401(k) plans have become an increasingly popular individual savings vehicle, but they could be jeopardized by the president's tax reform proposal.

401(k) Cash or Deferred Arrangements
Cash or deferred arrangements have become an increasingly popular form of individual savings. Commonly called 401(k) plans after the Internal Revenue Code section that authorized them, participating employees can make pretax contributions to a 401(k) plan in lieu of salary. The contributions are placed in a trust fund and invested under the direction of the employee. Contributions and any investment gains accumulate tax free until distribution, at which time taxes are paid.

Although no nationwide data exist on the actual number of 401(k) plans in existence today, a survey sponsored by EBRI and the Department of Health and Human Services (HHS) indicates that about 4.8 million private-sector employees were offered a 401(k) plan in 1983. EBRI estimates that as many as 19 million employees are currently eligible to participate in 401(k) plans. Legislation recently introduced in the Congress to establish a new civil service retirement system would include a form of 401(k) plan for federal workers.

The ability to save on a pretax basis is one reason these plans are attractive to employees. Accessibility to funds through loan or withdrawal provisions when special needs arise and employer matching contributions also make these plans attractive. New survey data suggest that the existence of these features corresponds to higher participation rates than in plans without these characteristics, with an employer matching provision bearing the strongest relationship to participation.

President Reagan's tax reform initiative announced in May argues that the tax advantages available to individuals through employer-sponsored 401(k) plans substantially exceed those available to other individuals (through IRAs) and that the tax-favored treatment made available to employer-sponsored plans should be directed primarily at enhancing retirement security. The president's proposal would apply new restrictions to 401(k) plans, limiting contribution amounts to $8,000, introducing an IRA offset, revising already complex nondiscrimination rules and eliminating hardship withdrawals. The restrictions on 401(k) plans in the president's proposal may, however, work against retirement saving by jeopardizing the popularity of 401(k) plans and creating a disincentive for continued employee participation—particularly among lower income workers.
Introduction

A qualified cash or deferred arrangement (CODA) allows an employee to elect to have a portion of his compensation contributed to a profit sharing or stock bonus plan in lieu of salary. CODAs are commonly referred to as 401(k) plans because of the tax code section authorizing such plans. The employee contribution is treated most commonly as a pretax reduction in salary, which is then paid into the plan by the employer on behalf of the employee. In some cases, an employer may make a discretionary contribution to the plan on behalf of the employee. In both instances, the employee defers income tax on the 401(k) plan contribution until withdrawal. These plans provide a good vehicle for employee saving, and, at the same time, the employee is able to defer tax on a portion of the income until a future time.

Until now, the major concern of employers in establishing 401(k) plans may have been the lack of regulatory guidance. A more significant concern for plan formation is probably President Reagan’s tax reform proposal announced in May.

Various forms of deferred compensation have existed for years. As early as the mid-1950s, cash or deferred option profit sharing plans using pretax employee contributions were permitted by the Internal Revenue Service (IRS) as long as at least one-half of the participants electing to defer compensation were in the lowest paid two-thirds of all plan participants.

Until 1972, the IRS maintained that deferred compensation would not be considered constructively received, or made available to an employee, and thus not currently taxed. In 1972, the IRS issued a proposed regulation that reversed its prior position on tax deferral and effectively eliminated these plans. Because there were some CODAs in existence at that time, Congress, through the 1974 Employee Retirement Income Security Act (ERISA), allowed the tax treatment of CODAs in existence before June 28, 1974, to continue. New plan formation, however, was frozen until Congress could study the use of preferential tax treatment for deferred compensation.

The Revenue Act of 1978 sanctioned CODAs (effective January 1, 1980) by adding section 401(k) to the Internal Revenue Code (IRC). Preliminary regulations issued in November 1981 delineated new and more restrictive nondiscrimination and coverage requirements beyond ERISA’s minimum standards for qualified benefit plans.

Although final rules have not been released, the IRS announced in February 1982 that employers could rely on the proposed regulations as guidelines in qualifying their 401(k) plans. These regulations, however, left open the interpretation of plan distribution rules, and as a result, some employers have been reluctant to initiate a 401(k) plan without final regulations.

Final CODA regulations were expected in mid-1985, but a number of proposals to change 401(k) plans may be holding back a final ruling by the IRS. Until now, the major concern of employers in establishing 401(k) plans may have been the lack of regulatory guidance. A more significant concern today is probably President Reagan’s tax reform proposal announced in May. The plan would significantly change many current rules and features of 401(k) plans, such as limiting contribution amounts, revising nondiscrimination rules and eliminating hardship withdrawals.

One of the most significant applications of section 401(k) is the ability of plan sponsors to set up a qualified savings plan funded solely through a salary reduction agreement.

This Issue Brief discusses current law 401(k) contribution, distribution and nondiscrimination requirements and summarizes available data on plan design and experience (e.g., how many plans have a loan provision). It also examines the 401(k) provisions of the president’s tax plan and, to the extent possible, their expected effects.

Types of 401(k) Arrangements

There are four principal types of benefit plans to which section 401(k) is applicable: (1) thrift plans, (2) cash or deferred option profit sharing plans, (3) “stand alone” salary reduction plans, and (4) cafeteria plans.

Thrift Plans

A thrift, or savings, plan that utilizes section 401(k) closely resembles a conventional thrift plan: the employee makes a voluntary contribution—generally as a percentage of pay—to
the plan, which is often supplemented by a matching employer contribution. The funds are held in trust and invested until distribution.

In a conventional thrift plan, employee contributions are made with after-tax income. In a 401(k) thrift plan, however, an employee contributes a portion of his earnings through a pretax salary reduction. Federal and most state income taxes are computed on the employee’s earnings minus his 401(k) contribution. For purposes of plan qualification and tax status, the IRS considers a thrift plan to be the same as a profit sharing plan.

An employer who maintains both a 401(k) and a flexible benefit plan may allow any cash paid from the flexible benefit plan to be transferred to a 401(k) plan on a tax-sheltered basis.

Cash or Deferred Option Profit Sharing Plans

Profit sharing plans with a salary reduction feature are commonly called cash or deferred option profit sharing plans. Like a traditional profit sharing plan, the employer makes contributions—based generally on the employer’s current or accumulated profits—to the plan on behalf of the participants. The allocation to each individual usually is determined by calculating the proportion of each employee’s compensation relative to the total compensation of all participants. The resulting percentage is the proportion of the employer’s annual contribution allocated to the individual. The entire contribution may be credited to an employee’s account, or a portion of it may be paid out in cash. Amounts deferred by the employee are held in trust and invested and, subject to certain restrictions, are not taxed until distribution.

Similar to a traditional profit sharing plan, a cash or deferred option profit sharing plan usually does not require employee contributions. Many plans do, however, permit such contributions.

“Stand Alone” Salary Reduction Plans

One of the most significant applications of section 401(k) is the ability of plan sponsors to set up a qualified savings plan funded solely through a salary reduction agreement. This type of plan is sometimes referred to as a “stand alone” salary reduction plan, because it can be established exclusively with employee salary reductions. A “stand alone” plan allows an employee to defer a percentage of his pretax earnings each year, and the funds are held in trust until distribution. A conventional plan requires only employee contributions, but the most prevalent type of plan includes employer matching contributions.

Flexible Benefit Plans

The use of section 401(k) in a qualified flexible benefit plan (often referred to as a cafeteria plan) has been one of the most interesting applications of the cash or deferred arrangement concept. A flexible benefit plan, authorized under section 125 of the IRC, allows an employee to choose among a variety of benefit options (taxable and nontaxable). Typically, a flexible benefit plan includes benefits such as life insurance, medical/dental, disability, legal services, child care and cash. The employee is not taxed on the nontaxable benefits selected but is taxed on the value of any taxable benefits chosen.

An employer who maintains both a 401(k) and a flexible benefit plan may allow any cash paid from the flexible benefit plan to be transferred to a 401(k) plan on a tax-sheltered basis. In addition, through a salary reduction arrangement, flexible benefit plans may permit employees to purchase additional coverage with their own pretax dollars.

An EBRI survey indicates that about 4.8 million private-sector employees were offered 401(k) plans in 1983. EBRI estimates that approximately 19 million employees are currently eligible to participate in 401(k) plans.

Plan Coverage and Participation

Although no nationwide data exist on the actual number of 401(k) plans in existence today, a survey sponsored by EBRI and the Department of Health and Human Services (HHS) under contract with the Bureau of the Census indicates that about 4.8 million private-sector employees were offered 401(k) plans in 1983. This represented less than 7 percent of private-sector employees, but the number of firms offering 401(k) plans appears to be growing. EBRI estimates that approximately 19 million employees are currently eligible to participate in 401(k) plans. A 1985 survey sponsored by the Employers Council on Flexible Compensation (ECFC) suggests that 401(k) plans may now cover 28 percent of the private-sector work force.2

Table 1
IRA Usage (1982) and 401(k) Usage (May 1983)
Private Nonfarm Wage and Salary Workers by Earnings and Age

<table>
<thead>
<tr>
<th>Number Offered Plan (000's)</th>
<th>Percent Participation (%)</th>
<th>Number of Workers (000's)</th>
<th>Percent Participation (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Private Sector</td>
<td>4,822</td>
<td>72,465</td>
<td>16.5%</td>
</tr>
<tr>
<td>Age</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less than 25</td>
<td>555</td>
<td>16,415</td>
<td>2.3%</td>
</tr>
<tr>
<td>25 to 34 years</td>
<td>1,627</td>
<td>21,553</td>
<td>11.0</td>
</tr>
<tr>
<td>35 to 44 years</td>
<td>1,364</td>
<td>14,681</td>
<td>18.5</td>
</tr>
<tr>
<td>45 to 54 years</td>
<td>795</td>
<td>10,627</td>
<td>30.3</td>
</tr>
<tr>
<td>55 to 59 years</td>
<td>302</td>
<td>4,723</td>
<td>39.9</td>
</tr>
<tr>
<td>60 to 64 years</td>
<td>139</td>
<td>2,835</td>
<td>37.1</td>
</tr>
<tr>
<td>65 years and over</td>
<td>a</td>
<td>1,630</td>
<td>20.3</td>
</tr>
<tr>
<td>Earnings</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$1–4,999</td>
<td>111</td>
<td>8,551</td>
<td>6.3%</td>
</tr>
<tr>
<td>$5,000–9,999</td>
<td>379</td>
<td>13,305</td>
<td>7.3</td>
</tr>
<tr>
<td>$10,000–14,999</td>
<td>791</td>
<td>14,459</td>
<td>10.7</td>
</tr>
<tr>
<td>$15,000–19,999</td>
<td>934</td>
<td>10,196</td>
<td>16.8</td>
</tr>
<tr>
<td>$20,000–24,999</td>
<td>769</td>
<td>7,842</td>
<td>19.3</td>
</tr>
<tr>
<td>$25,000–29,999</td>
<td>574</td>
<td>4,292</td>
<td>27.8</td>
</tr>
<tr>
<td>$30,000–49,999</td>
<td>832</td>
<td>5,336</td>
<td>38.2</td>
</tr>
<tr>
<td>$50,000 and over</td>
<td>273</td>
<td>1,412</td>
<td>58.9</td>
</tr>
</tbody>
</table>


a Number of workers too small for rates to be calculated reliably.

Participation rates in 401(k) plans are high. Two recent surveys, one by Hewitt Associates and another by Towers, Perrin, Forster & Crosby, report that 60 and 63 percent, respectively, of eligible employees were participating in the plans at the end of 1984. This represents significant improvement over time, when compared to data from 1983.

In the May 1983 EBRI/HHS survey, 39 percent of eligible workers reported that they participated in a 401(k) plan, compared to an overall participation rate of 16.5 percent for individual retirement accounts (IRAs) (table 1). For every age and earnings group 401(k) participation rates were higher than participation rates for IRAs in the survey. Among workers age 35 to 44 offered 401(k) plans, 43 percent made contributions to them. This rate is higher than the IRA participation rate in the survey for any age group including workers relatively close to retirement. Participation rates for 401(k) plans were more than 68 percent for workers age 60 to 64.

Participation rates for workers earning $10,000 to $25,000 annually are more than double IRA participation rates. A greater proportion of IRA participants earn less than $25,000, in part because of the higher earnings of workers in firms offering 401(k) plans. If 401(k) plans grew to include a broader cross section of employers, 401(k) contributions would likely be made by workers throughout the earnings distribution.

**Contributions**

Generally, a 401(k) plan participant can direct his contribution to a menu of investment choices that may include as
many as four or five options. When 401(k) plans were first introduced, they consisted of one, possibly two, investment options. Company stock was apparently the most prevalent, and the second option was generally a conservative investment vehicle, such as a guaranteed investment contract (GIC). Plans now appear to be broadening their investment offerings. In a recent Hewitt Associates survey, 82 percent of the plans surveyed offered equity funds, which have potential for growth but also a greater element of risk than GICs. Other investment options often include bond funds, money market funds, short-term securities, government securities, balanced funds, company stock and real estate. The availability of different funds allow the participant the option of directing investments toward individual retirement planning goals.

Contributions to a qualified 401(k) plan must satisfy two rules which limit individual participant contributions and employer deductible amounts. These are the same limits that apply to other qualified retirement plans.

The first, on individual amounts, limits the participant's pretax contribution, any employer contribution and a portion of the participant's aftertax contribution to $30,000 or 25 percent of compensation, whichever is less. These limits are set for all retirement and capital accumulation plans in section 415 of the IRC.

The second rule limits the total 401(k) plan contribution that the employer may claim as a deductible business expense. Aggregate employer contributions to a qualified plan may not exceed 15 percent of eligible employee compensation. Contributions above this maximum and any unused deduction from years when the employer did not contribute the maximum can be carried forward. Total deductible employer contributions in years where there is a "carryforward" are then 25 percent of total pay. If the employer maintains other defined contribution plans, the contribution for all plans may not exceed 25 percent of total participant compensation. Special limits apply for employers who maintain both a defined contribution and a defined benefit plan. In general, contributions to participants covered by both types of plans may not exceed 125 percent of the specific dollar limit placed on the plan.²

### Employee 401(k) contributions are not taxed at the federal level until distribution. The deferral of taxation applies also to most states and municipalities.

Contributions to a 401(k) plan can be of three types:

- Elective contributions—pretax contributions (made by the employer on behalf of the employee) generally in the form of a salary reduction.
- Nonelective, or matching, contributions—contributions made by the employer from employer funds. These are sometimes referred to as matching contributions, although the employer does not always provide a 100 percent "match."
- Voluntary contributions—aftertax employee contributions in addition to those made on a pretax basis.

Employer contributions are a prevalent feature of 401(k) plans. More than 80 percent of plans in each of three recent surveys offer a company match.³ Often the match is tied to the employee's deferral amount. An employer, for example, will match $.50 for every $1.00 contributed by the employee—usually limited to a maximum amount. Sometimes the match is based on multiple factors, such as an employee's salary and length of service. The Hewitt survey found that the presence of an employer matching contribution is the most significant factor in gaining the participation of low and middle income workers.

Employee contributions are not taxed at the federal level until distribution. The deferral of taxation also applies to most states and municipalities.⁶ Voluntary employee contributions made as aftertax dollars are limited to 10 percent of total salary. Any earnings generated by 401(k) contributions (elective, matching and voluntary) are not taxed until withdrawal.⁵

### EBRI found that the lower earning two-thirds of participants contributed an average of 4.9 percent of compensation. The upper earning one-third of participants contributed an average of 6.5 percent.


Until the end of 1983, employer matching contributions and elective employee contributions to a 401(k) plan were not considered wages for the purposes of Social Security (FICA) and unemployment (FUTA) taxes. The employee, therefore, was not currently taxed for FICA or FUTA on the contribution amount, and the employer incurred lower payroll taxes. The 1983 Social Security Amendments, however, imposed FICA and FUTA taxes on the employee's pretax 401(k) contribution, generally effective beginning January 1, 1984, for FICA taxes and January 1, 1985, for FUTA taxes. The exact date depends on when the plan went into effect.7

The 1983 Social Security Amendments, however, imposed nonfarm workers contributed up to $1,199 of wages for the purposes of Social Security (FICA) and unemployment (FUTA) taxes. The employee, therefor, was not currently taxed for FICA or FUTA on the contribution amount, and the employer incurred lower payroll taxes. The 1983 Social Security Amendments, however, imposed FICA and FUTA taxes on the employee's pretax 401(k) contribution, generally effective beginning January 1, 1984, for FICA taxes and January 1, 1985, for FUTA taxes. The exact date depends on when the plan went into effect.7

Permissible distributions from a 401(k) plan may vary from plan to plan, depending on how plan administrators define the term "hardship."  

The amount employees contribute to their 401(k) plans varies. As a percentage of salary, lower paid employees generally defer less than higher paid. Surveys by Hewitt and Massachusetts Mutual Life Insurance Company report the average percentage deferred by the lower paid two-thirds of plan participants to be 3.4 and 4.0 percent, respectively, versus 5.4 and 5.8 percent, respectively, by the higher paid one-third of plan participants.8

The May 1983 EBRI/HHS survey provides the only nationwide data on actual dollar amounts employees contribute to a 401(k) plan. In 1983 nearly 43 percent of private-sector nonfarm workers contributed up to $1,199. Of course, these figures translated into a percentage of salary would vary depending on an individual’s annual salary. EBRI found that the lower earning two-thirds of participants contributed an average of 4.9 percent of compensation. The upper earning one-third of participants surveyed contributed an average of 6.5 percent.

Table 2 supplies data on contribution amounts to 401(k) plans among workers with various earnings levels. Seventy-two percent reported total contributions of less than $2,000. Contribution amounts, as would be expected, increased with age.

Distributions

Distributions from 401(k) plans, like other defined contribution plans, may be made as in-service or out-of-service withdrawals. Distributions when the 401(k) participant is not working for the employer may be made upon the participant's retirement, death, disability or termination of employment. In-service 401(k) payments may be made upon the participant's attainment of age 59 1/2, upon the plan's termination or because of financial "hardship."

Table 2

<table>
<thead>
<tr>
<th>Earnings</th>
<th>Totala</th>
<th>Less Than $700</th>
<th>$700–1,199</th>
<th>$1,200–1,999</th>
<th>$2,000+</th>
<th>Not Reported</th>
</tr>
</thead>
<tbody>
<tr>
<td>Totalb</td>
<td>1,886,819</td>
<td>558,405</td>
<td>250,329</td>
<td>550,822</td>
<td>365,306</td>
<td>161,958</td>
</tr>
<tr>
<td>(percent)</td>
<td>100.0%</td>
<td>29.6%</td>
<td>13.3%</td>
<td>29.2%</td>
<td>19.4%</td>
<td>8.6%</td>
</tr>
<tr>
<td>Less than $10,000</td>
<td>87,169</td>
<td>c</td>
<td>c</td>
<td>c</td>
<td>c</td>
<td></td>
</tr>
<tr>
<td>(percent)</td>
<td>100.0</td>
<td>c</td>
<td>c</td>
<td>c</td>
<td>c</td>
<td></td>
</tr>
<tr>
<td>$10,000–19,999</td>
<td>547,580</td>
<td>235,331</td>
<td>76,058</td>
<td>140,987</td>
<td>c</td>
<td>c</td>
</tr>
<tr>
<td>(percent)</td>
<td>100.0</td>
<td>43.0</td>
<td>13.9</td>
<td>25.7</td>
<td>c</td>
<td>c</td>
</tr>
<tr>
<td>$20,000–29,999</td>
<td>568,324</td>
<td>155,358</td>
<td>121,764</td>
<td>174,063</td>
<td>c</td>
<td>c</td>
</tr>
<tr>
<td>(percent)</td>
<td>100.0</td>
<td>27.3</td>
<td>21.4</td>
<td>30.6</td>
<td>c</td>
<td>c</td>
</tr>
<tr>
<td>$30,000+</td>
<td>608,425</td>
<td>79,798</td>
<td>c</td>
<td>200,979</td>
<td>211,250</td>
<td>c</td>
</tr>
<tr>
<td>(percent)</td>
<td>100.0</td>
<td>13.1</td>
<td>c</td>
<td>33.0</td>
<td>34.7</td>
<td>c</td>
</tr>
</tbody>
</table>


a Details may not add to totals due to rounding.
b Total includes 4.0 percent who did not report earnings.
c Numbers too small to be calculated reliably.

7 Internal Revenue Code sec. 3121(v) as added by P.L. 98-21. 8 Hewitt Associates, p. 8; Massachusetts Mutual, p. 9.
Hardship Withdrawals

The IRS proposed regulations permit in-service access to 401(k) funds (other than through a loan) when a participant has an “immediate and heavy financial need.” A hardship distribution, the IRS states, “cannot exceed the amount required to meet the immediate financial need created by the hardship and not reasonably available from other resources of the employee.”

A case study of hardship approved during 1984 and 1985 indicates that 88 percent of approved applications were for the purchase of a primary residence.

The proposed regulations offer no additional explanation of the hardship rules, however. The IRS, for example, sketchily defines the term “heavy,” and the term “other resources” is not defined. This leaves uncertainty as to whether “other resources” refers to assets owned by the employee (e.g., bank accounts or automobiles) or to funds the employee could borrow. Because hardship is defined subjectively, the term is open to the plan administrator’s interpretation. Permissible distributions from a 401(k) plan may, therefore, vary from plan to plan, depending on how plan administrators define the term “hardship.”

The effect of IRS’ undefined hardship rule is not entirely clear. Based on survey data available, a few employers have delayed implementing plans until final, more definitive hardship rules are released. 9 Most employers have structured their hardship provisions based on IRS revenue rulings, which have suggested that hardship withdrawals would be permitted for the purchase of a primary residence, for college tuition and for major medical expenses.

It appears that many employers included provisions for hardship withdrawals. Both Massachusetts Mutual and Hewitt found that nearly 90 percent of plans surveyed allowed hardship distributions. Hewitt data show that nearly one-half (46 percent) of plans surveyed use three specified criteria—purchase of a primary residence, education and death/sickness in family—to satisfy the definition of hardship. Thirty-four percent of the plans allow these three criteria and also include “other” extreme hardships (e.g., catastrophic expenses).

A case study of hardships approved during 1984 and 1985 (through April) by a major corporation indicates that of 38,000 participants, 346 requested hardship withdrawals and 279 were approved. Only a small proportion (.7 percent) of participants in this case study actually received a hardship distribution. Of those approved, 88 percent were for the purchase of a primary residence. The remaining 11 percent were for college tuition (4 percent) and other (7 percent). Expenses in the “other” category must create an immediate and heavy financial need, be generally unanticipated and cause a substantial loss or damage to the employee’s or the family’s life or property. The company requires substantial documentation for every hardship request. The applicant must complete a general hardship application—to which must be attached special verification documentation, such as a signed contract for a home or a tuition bill—and a statement of financial resources.

Employees seem to be concerned about hardship withdrawals. Sixty-six percent of respondents in the Massachusetts Mutual survey reported that the limited access to funds is perceived as the biggest drawback to 401(k) plans.

Only a small proportion (.7 percent) of participants in this case study actually received a hardship distribution.

Taxation

A distribution from a 401(k) plan may be in the form of a lump sum or an annuity. The form of the distribution determines the tax treatment of the funds.

A hardship withdrawal and a distribution in the form of an annuity are taxed as ordinary income. If the distribution is in the form of a lump sum, it may qualify for 10-year forward income averaging or it may be rolled over into an IRA or other qualified plan, as long as it meets certain requirements.

10-Year Income Averaging—This tax computation method allows an employee to separate the distribution into tenths, compute the income tax on one-tenth and multiply the result by 10. In effect, the employee is allowed to pay the tax on a distribution as if he had received it over 10 years. Because of the United States’ progressive income tax system and the fact that this tax is computed separately and at a different rate from the taxpayer’s other income, the 10-year forward income averaging rule can result in substantial tax savings.

The following requirements must be met for a 401(k) distribution to qualify for 10-year averaging:

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• The employee has been a participant in the plan for at least five years prior to the year of distribution.

• The distribution is from a qualified plan.

• The distribution comes from all the employer’s profit sharing plans in which the employee had funds and constitutes the full amount credited to the employee.

• The distribution is paid in a single tax year.

• The distribution is paid at attainment of age 59 1/2, termination of employment, disability or death. (A hardship distribution does not qualify.)

Rollovers—In general, distributions from a 401(k) plan may be rolled over to another qualified plan or to an IRA if the transaction takes place within 60 days of the participant’s receipt of the distribution. The entire distribution or any portion may be rolled over. No tax is paid on the portion rolled over until withdrawal. Once a distribution is rolled over to, and subsequently paid out of, an IRA, however, it cannot qualify for 10-year averaging.

◆ Loans

The ability to borrow from an employer’s 401(k) plan or any other qualified employer plan is dependent on the plan’s provision for a loan and subject to stringent guidelines set forth in the Code and in IRS regulations. A loan from a 401(k) plan is not taxable, if it does not exceed the lesser of (1) $50,000 or (2) $10,000 or one-half of the employee’s accrued benefit under the plan, whichever is greater. It must be repaid within five years, or within a reasonable time, if the loan is used to acquire or improve the principal residence of the participant or of a member of the participant’s family.

◆ Nondiscrimination Rules

Congress has historically been concerned that lower-paid employees have access to benefits and contributions from a qualified employee benefit plan equivalent to those received by higher-paid employees. As such, it has required that qualified plans structure their benefit and contribution levels to achieve this goal. In addition, Congress requires that plans’ lower-paid employees actually use the savings opportunities made available to them. The nondiscrimination rules governing 401(k) plans were designed to be especially stringent because Congress felt that cash or deferred arrangements would be inherently more attractive to higher-paid than to lower-paid employees.

401(k) plans must meet the nondiscrimination rules applicable to other qualified retirement plans. These rules are designed to prevent the plans from discriminating in favor of employees who are officers, shareholders, or highly compensated. A plan may not discriminate in terms of eligibility, benefits provided or contributions made.\(^{10}\)

Prior to the Deficit Reduction Act of 1984 (DEFRA), 401(k) plans were allowed to meet either the general nondiscrimination rules governing contributions or more specific, special 401(k) nondiscrimination rules. DEFRA now requires that all 401(k) plans meet the special 401(k) nondiscrimination test as described in the proposed regulations.\(^{11}\)

In general, the special test compares the amounts that the most highly compensated (highest paid one-third of eligible employees) elect to defer—as a percentage of compensation—with the amounts that the remaining eligible employees (the lower paid two-thirds) defer.

Hewitt Associates found that 36 percent of plans surveyed have loan provisions.

Hewitt Associates found that 36 percent of plans surveyed have loan provisions. Massachusetts Mutual reported similar findings, at 38 percent. Massachusetts Mutual, in addition, examined the incidence of loan provisions as related to number of plan participants. In plans having 250 participants or fewer, a higher percentage (59 percent) had loan provisions than those in plans with 1,000 or more participants (40.9 percent). On the other hand, in plans with between 251 and 1,000 participants, 35 percent had loan provisions.

\(^{10}\) Internal Revenue Code sec. 410(b) describes the nondiscrimination in eligibility tests. Internal Revenue Code sec. 401(a)(4) describes the nondiscrimination in contributions test.

\(^{11}\) For a good explanation of the general and special rules governing 401(k) plans, see Hewitt Associates, Nondiscrimination Standards Affecting 401(k) Plans, 1985.
The test works this way: The eligible group of employees (for the plan year) is divided into the highest paid one-third and the lowest paid two-thirds. Then, within each group, the percentage deferred by each employee (including zeros for eligible but nonparticipating employees) is averaged to get an “actual deferral percentage” (ADP) for each group. The ADP for the highest-paid group is then compared with the ADP for the lowest-paid group.

The ADP test may be satisfied in one of two ways:

Test 1: The 1.5 test—The ADP for the eligible highly compensated (top 1/3) may not be more than the ADP of the other eligible employees (lower 2/3) multiplied by 1.5.

Test 2: The 3 percent or 2.5 test—The excess of the ADP for the top 1/3 over the lower 2/3 may not be more than 3 percentage points, and the ADP for the top 1/3 may not be more than the ADP of the lower 2/3 multiplied by 2.5.

The permissible contribution differential between the two groups, then, may be as follows: the percentage of pay contributed by the higher-paid group can be 150 percent of the average percentage contributed by the lower-paid group, or it may be 250 percent if the actual difference is no more than 3 percentage points.

For example, if the actual deferral percentage for the lower-paid group is 4 percent and the actual deferral percentage for the higher-paid group is 7 percent, are the nondiscrimination rules satisfied?

Test 1: Because 7 percent (the ADP of the higher paid) is greater than 6 percent (4 percent x 1.5), test 1 is not satisfied.

Test 2: Because 7 percent (the ADP of the higher paid) is not more 3 percentage points more than 4 percent (the ADP of the lower paid) and 7 percent is not more than 10 percent (the ADP of the lower paid multiplied by 2.5), test 2 is satisfied.

Because one of the tests has been satisfied, the special nondiscrimination rules are satisfied. If neither of these rules had been met, adjustments to the contribution percentage of the higher group would have to be made. These are typically made as an across-the-board reduction in the percentage contributed by the higher-paid group.

The employer is not required to include employer matching contributions in applying the nondiscrimination test. The IRS does, however, permit the employer to include such contributions in satisfying the test. Such amounts must be 100 percent vested and subject to 401(k) withdrawal restrictions.

◆ Vesting

Under a qualified 401(k) plan, an employee's right to his accrued benefit (i.e., any elective contribution and any employer contribution used to satisfy the ADP test) is not forfeitable. The amount must be immediately and 100 percent vested in the employee. Employer matching contributions (unless they are used to satisfy the ADP test) and voluntary employee contributions do not need to be immediately and 100 percent vested. They must, however, vest in accordance with ERISA requirements.

◆ Plan Design Characteristics and Plan Experience

The relationship between plan design characteristics and plan experience (participation levels and average deferral percentages) is largely unknown. Hewitt Associates' 1985 survey, however, compared various design characteristics (including matching contributions, loans, withdrawals and maximum salary reduction) with levels of participation and percentage of salary deferred.

When companies provided a dollar-for-dollar match, participation rates jumped to 64 percent as compared to a 41 percent participation rate when plans had no employer matching contribution.

Employer matching contributions, loan provisions and withdrawal provisions all seemed to correspond with higher rates of participation among both the lower paid two-thirds and the higher paid one-third of eligible employees. The spread, however, was not large except in the case of company matches, where participation rates jumped to 64 percent (lower paid two-thirds) when companies provided a dollar-for-dollar match, as compared to a 41 percent participation rate when plans had no employer matching contributions.

The maximum salary reduction allowed by a plan did not appear to significantly affect participation levels.

Average deferral percentages increased with a plan's provision for a loan, withdrawal, or employer matching contribution, but generally not much more than 1 percentage point. Plans with higher matched salary reduction levels and higher total maximum salary reduction levels were the exception, experiencing substantially higher deferral rates. When plans matched 7 to 10 percent of salary, for example, the lower paid two-thirds of participating employees contributed 8.4
percent of salary as compared to 6.0 percent when 2 to 3 percent of salary was matched.

Employer matching contributions appear to encourage both employee participation in a 401(k) plan and to a lesser extent a higher contribution percentage, resulting in a broader participation among the employer’s work force and a greater level of employee saving.

◆ Plan Operation

The establishment and operation of a qualified 401(k) plan can be a complex procedure and may be a drawback for some employers. Under the proposed regulations, a 401(k) plan must maintain separate accounting between the portion of the employee’s accrued benefit that is subject to the special vesting and withdrawal rules and any other (after-tax) benefits. Although the proposed regulations do not require a specific accounting method to be used, they state that the accounting must allocate investment gains and losses on a reasonable pro rata basis and adjust account balances for withdrawals and contributions.

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Offsetting an employee’s IRA contribution against 401(k) contributions could be difficult for employers to administer and for tax authorities to enforce.

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In each participant’s account, depending on the structure of the plan, there may need to be a separate record for deductible contributions (employee elective and employer matching), nondeductible “voluntary” employee contributions and vested and nonvested company contributions. Special rules exist for contributions made before 1980. In addition, although elective and nonelective contributions are not subject to federal and most state taxes, elective contributions are subject to Social Security and federal unemployment taxes.

◆ Tax Reform and 401(k) Plans

Arguing that cash or deferred arrangements act to circumvent the contribution limitations on IRAs, the Treasury Department’s November 1984 tax reform proposal recommended that CODAs be eliminated. President Reagan’s May 1985 tax reform plan proposed instead that the plans be allowed to continue, but that they be capped below levels available in other qualified retirement plans, that IRA contributions be offset against the contribution limit on section 401(k) plans and that stricter nondiscrimination requirements be made applicable to these plans. In addition, 401(k)s would be available only to taxable employers, 10-year forward income averaging would no longer be available for lump-sum distributions (from any qualified retirement plan) and hardship distributions would be disallowed.

Cap on Employee Contributions

Under the Reagan plan, an employee’s elective (pretax) contribution to a cash or deferred arrangement would be limited to $8,000 per year. The $8,000 would be reduced by any deductible IRA contribution for that year. Although the proposal does not specify how spousal IRAs are to be treated, Treasury Department officials have conceded that only the worker’s IRA contribution would count against the 401(k) limit. Employer (and after-tax employee) contributions will not be applied against the $8,000 limit. The proposal does not say whether the $8,000 cap would be indexed against inflation. Elective contributions would be applied, as under current law, to section 415 annual contribution and benefit limits.

Offsetting an employee’s IRA contribution against 401(k) contributions over $6,000 could be difficult for employers to administer and for tax authorities to enforce. Elections to section 401(k) plans are made at specified times during the plan year, while employee contributions to IRAs for a given year can be made at any time over a period of 15 1/2 months. Tax authorities could correlate IRA contributions and section 401(k) contributions using a process similar to the Form 1099 reporting process for interest and dividends. This would fail to impose a prior restraint on those who would attempt to have both accounts and would instead have to rely on penalties and/or recapture of improperly contributed funds after the fact.

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The revenue impact of the IRA offset would be negligible. Based on the results of the EBRI/HHS survey, fewer than 700,000 persons—less than 40 percent of section 401(k) participants—both had an IRA and participated in a section 401(k) plan in 1983.

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Alternatively, a likely policy method would be to show the amount of the employee’s 401(k) contribution on his W-2 schedule, a copy of which would be required before an employee could open an IRA. Treasury has suggested that 401(k) deferral amounts could be included on a worker’s W-2 form, and the worker would deduct 401(k) contributions on his individual income tax, the same way a worker treats IRA contributions. This would place the burden on the employee.
The revenue impact of the IRA offset would be negligible. Based on the results of the EBRI/HHS survey, fewer than 700,000 persons—less than 40 percent of section 401(k) participants—both had an IRA and participated in a section 401(k) plan in 1983 (table 3). The average estimated 401(k) employee contribution among these persons was $1,720. Even among 401(k) participants earning more than $50,000, the average contribution was $2,261. EBRI has estimated that approximately 50,000 persons who currently participate in a 401(k) plan would be affected by the offset.

Nondiscrimination Test
The president's plan claims that current law permits excessive disparity between contributions of the highly compensated employees in a 401(k) plan and other employees. As such, the nondiscrimination test for CODAs would be modified in a number of ways. The proposal would change the current law employee groups used in applying the test, and, furthermore, would tighten the permitted contribution differential between the two groups. The proposal would replace the current concept of the highly compensated, or highest paid one-third, with the concept of "prohibited group." The president's proposal defines a prohibited group member as any employee who, at any time during the three-year period ending with the year in question, was (1) a one-percent (or more) owner of the employer; (2) receiving $50,000 or more in annual compensation; (3) among the highest-paid 10 percent or the three highest-paid employees, but only if he made at least $20,000; or (4) a family member of a prohibited group member. The $20,000 and $50,000 limits would be indexed for inflation.

The new nondiscrimination test would compare the percentage deferred by each prohibited group member, individually, with the average percentage deferred by the nonprohibited group participants. Currently, the average percentage of pay that each group of employees in aggregate contributes is compared. The latter method allows individual employees in the higher paid one-third to defer more if other employees in the group elect to defer little or nothing.

The proposed test would be satisfied only if no prohibited group member had a deferral ratio in excess of the greater of the following two amounts: (1) 125 percent of the ADP for the nonprohibited group eligible employees, or (2) the lesser of 200 percent of the ADP for the other eligible employees or the ADP for the other eligible employees plus 2 percentage points. In calculating the deferral ratio for a prohibited group member, only the first $200,000 of compensation would be considered.

If the deferral ratio for any prohibited group member exceeds the applicable limit for such year, the excess elective contributions would be treated as nondeductible employer contributions subject to a 10 percent tax. The excess elective contributions (and any earnings attributable to them) would have to be distributed to the employee, or the plan would become disqualified.

The proposal would replace the current concept of the highly compensated, or highest paid one-third, with the concept of "prohibited group."

One effect of the proposed new nondiscrimination rules would be that 401(k) plans will have to reduce allowed deferral amounts by the higher paid participants to comply with the tighter average deferral ratio.

A less obvious effect of the president's proposal on 401(k) plans is the application to acquisitions and mergers. As currently written, the proposal would effectively require the same level of benefits and essentially the same set of nondiscrimination standards to be applied to an acquired company and its parent firm. The effect would be highly visible in

| Table 3 |
|------------------|------------------|------------------|
| **Annual Earnings** | **Number of people with both** | **Average 401(k) Contribution** | **Average IRA Contribution** |
|------------------|------------------|------------------|
| Less than $20,000 | 161,689 | $1,227 | $1,320 |
| $20,000—24,999 | 89,780 | 652 | 1,530 |
| $25,000—29,999 | 91,775 | 1,537 | 1,775 |
| $30,000—49,999 | 204,946 | 2,363 | 1,732 |
| $50,000 and over | 111,663 | 2,261 | 2,017 |
| All groups | 659,853 | $1,720 | $1,657 |


* Table includes only private-sector employees. Public-sector employees with plans similar to section 401(k) plans were not tabulated in the survey.
pension, health and welfare plans, where two firms may have very different benefit levels and covered employee groups. But the proposal might also affect 401(k) plan formation. Companies owned by a holding company might have to install 401(k) plans if the parent company offered the plan, unless the parent company terminated its own 401(k) plan. In addition, eligibility requirements would have to be made uniform among acquired companies and parent firms.

**Employer Matching Contributions**

Special nondiscrimination rules would be applied to employer matching contributions in 401(k) and other qualified plans in lieu of the general rules that employer contributions currently must meet. The president's proposal would establish two separate tests. The first test would apply to employer matching contributions that (1) are fully and immediately vested; (2) may not be distributed from the plan prior to the employee's death, disability, separation from service, attainment of age 59½ or plan termination; and (3) do not exceed 100 percent of the employees' mandatory contributions. If these conditions were met and if the employer matching contributions were tied to elective contributions, both amounts would be combined in applying the nondiscrimination test. This aggregation is currently allowed: under the proposed plan, it would be required.

If employer matching contributions did not fall into the three categories above, a second test would be applied. Employer matching contributions would be treated as elective deferrals, but the deferral ratio for each prohibited group member would be limited to the greater of (1) 110 percent of the ADP for the nonprohibited group members, or (2) 150 percent of the ADP for the nonprohibited group members or the ADP for the nonprohibited group members plus 1 percentage point, whichever is less. Excess employer matching contributions would be treated in the same fashion as excess elective contributions to a CODA.

Table 4 illustrates the current law nondiscrimination limits for and proposed modifications to 401(k) contribution amounts. The percentage limits refer to the employee's compensation. Note that the current law 401(k) limits apply to the average of the elective deferrals by the highly compensated employees, whereas the proposed limits apply to each prohibited group member's deferral ratio.

**Employee Eligibility**

Under the proposed Reagan plan, a special eligibility test would be applied to CODAs. The ratio of prohibited group members eligible to make contributions to the total prohibited group members could not exceed 125 percent of the analogous ratio for nonprohibited group employees. An em-

An employer could not require more than one year of service as a condition of eligibility for a CODA.

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<th>Base ADP for Non-prohibited Group</th>
<th>Current Maximum ADP for High-Paid Group</th>
<th>Proposed Maximum Deferral Ratio for Each Prohibited Group Member</th>
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Source: Office of the Secretary of the Treasury, "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, May 28, 1985."
employer matching contributions) to employees' elective contributions. Employees with less than one year of service, employees who have not attained age 21, employees covered by a collective bargaining agreement and nonresident aliens with no U.S. earned income could be excluded from eligibility.

**Distributions**

President Reagan's tax reform proposal claims that the ability of individuals to gain access to tax-favored funds (including 401(k) money) before retirement encourages individuals to use the funds as "short-term savings accounts rather than as retirement savings vehicles."

To encourage the use of 401(k) funds for retirement, the president's plan would no longer allow distributions from a 401(k) plan because of hardship. In-service withdrawals would be permitted if the participant attains age 59 1/2 or if the plan terminates. Withdrawals due to separation from service, retirement, death or disability would still be permitted, but the use of 10-year forward income averaging and capital gains treatment for lump-sum distributions would be prohibited.

Because tighter withdrawal rules will curb employee accessibility to 401(k) funds, loans may become more important to the employee.

This provision would be phased in over a six-year period for individuals age 55 or older on January 1, 1987. Withdrawals prior to age 59 1/2 (except because of death or disability) would be subject to a 20 percent excise tax. The tax would be 10 percent if the distribution is used to purchase a home, pay for college or support someone who is unemployed and has exhausted his unemployment benefits. If the payout is made as a life annuity (for at least 15 years) and the individual is at least age 50 when the payments begin, there would be no excise tax.

The Reagan plan also changes the current minimum distribution rules for the timing of payouts, making them uniform for all tax-favored retirement savings programs. A plan would be required to commence distributions before April 1 following the year in which the participant attains age 70 1/2, or if later and the individual is not a 5 percent owner, the year in which the individual retires. Upon failure to satisfy the rules, a participant would be liable for a 50 percent excise tax on the amount by which the minimum payment required exceeds the actual distribution.

**Deduction Limit Changes**

The deduction limit changes for profit sharing plans in the president's plan apply to 401(k) plans as well. The current employer deductible limit of 15 percent of total employee pay would be changed to a 15 percent limit for each individual employee. Excess contributions could be carried forward to be deducted in future years, but they would be included in the 15 percent limit in those future years. A 10 percent tax would be applied to contributions in excess of the deduction limit for the year of the contribution and for each year that the excess funds remain in the plan and are not deductible.

**Loans**

The current rule on tax-exempt loans from 401(k) plans would be modified so that the $50,000 limit is reduced by the highest outstanding loan balance owed by the employee to the plan during the prior 12 months. A participant would not, therefore, be able to maintain a permanent $50,000 outstanding loan balance. A repayment period greater than the current five-year standard would be permitted only if it is used for the first-time purchase of a participant's principal residence.

Section 457 plans have none of the employee protections under ERISA. The employer promises to pay accumulated benefits, but legally the assets belong to the employer rather than to an employee benefit trust (as in a 401(k) plan). Participants hold only an unsecured promise that the employer will pay deferred contributions and investment earnings.

The proposed loan rule is designed to ensure repayment of a loan. This will probably not diminish the use of loans from 401(k) plans. In fact, because tighter withdrawal rules will curb employee accessibility to 401(k) funds, loans may become more important to the employee. As a result, employees may exert pressure on the employer to establish a loan provision if not already included in the plan.

**Eligible Employers**

The president's proposal reasons that because tax-exempt and public-sector employers have their own tax-favored elective retirement plans in the form of tax-sheltered annuities and section 457 deferred compensation plans, the extension of 401(k) plans to these entities would be duplicative. Under the president's proposal, only private, taxable employers would be permitted to have a 401(k) plan. Tax-exempt and
Section 457 plans have none of the employee protections under ERISA. Under such plans, the employer promises to pay accumulated benefits, but legally the assets belong to the employer rather than to an employee benefit trust (as in a 401(k) plan). Contributions are part of the employer's general assets and are subject to the claims of all creditors. Participants hold only an unsecured promise that the employer will pay deferred contributions and investment earnings. In addition, section 457 plans are not required to meet special 401(k) nondiscrimination eligibility rules or rules limiting contributions, both of which are designed to prevent discrimination in favor of higher-paid employees.

**The 401(k) Role in Tax Reform**

While increasing saving is not a necessary part of tax reform, the administration's tax reform proposal and several major congressional tax reform proposals contain initiatives aimed at increasing savings. Restrictions on section 401(k) plans would work against these provisions by reducing savings incentives.

While increasing saving is not a necessary part of tax reform, the administration's tax reform proposal and several of the major congressional proposals contain initiatives aimed at increasing savings. Restrictions on section 401(k) plans would work against these provisions by reducing savings incentives.

Section 401(k) plans are the only contributory retirement plan vehicle that is broadly used that allows workers a tax deferral on their contributions. Restrictions on contributions to and withdrawals from these plans would reduce their attractiveness as a means for individual savings. Lower- and moderate-income persons could have less incentive to participate in these plans because their contributions would become less liquid. Higher-income persons, in turn, could have less incentive to participate since the limits on contributions would reduce the plan's value as a savings and retirement vehicle. For all income groups, more of the relative burden of retirement savings would be placed on employer-based retirement plans and Social Security.

The proposed new nondiscrimination rules and the IRA offset against 401(k) contributions would make administration of the Internal Revenue Code more complex, while most tax reform proposals are aimed instead at making it simpler to understand and enforce.

**Revenue Effects of Changing 401(k) Rules**

The Treasury estimates that the section 401(k) proposals in the president's tax plan would increase revenues by $1.1 billion in 1986 and by $2.8 billion in 1990. Based on the marginal tax rates used by the Treasury to value pension-related tax expenditures, this implies that contributions to section 401(k) plans would decrease by about $4 billion in 1986 if the president's proposal were enacted. The original Treasury proposal, which would have abolished 401(k)s, estimated that total repeal of section 401(k) arrangements would increase federal revenues by $0.6 billion in 1986, implying a much lower participation level than that assumed in the Reagan proposal.

In the proposed federal worker savings plans, there would be no per-employee dollar limit imposed on contributions (as in Reagan's proposal), and there would be no nondiscrimination rules applied to employee or employer contributions.

**A Form of 401(k) for Federal Workers**

While President Reagan's tax reform proposal would introduce new restrictions on 401(k) plans, legislation recently announced to establish a new civil service retirement system would include a form of 401(k) plan. The bill (S. 1527), introduced by Senators Ted Stevens (R-AK) and William Roth (R-DE), would not include many of the current requirements on these plans. For example, there would be no nondiscrimination test on contributions of higher-paid federal workers versus lower-paid federal workers.

Introduced in response to the 1983 Social Security Amendments, which required that a new civil service retirement system be established to cover federal employees hired after January 1, 1984, the Stevens-Roth bill would supplement a new primary retirement plan with a thrift savings plan. Participants in the plan would be permitted to contribute, on a pretax basis, up to 10 percent of their pay. The contributions would be supplemented by matching employer (government) contributions, at the rate of $.50 for each dollar contributed up to a maximum of 5 percent.
There would be no per-employee dollar limit imposed on contributions (as in Reagan's proposal), and there would be no nondiscrimination rules applied to employee or employer contributions.

Rep. Rod Chandler (R-WA) has also introduced a new federal worker retirement system (H.R. 2869) that contains a pretax savings feature. The structure and limits are similar to those in the Stevens-Roth plan.

It does not appear that adoption of the president's tax reform proposal would include a federal worker plan. In addressing the issue of a new civil service retirement system, Congress may want to consider the following questions: Should public- and private-sector employees have the same protections? Should the federal government be subject to the same requirements as private employers in the provision of employee benefits?

**Worker Mobility and Cost Containment**

CODAs have become an increasingly popular tool for controlling employer pension costs. Employees are able to supplement employer contributions to section 401(k) plans with tax-deferred contributions of their own. This allows employers to contain their retirement plan costs. In general, section 401(k) plans probably represent a net reduction in employer pension contributions relative to the level that would be required to ensure adequate retirement income with lower employee retirement saving.

Section 401(k) plans can help meet the need for retirement income security among mobile workers and workers with intermittent labor-force participation. Employee elective contributions to section 401(k) plans are, by law, fully and immediately vested and may be withdrawn by the employee upon employment termination to be rolled over into another retirement savings program.12 Furthermore, if an employer provides a matching contribution, the vesting period for it is generally shorter than under other employer-sponsored plans. Short-tenure workers, therefore, may be better served by 401(k) plans than by more traditional plans with longer vesting periods. These workers and workers with intermittent labor-force participation are protected because they can "roll over" the accumulated contributions and earnings of the plans into IRAs. As a result, section 401(k) plans may particularly benefit young workers with high labor-force mobility and women who may leave the labor force for a protracted time.

On the other hand, it must be noted that some 401(k) plans are currently used as savings for emergencies and special needs such as home purchase, college education and major medical expenses. In such cases there are societal gains, but not direct retirement income.

Section 401(k) plans can also serve as a mechanism for indexing a worker's retirement income. Although pension benefit increases are seldom automatic, most employers provide ad hoc cost-of-living adjustments for current retirees. Under present law, sponsors of defined benefit pension plans may not be able to reserve sufficient funds for future ad hoc cost-of-living increases, even if the plans have clear histories of providing them. Ad hoc increases, therefore, are funded from current contributions, offset against actuarial gains or added to a plan's unfunded liability. Many employers may have less of a need to provide increases if the "individual savings" aspect of retirement income is increased through 401(k) plans.13

**Conclusion**

401(k) plans provide a unique vehicle for retirement savings and capital accumulation. Their current preferential tax status makes them popular with employees, who can defer income tax on contributions until withdrawal. Employer contributions make 401(k)s even more attractive. For many employees, the flexibility that allows them to take their funds with them upon terminating employment is an advantage over defined benefit plans.

As with other qualified retirement plans, employers can deduct contributions to a 401(k) plan as a business expense on their income tax. In addition it appears that employers view provision of a 401(k) plan as a way to maintain a competitive employee benefits package. Complex accounting and record-keeping procedures to ensure nondiscrimination can be a drawback, however, and the definition of hardship is still an issue.

The introduction of President Reagan's tax reform initiative poses new questions for employers and participants. The proposed 401(k) rules are very complex, and many observers are concerned that they will create tremendous administrative and enforcement difficulties and make 401(k) plans less attractive to employees and employers.

It appears that Congress and the administration are intent on trying to "simplify" tax laws. Retirement and capital accumulation plans (including 401(k) plans) will, no doubt, be items for consideration.

12 Other secondary defined contribution plans may be rolled over into an IRA, but only 401(k) contributions vest completely and immediately.

13 Other secondary defined contribution plans may help provide inflation protection as well.
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