the actual deferral percentage tests, the plan administrators who monitor the deferral percentages should have the right to reduce the elective contributions for the top ⅓ employees when necessary. If actual monitoring sounds too burdensome, there are fail safe methods that can be designed so that monitoring can be prevented. The only fail safe method so far allowed in the proposed regulations is the use of nonelective employer contributions.
as a base, with a fixed limitation for nonelective contributions above such base. Of course, that method cuts off some of the flexibility I just mentioned.

Sometimes employers use a failsafe method but are surprised at the high level of nonelective contributions made by the lower ½ employees, which would have necessitated very little monitoring in any event. Often such employers continue to use the fail safe technique while giving up extra flexibility for a fear that never materializes in operation.

Finally, the proposed regulations have an alternative to meeting the special rules. They permit qualification through compliance with the general rules of nondiscrimination as well. The problem with this alternative is that no one knows for sure what the general rules of nondiscrimination are. One thing we do know under the general rules is that integration with Social Security is permitted. Using the employer contributions made on behalf of the employees to Social Security helps show nondiscrimination. Note, however, the recent Tax Reform Act of 1984 as passed by the House, which eliminates the right of Section 401(k), plans to meet the general rules instead of the special rules. Such act would require us to comply with the special rules. Since that part of the bill will probably be enacted, integrated Section 401(k) plans will not be feasible.

I want to close by addressing a few administrative problems. First, the elective contributions and the earnings thereon must be separately accounted for in the plan. If not, IRS says, quite reasonably I think, all contributions will be subject to 100% vesting and the distribution limitations at all times. This is a bookkeeping and accounting requirement. All contributions can still be comingled for investment purposes.

As for investments, there are no legal requirements particularly applicable to elective contributions. But as a practical matter, employees often are very concerned about the investment of their elective contributions. Thus, I think it appropriate at times to give the employees some kind of choice as to the investment of their elective contributions. Bank collective funds, mutual funds, or even insurance company special and guaranteed accounts can work very well in these situations. I do not think totally self-directed accounts do not work very well because often there are problems respecting unsophisticated employees, prohibited transaction situations, and increased administrative costs.

Valuations are required for Section 401(k) and other qualified plans on an annual basis. But if elective contributions are made throughout the course of a year, more frequent valuations may have to be made to ascertain the return attributable to those contributions. This results in an additional administrative cost.

Yet another administrative cost involves FICA and FUTA payments. Since elective contributions are treated as employer contributions, they are not subject to federal income tax when contributed and thus not subject to federal
income tax withholding. After 1983, however, elective contributions are deemed wages for Social Security purposes. After 1984, they will be deemed wages for purposes of the Federal Unemployment Tax. With respect to FICA, if we have elective contributions by an employee, we must reduce his or her take-home pay from his or her other wages in order to pay for the employee’s share of the FICA tax imposed against his or her elective contributions. From the way the statute is written, some question exists as to whether this situation occurs with respect to the Self-Employment Tax.

State and local laws differ as to their treatment of elective contributions. In Ohio, for example, elective contributions are not subject to state income tax. In many cities, such as my own of Cincinnati, they are subject to tax. You may have elective contributions not subject to federal income tax withholding, subject to Social Security tax, subject to Federal Unemployment Tax, not subject to state income tax, but subject to city income tax, all of which may be very upsetting to your payroll people.

I do not want to pretend that these plans are the great panacea. They do have administrative costs and administrative inconveniences. On the other hand, I think if properly designed, these Section 401(k) plans are a real benefit to clients because they allow the individual employee a choice to put money into the best tax shelter of them all, and the one least attacked by the IRS, that of qualified plans.

CASH OR DEFERRED ARRANGEMENTS:

QUESTION AND ANSWER SESSION

My first question is this: If a top ½ employee’s elective contribution exceeds the permissible amount, how long does he or she have to withdraw the excess amount? If the actual deferral percentage rules are being violated, can we just have the top ½ employee withdraw the excess amounts back to an acceptable level? I would like the answer to be that there are failsafe methods to prevent such violations. For example, we could either recharacterize excess amounts as nondeductible, or deductible, employee contributions or all the excess contributions to be returned. Unfortunately, the proposed regulations do not specifically permit these methods at the present time, and in fact the Department of Treasury has indicated that the proposed regulations do not permit either the recharacterization or the removal of excess elective contributions. So, as the proposed regulations are written, if you’ve violated the deferral rules going in, no recourse is available.

Now, that’s a harsh rule, but I might also mention certain rumors in this regard. The rumors that I’ve heard are that the final regulation, if and when they
get enacted, will contain some workable failsafe method. Perhaps they will allow recharacterization or perhaps removal, although I am guessing that recharacterization will be the permitted method. Although there may be relief in the final regulations, right now you better make sure that excess amounts do not go in to begin with, and I recommend frequent monitoring during the year so that corrections can be made before the year ends.

A second question: Can partners and self-employed proprietors participate in a Section 401(k) plan? My best memory is that a private letter ruling says you can have partners in a Section 401(k) plan. This makes sense to me since Section 401(c) of the Code defines "employee" for all purposes of Section 401 as including self-employed persons.

Another question asks whether the annual contribution under a cash or deferred arrangement must be limited to $30,000 per year. The answer basically is yes, but it is a little more confusing than that. The $30,000 limit, of course, is the annual addition limit that applies to all qualified plans and pertains to contributions for an employee under all defined contribution plans for one year. Defined contribution plans include not only a Section 401(k) plan but any profit sharing, stock bonus, target benefit, or money purchase pension plan. The amounts that can be allocated as employer contributions, forfeitures, and certain nondeductible employee contributions is in the aggregate limited for all such plans to the lesser of $30,000 or 25% of compensation. So, if all you had was a cash or deferred plan, the limit for annual additions is the lesser of $30,000 or 25% of compensation.

But remember, we also have deduction limitations for the employer, even though these do not present a qualification issue. However, very few employers like to put money in a plan when they cannot get an immediate deduction. The deduction limit for just one profit sharing or stock bonus plan is 15% of compensation. To get to $30,000 we would need an employee who has at least a $200,000 compensation.

A related question is whether a separate pension plan in addition to a cash or deferred plan will increase the $30,000 annual contribution limit per employee. If by pension plan we mean a money purchase pension plan the answer of course is no. If we are talking about a defined benefit pension plan, the applicable limitation is related to the definition of the benefit that is finally paid out. As we know, the aggregate limits on contributions to both defined benefit and defined contribution plans involve a defined contribution plan fraction and defined benefit plan fraction. If one puts in the full amount allowed for the defined contribution plan, he could contribute an amount sufficient to fund between 25% and 40% of the maximum allowed under law for the defined benefit plan considered on its own, unless some of the TEFRA "super top heavy" rules apply. So although it is possible to contribute beyond $30,000 for a participant when a defined benefit plan is added, the limitation rules ap-
A final question asks whether a plan loan will result in a distribution if it involves a balloon payment at the end of the five year period, the loan term most typical after TEFRA. In the old days, many plans used ten year loans because there were several private letter rulings that seemingly blessed ten year loans, and some people would expect to make a balloon payment at the end of ten years, much to our chagrin. I advise against such a practice. Often the loan will look too much like an advanced distribution of the account balance simply disguised as a loan not intended to be repaid, especially in light of an impending retirement or other separation from service. I like to suggest annual payments of principal and interest to make the loan as authentic as possible.

Now that TEFRA has limited the time period to five years, the potential for the occurrence of a distribution event during the term of the loan is diminished, so I am a bit more ambivalent now on this issue. Still I advise everyone to provide for annual payments of principal and interest or at least interest, but I know there are many attorneys who do otherwise. I really doubt whether the IRS is going to attack a loan if it is a five year loan that is paid off at the end of the five years and not rolled over immediately, or very soon afterward, into a new loan. Yet I don't know for sure and, as a practitioner, I still want annual payments of principal and interest or at least interest. If a client is adamant about using a balloon payment, I'll simply explain the risks but be prepared to fully defend the practice if needed. I think one can be too pigish in this area, and I preach caution whenever I can. Much benefit can be derived from qualified plans without trying to take 100% of everything. I think we should be alert to any future IRS guidance respecting this aspect of plan loans.