For long-term savings, 401(k)s remain an attractive, tax-effective employer-sponsored retirement plan.

After Tax Reform: Revisiting 401(k)s

Since 1981, 401(k) arrangements have grown to become a popular employer-sponsored savings vehicle. The number of 401(k)s established and the number of employees participating in them has been growing steadily. A recent survey reports that from 1981 to 1986, the percentage of large firms sponsoring 401(k)s increased from 0 to 89 percent. More employees, as well, are finding 401(k)s valuable for savings. Census Bureau data report that 56 percent of eligible workers in 1984 (latest nationwide survey) were participating in 401(k) arrangements, up from 39 percent in 1983. Surveys of larger firms show participation rates approaching 70 percent. Federal workers can also participate in a 401(k)-type plan under the new Federal Employees Retirement System.

The most common design of a 401(k) allows an employee to defer a portion of current salary (before tax) to an individual account, where it is invested and accretes tax free until withdrawal. Employers may deduct any company contributions as a business expense. The ability to save on a pretax basis is one reason these plans have been attractive. Employer contributions have encouraged participation and have increased savings accumulations.

Congress imposed new rules through the 1986 Tax Reform Act that seek to assure the emphasis of 401(k)s is on long-term saving for retirement, not short-term goals. In this vein, tax reform restricts preretirement withdrawals to limited circumstances, imposes a penalty tax on early withdrawals, and tightens nondiscrimination rules.

Some argue that these changes create a disincentive for some individuals to save through a 401(k), but for long-term savings 401(k)s are still an attractive, tax-effective vehicle, especially when there is an employer match. The Employee Benefit Research Institute estimates that an initial contribution of $1,000 to a 401(k)—assuming a 7 percent rate of interest and accruing for 20 years—would yield almost 1 1/2 times the amount as the same investment under the same assumptions in a regular savings account. When a 50 percent employer match is included, the 401(k) accrual is more than 100 percent greater.
Introduction

A "401(k)" plan is an employer-sponsored retirement arrangement in which the participant may contribute a portion of compensation (otherwise payable in cash) to a qualified profit sharing, stock bonus or money-purchase pension plan established prior to 1974. Typically, the contribution is made as a pretax reduction in, or deferral of, salary, which is paid into the plan by the employer on behalf of the employee. In some cases, an employer contributes a portion of the company’s profits to the plan on behalf of the employee. In both instances, the employee defers income tax on the 401(k) contribution and on any earnings until withdrawal. Some plans permit employee after-tax contributions, which also accumulate tax free until withdrawal, and provide employer “matching” contributions, usually conditioned on a minimum contribution by the employee.

Various forms of deferred compensation have existed for years. As early as the mid-1950s, certain profit sharing plans using pretax employee contributions were permitted by the Internal Revenue Service (IRS) as long as at least half of the participants electing to defer were in the lowest paid two-thirds of all plan participants. The primary advantages of these plans were the employee’s ability to defer tax on a portion of income until a future time, to accumulate the earnings on a tax-deferred basis, and to save for retirement on a regular schedule.

In permitting these plans, the IRS departed from general tax principle, which treats income as taxable when it is “constructively received” by, or made available to, an individual whether or not the individual actually received the income. In 1972, however, the IRS issued a proposed regulation that would have reversed its prior position on constructive receipt and effectively eliminated tax-deferred income. There were a number of deferred compensation arrangements in existence at that time, so Congress, through the Employee Retirement Income Security Act (ERISA) of 1974, allowed the tax treatment of plans in existence before June 28, 1974, to continue. New plan formation, however, was frozen until Congress could study the use of these arrangements and their preferential tax treatment.

The Revenue Act of 1978 added section 401(k) to the Internal Revenue Code (IRC)—hence the commonly used term “401(k)” plan. Technically these plans are referred to as “cash or deferred arrangements” (CODAs) because the employee must have the option to take the compensation in cash or defer it. Proposed regulations issued in 1981 defined special coverage and nondiscrimination rules that 401(k) plans must satisfy and placed restrictions on preretirement withdrawals.

Despite the uncertainties surrounding 401(k) plans in recent years because of the absence of final regulations and potential tax policy changes, survey data shows a significant growth in these arrangements since 1981.

Final regulations have been pending for years. Congressional and administration tax reform proposals, which all included some modification of 401(k)s, probably held up final rulemaking. The Treasury Department’s November 1984 tax reform plan recommended that 401(k) arrangements be eliminated. President Reagan’s May 1985 tax reform plan proposed continuation of the plans but with some modifications—reduced contribution limits and stricter nondiscrimination requirements. The final outcome of tax reform efforts, the 1986 Tax Reform Act (TRA) (Pub. L. 99-514), did not leave 401(k) plans untouched. Many 401(k) features were revised: contribution amounts were limited, nondiscrimination rules were tightened, and preretirement withdrawals were limited to certain cases and subject to a penalty tax. The congressional intent in these new rules is to assure that 401(k) plans are used for long-term savings for retirement, not general short-term savings, and 401(k) benefits and coverage are more evenly distributed between highly paid employees and lower-paid employees.

Despite the uncertainties surrounding 401(k) plans in recent years because of the absence of final regulations and potential tax and policy changes, survey data
shows a significant growth in these arrangements since 1981. And employee interest remains high despite new restrictions imposed by tax reform. Many benefit experts believe these arrangements remain a good vehicle for long-term retirement savings and expect the number of plans and participants to continue to increase. On the other hand, Congress continues to examine possible changes in 401(k) plans as a part of their review of retirement policy.

This Issue Brief discusses 401(k) contribution, distribution, and nondiscrimination requirements as revised by TRA and summarizes available data on the prevalence of 401(k) plans, rate of participation, average contribution amounts, and plan design features. This Issue Brief also reviews the new savings plan provision in the federal employees retirement system (FERS), discusses the possible effects of tax reform on 401(k) plans, and examines the tax and retirement savings implications of saving through a 401(k) arrangement under tax reform rules.

**Types of 401(k) Arrangements**

There are essentially two ways that an employee is able to defer compensation under a 401(k) arrangement. The most common is through an actual salary reduction. The employee designates a percentage of salary to be contributed to the plan, thereby reducing current salary and reducing the base upon which Social Security, unemployment and some state taxes are based. The second type of 401(k) deferral allows an employee to put a profit sharing distribution (all or part) in a retirement account and defer taxes on the amount.

Salary reduction arrangements are the most common, and can be part of an employer's regular savings (or thrift) plan, money-purchase plan, or flexible benefit plan. There are also "freestanding" plans, which are not part of any other plan and are typically set up solely with employee salary deferrals. Many companies, however, may decide to provide employer contributions because of tax reform. (See 401(k)s after Tax Reform later in this report.)

Flexible benefit plans used in conjunction with a 401(k) arrangement allow employees to purchase benefit coverage beyond that provided by the employer with pretax dollars. Employees commonly pay for additional life insurance coverage, prescription drugs, higher health plan coverage, or dependent care with this money.

**Prevalence of 401(k) Plans, Eligibility, and Participation**

A review of survey data suggests that 401(k) arrangements are becoming increasing popular in mid- to large-size firms, with their greatest concentration in larger firms. Forty-seven of the nation's "top 50" industrial companies had 401(k) arrangements in 1986 reports The Wyatt Company (The Wyatt Company, 1987), and 78 percent of the largest 1,046 U.S. companies had 401(k)s (Greenwich Associates, 1987). A 1986 Bankers Trust Company survey of 242 defined contribution plans in medium and large companies found that 89 percent of the plans had a 401(k) provision (Bankers Trust Company, 1987).

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Growth in 401(k) arrangements appears to have been most pronounced from 1982 to 1984. Two-thirds of the
401(k) plans in the Bankers Trust Survey were adopted in 1983 and 1984. Between 1982 and 1984, Hewitt Associates reports that plan establishment jumped from 2 to 68 percent of firms surveyed. Chart 1 shows the growth of 401(k)s from 1981-1986 at the 250 firms surveyed by Hewitt.

The number of employees eligible for 401(k) participation also appears to be growing. A survey sponsored by the Employee Benefit Research Institute (EBRI) and the U.S. Department of Health and Human Services (HHS) under contract with the Bureau of the Census indicated 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 by 1986, the Department of Labor reports that 33 percent of full-time workers in medium and large firms (21.3 million) were eligible to participate in 401(k) arrangements, bringing the total of eligible private-sector workers to 7 million (U.S. Department of Labor, 1987).

New Census Bureau data on 401(k) eligibility support the limited evidence earlier available that 401(k)s are more prevalent in large companies. Table 1 illustrates a direct relationship between firm size and eligibility to participate in a 401(k). Employees in small firms with under 100 were almost four times less likely to be eligible for a 401(k) plan than employees working in firms with between 500 and 999 workers and more than five times less likely than employees in firms with 1,000 or more workers.

Federal employees are another group of workers who now have the opportunity to participate in a tax-deferred retirement program similar to a 401(k) plan. Federal workers hired after December 31, 1983, who are under the new Federal Employees Retirement System (FERS), are automatically covered under a thrift/savings plan. The 2 million federal workers hired before 1984 who are covered under the Civil Service Retirement System (CSRS) are also eligible to participate in the thrift plan. (For a detailed description of the provisions, see Federal Thrift Plan, below.)

The 1986 Tax Reform Act excludes a previously eligible group of employees from having 401(k) plans. Tax-exempt employers and state and local governments may no longer set up these plans, but plans adopted by tax-exempt employers before July 2, 1986 and by state and local governments before May 6, 1986, may remain in existence. Instead, these organizations may set up unfunded deferred compensation plans known as section 457 plans. (See State and Local Government and Tax-Exempt Employers, below.)

Participation rates in private-sector 401(k) plans are high and have been growing. In May 1983, the EBRI/

Participation rates in private-sector 401(k) plans are high and have been growing.

The overall participation rate in 401(k)s varies somewhat by salary, a Wyatt Company survey shows. For employees in the lower two-thirds of the salary distribution, the average participation rate was 50 percent. For employees in the upper one-third of salary distribution, the participation rate averaged 73 percent. (The earnings breakpoint averaged $37,830.) Participation rates are lower in the federal thrift plan—about 36 percent of workers currently under FERS and 19 percent of CSRS employees. The growth of employee participation in private programs suggests that participation in the federal thrift plan may grow in the years ahead.

Tax reform appears to have had little impact to date on employee participation in existing 401(k) plans, reports Hewitt, with most companies expecting the percentage of eligible employees to stay the same or change very little. However, because the 1986 Tax Reform Act eliminates tax-deductible individual retirement account (IRA) contributions for some workers, there could be an increase in the number of employees who participate in 401(k) plans. EBRI estimates that of the 10 million taxpayer units ineligible to make a fully deductible IRA, approximately 1 million are participating in 401(k) plans. These workers might increase their 401(k) contributions to offset denied IRA contributions.

**Federal Thrift Plan**

The 1983 Social Security Amendments required that a new civil service retirement system be established to cover federal employees hired after December 31, 1983. The new system, FERS, which Congress adopted in 1986 and which went into effect in January 1987, combines Social Security, a modified civil service defined benefit pension, and an optional tax-deferred thrift plan. Employees hired before the end of 1983 have the option of joining the new system or remaining in CSRS. CSRS participants have until December 31 of this year to switch plans.

The thrift plan, similar to private-sector 401(k) plans, is available to all federal workers, including CSRS-covered employees. Those workers hired since the end of 1983 (605,029 as of early September) are automatically covered under the thrift plan, and the government contributes the equivalent of one percent of pay for each employee whether or not the individual contributes. Participants may contribute up to 10 percent of base salary (up to a maximum of $7,000 indexed annually with section 415 limits). The government will then match dollar-for-dollar the first 3 percent of employee contributions and 50 percent of the next 2 percent, with no match beyond 5 percent. Federal workers covered by CSRS may contribute up to 5 percent of their salaries to the thrift plan but are not entitled to government contributions.

Tax reform appears to have had little impact to date on employee participation in existing 401(k) plans, with most companies expecting the percentage of eligible employees to stay the same or change very little.

The latest data indicate that almost 36 percent (216,000) of workers under FERS are contributing to the thrift plan and about 19 percent (372,690) of CSRS parti-
pants are contributing to the plan. This rate is somewhat lower than some policymakers envisioned. (The Washington Post reported in May that FERS authors expected a 40-50 percent participation rate.) These rates do not reflect additional participation expected by those employees currently under CSRS who may sign up for the new retirement plan and thus receive an automatic government contribution and be eligible for a government match.

There will eventually be three investment options among which employees may choose: a government securities fund, a fixed income fund, and an equities index fund. In 1987, 100 percent of employee contributions are automatically invested in government securities. For each year thereafter the minimum contribution to the securities fund will be reduced by 20 percent until 1992. All government contributions will be 100 percent invested in government securities until 1992, decreasing by 20 percent a year until 1997.

Lower-than-expected participation rates in the plan have lead the Federal Retirement Thrift Investment Board to suggest that the federal plan be exempt from nondiscrimination rules.

According to estimates by the Federal Retirement Thrift Investment Board, which manages the plan, a FERS-covered employee who contributes 5 percent of salary to the plan for 30 years and retires at age 62 on an average salary of $30,000 will receive a retirement benefit (including Social Security, the basic government pension, and earnings from the thrift plan) equal to 68 percent of salary. This compares to a benefit from the current civil service retirement program equal to about 55 percent of final salary for an employee retiring after 30 years.

The federal thrift plan must satisfy the same nondiscrimination rules as private-sector 401(k) plans. The maximum contribution level as a percentage of salary of government employees earning over $50,000 will depend on the contribution level of employees earning under this amount. Lower-than-expected participation rates in the plan have lead some in the government (specifically the Federal Retirement Thrift Investment Board) to suggest that the federal plan be exempt from these nondiscrimination rules.

The Government Accounting Office (GAO), in response to a request by Rep. William Ford (D-Mich.), reviewed the nondiscrimination rules and suggested several options for helping to improve participation among federal workers. One option would be to adopt the same nondiscrimination rules for the federal plan that are applied to 403(b) tax-sheltered annuities under tax reform. These would maintain employee eligibility and coverage requirements, but would not limit the contributions of upper income employees to a certain percentage of lower-paid contributions. Another option says GAO, could be, to add an employer matching contribution provision for CSRS-covered employees, which might encourage greater participation in the thrift plan among these employees.

State and Local Governments and Tax-Exempt Organizations

In the past several years, some public-sector and tax-exempt employers have established 401(k) plans. But because 401(k)s are considered profit sharing plans for tax purposes, and state and local and tax-exempt organizations generally have no profits, there had been some question as to the legality of having 401(k) plans in these firms. A more common arrangement has been an unfunded deferred compensation plan known as a section 457 plan. Greenwich Associates in a 1986 survey assessed the relative use of 401(k) plans and 457 plans among public pension funds (table 2). A substantial proportion (42 percent) of funds maintained a 457 plan; 11 percent had a 401(k) plan (Greenwich Associates, 1987).

The 1986 Tax Reform Act precludes state and local governments and tax-exempt organizations from establishing a 401(k) plan. (Plans of state and local governments adopted before May 6, 1986, and tax-

November 1987
Contributions

There are four types of 401(k) contributions:

1. Elective contributions—tax-excludible employee contributions (made by the employer on behalf of the employee) in the form of a salary reduction.

2. Nonelective contributions—contributions made by the employer from employer funds. Sometimes these are made to help satisfy nondiscrimination tests.

3. Matching contributions—employer contributions that “match” employee contributions, although the employer does not always provide a full dollar-for-dollar match.

4. Voluntary contributions—after-tax employee contributions not made through a salary reduction.

Currently, companies have no regulatory guidelines to follow for structuring the number and type of investment options provided for contributions to a 401(k) arrangement. Employers commonly offer several investment alternatives for 401(k) contributions that might include: (1) a fixed fund, which invests in a guaranteed investment contract (GIC) with an insurance company; (2) a balanced fund, which is designed to provide stability as well as growth through an investment mix of stocks and bonds; or (3) a stock fund, which may have the most potential growth, but also the most risk. Some employers offer bond funds, money market funds, fixed income securities, real estate or company stock. Surveys of employee investment choices indicate that GICs and company stock are popular (MassMutual, 1985; Hewitt Associates, 1985).

The Labor Department has now proposed regulations that broadly define the “range” of investment options required for 401(k) contributions, the frequency with which plan participants may change investments, and the sufficiency of information regarding investment alternatives. (The complete rule is published in the September 3, 1987, Federal Register, pp. 33508-33517.)

Employer matching 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.

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Table 2
Use of 401(k) Plans at Public Pension Funds, 1986

<table>
<thead>
<tr>
<th>Plan Type</th>
<th>Have 457 Plans</th>
<th>Have 401(k) Plans</th>
<th>Established but Not Yet Implemented</th>
<th>Total Plan Use</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over $500 million</td>
<td>29%</td>
<td>13%</td>
<td>2%</td>
<td>38%</td>
</tr>
<tr>
<td>$251–500 million</td>
<td>39%</td>
<td>7%</td>
<td>4%</td>
<td>43%</td>
</tr>
<tr>
<td>$101–250 million</td>
<td>63%</td>
<td>12%</td>
<td>2%</td>
<td>71%</td>
</tr>
<tr>
<td>$51–100 million</td>
<td>48%</td>
<td>13%</td>
<td>4%</td>
<td>60%</td>
</tr>
<tr>
<td>$25–50 million</td>
<td>49%</td>
<td>13%</td>
<td>4%</td>
<td>58%</td>
</tr>
<tr>
<td>Under $25 million</td>
<td>29%</td>
<td>12%</td>
<td>0%</td>
<td>41%</td>
</tr>
<tr>
<td>Total Funds</td>
<td>42%</td>
<td>11%</td>
<td>3%</td>
<td>51%</td>
</tr>
</tbody>
</table>

Source: Greenwich Associates

exempt plans adopted before July 2, 1986, may continue.) Instead, these groups may maintain section 457 plans, and some tax-exempt organizations may establish 403(b) tax-sheltered annuities. Section 457 plans can be less attractive than 401(k)s and 403(b)s: 457 assets are a part of the employer’s general assets and subject to creditor’s claims; and 457 distributions cannot be rolled over to an IRA or other plan, they can only be transferred to another 457 plan.

401(k) Plan Design and Operation

A 401(k) arrangement can include a variety of design features combined to accommodate the goals of the employer and the expectations of employees. A plan can be designed relatively simply, i.e., with employee salary reduction contributions alone and no withdrawal or loan provisions; or more complex with employer and employee contributions, hardship withdrawal provisions, and loan features. Regardless of the design, a plan must follow operating rules governing contributions, distributions, loans, nondiscrimination, and vesting of 401(k) monies.
Employer matching contributions are a prevalent feature of 401(k) plans. 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.

Until the 1986 Tax Reform Act, 401(k) participants could contribute up to $30,000 or 25 percent of compensation, whichever was less—the same limits set for all defined contribution plans in section 415 of the IRC. Beginning in 1987, however, TRA limits employee elective contributions made with pretax dollars to $7,000, which are coordinated with elective contributions to simplified employee pensions, state and local government plans, tax-sheltered annuities (403(b) plans) and section 501(c)(18) trusts. In addition, the $7,000 limit applies to elective deferrals under all 401(k) arrangements in which the employee participates, including plans sponsored by different employers. Beginning in 1988, the $7,000 cap is indexed for inflation. Employee after-tax contributions are limited to 10 percent of salary.

Total employer and employee contributions to a 401(k) plan are limited in the same way as other defined contribution plans under IRC section 415. The sum of the employee's pretax contribution, any employer "matching" contribution and any after-tax employee contribution may not exceed the lesser of $30,000 or 25 percent of an employee's compensation. Before TRA, only a portion (beyond 6 percent) of the employee's after-tax contribution was counted in these limits.

Elective deferrals by highly paid employees could be further restricted by new TRA nondiscrimination rules for 401(k) plans, because these rules reduce the allowable disparity between the percent of compensation the higher-paid elect to defer and that which lower-paid employees defer. (See Nondiscrimination Requirements, below.) TRA also applies a limit of $200,000 on compensation that may be taken into account for computing contribution limits.

Bankers Trust Company found that 69 percent of the plans it surveyed allowed employees to make both pretax and after-tax contributions. Three out of every ten plans required the employee to make a specified minimum pretax contribution before being allowed to make an after-tax contribution. However, under TRA, a 401(k) plan can no longer condition an after-tax contribution on a minimum pretax contribution rate. This provision is effective for plan years after December 31, 1988.

As a percentage of salary, lower-paid employees generally contribute less to a 401(k) than higher-paid. Surveys by Hewitt and MassMutual both report the average deferred by the lower paid two-thirds of plan participants to be 3.7 percent (Hewitt, April 1987; MassMutual, 1985). Hewitt reports the average deferral percentage for the higher paid at 6.0 percent and MassMutual at 5.6 percent.

The 1983 EBRI/HHS survey provides the only nationwide data on actual dollar amounts employees contribute to 401(k)s. Thirty percent of private-sector workers contributed less than $700 annually, and 29 percent contributed between 1,200 and 1,999 annually (table 3). 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.

Distributions

Prior to passage of TRA, the employee's ability to withdraw funds from a 401(k) plan before age 59 1/2
Table 3
Annual Contribution to 401(k) Plan
Private Nonfarm Wage and Salary Workers, May 1983

<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>Total Workersb (percent)</td>
<td>1,887,000</td>
<td>558,000</td>
<td>250,000</td>
<td>551,000</td>
<td>365,000</td>
<td>162,000</td>
</tr>
<tr>
<td>Less than $10,000 (percent)</td>
<td>87,000</td>
<td>c</td>
<td>c</td>
<td>c</td>
<td>c</td>
<td>c</td>
</tr>
<tr>
<td>$10,000–19,999 (percent)</td>
<td>548,000</td>
<td>235,000</td>
<td>76,000</td>
<td>141,000</td>
<td>c</td>
<td>c</td>
</tr>
<tr>
<td>$20,000–29,999 (percent)</td>
<td>568,000</td>
<td>155,000</td>
<td>122,000</td>
<td>174,000</td>
<td>c</td>
<td>c</td>
</tr>
<tr>
<td>$30,000 + (percent)</td>
<td>608,000</td>
<td>80,000</td>
<td>c</td>
<td>201,000</td>
<td>211,000</td>
<td>c</td>
</tr>
</tbody>
</table>


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

was restricted to retirement, death, disability, termination of employment or of the plan, or financial "hardship." IRS proposed regulations defined hardship as an "immediate and heavy financial need." To make a determination of hardship, the IRS said there had to be a heavy and immediate financial expense and no other resources reasonably available to satisfy that expense.

Because of such sketchy regulation, most employers have structured their hardship provisions based on IRS revenue rulings, which suggest that hardship withdrawals are permitted for the purchase of a primary residence, for college tuition or for a major medical expense. Both MassMutual and Hewitt found that nearly 90 percent of plans surveyed before the passage of TRA had provisions for hardship distributions.

In drafting the 1986 Tax Reform Act, Congress expressed concern about the ability of employees to use a tax-favored retirement plan as a vehicle for short-term savings regardless of the goal. Thus, TRA imposes additional restrictions on withdrawals from 401(k) plans. Beginning with plan years after December 31, 1988, hardship withdrawals are limited to an employee's elective contributions made through salary reduction. Employees cannot withdraw employer contributions, employee after-tax contributions, or any income thereon. In addition, hardship withdrawals are subject to a 10 percent early distribution tax unless the withdrawal is for medical expenses to the extent deductible under federal income tax rules (expenses that exceed 7 1/2 percent of adjusted gross income).

Withdrawals before age 59 1/2 for any other reason are subject to a 10 percent additional tax unless the participant has died or has become disabled or the distribution is (1) in the form of an annuity or installments payable over the life or life expectancy of the participant (or the lives or life expectancies of the participant and the participant's beneficiary); (2) made after the participant has separated from service on account of early retirement on or after age 55; (3) received as a lump sum prior to March 15, 1987, if made on account of separation from service in 1986 and the recipient elects to treat the distribution as paid in 1986; or (4) made to or on behalf of an alternate payee pursuant to a qualified
domestic relations order. Withdrawals before age 59 1/2 are also permitted if the employee is in a plan that has been terminated without the establishment of a successor plan or works for a company or a subsidiary whose assets have been sold. A distribution that is rolled over to an individual retirement account or a qualified retirement plan will not be subject to the additional tax.

The tax treatment of 401(k) funds at distribution is determined by the type of distribution. A distribution in the form of an annuity and partial distributions while a participant is still employed are taxed as ordinary income with no special tax treatment given. If the distribution is in the form of a lump sum, it may qualify for five-year income averaging if received after age 59 1/2. Prior to TRA, 10-year averaging had been possible.

A one-time election of five-year averaging for a lump-sum distribution received after attainment of age 59 1/2 is permitted. A special rule for employees nearing retirement allows a participant who had attained age 50 by January 1, 1986, to make one election of five-year averaging (or ten-year averaging at 1986 tax rates) with respect to a single lump-sum distribution. Five-year averaging allows an employee to separate the distribution into fifths, compute the income tax on one-fifth, and multiply the result by five. In effect, the employee is allowed to pay tax on the distribution as if received over five years, disregarding any other income that may be received during that time. The five-year averaging rule can result in tax savings.

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

1. The employee has been a participant in the plan for five years (except in the case of death).
2. The distribution is from a qualified plan.
3. 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.
4. The distribution is paid in a single tax year.
5. The distribution is paid for death, attainment of age 59 1/2, termination of employment, or disability.

In general, an entire distribution from a 401(k) plan or any portion may be rolled over to another qualified retirement plan or to an IRA if the transaction takes place within 60 days of the participant’s receipt of the distribution. No tax is paid on the portion rolled over until withdrawal from the IRA. Once a distribution is rolled over to an IRA, however, it does not qualify for income averaging.

Loans

The rules governing loans from a 401(k) are generally the same as those for other qualified plans. Prior to TRA, a loan from a qualified plan was not taxable if it did 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 was greater. The loan had to be repaid within five years or within a reasonable period if it was used to acquire or improve the principal residence of the participant or of a member of the participant’s family.

Under these provisions, Buck Consultants found 60 percent of 401(k) plans surveyed had loan provisions (Buck Consultants, 1986). Other surveys report a lower percentage of 401(k) plans with loan provisions. Forty-five percent of plans in the TPF&C survey had loan provisions as did 44 percent of plans surveyed by Hewitt (1986).

The 1986 Tax Reform Act modifies the rules for loans made after December 31, 1986. The new requirements limit loans to $50,000, reduced by the participant’s highest outstanding loan balance at any time during the one-year period ending on the day before a new loan is made. The intent of this provision is to prevent participants from maintaining a perpetually high or revolving loan balance.

Under the previous limit, for example, a participant with a vested benefit of $60,000 and no previous loans could borrow up to $30,000. If the participant borrowed $20,000 and repaid $10,000, he or she was eligible to borrow another $20,000 since the $30,000 maximum would be reduced only by the $10,000 balance still remaining on the first loan. Under TRA, however, the same employee could borrow only $10,000 on a second loan (borrowed within a year of the first loan) since the $30,000 maximum would be reduced by the full amount of the first loan.
TRA also (1) denies the income tax deduction for interest paid on a loan from 401(k) elective deferrals; (2) requires level amortization of a loan over the permissible repayment period, with payments to be made at least quarterly; and (3) limits the availability of the extended repayment period for loans for principal residences to loans applied to the purchase of the participant's principal residence.

In practice, loans from 401(k) plans are often similar to those from lending institutions except that interest on the loan is paid back to the employee's account. The interest rate varies just the way rates do from "conventional" lending sources. Hewitt Associates recently examined loan interest rate practices in 74 plans with loan provisions.

Loan interest rates in effect during the second quarter of 1987 averaged 8.6 percent but ranged from 4.5 percent to 12 percent. Most companies, however, charged interest in the range of 7, 8, or 9 percent (chart 2). A majority of employers surveyed based interest rates on "external" money market indices, such as the prime lending rate, U.S. Treasury Bill rates, or "other" indices (e.g., the Government Agency Bond Rate or the current Pension Benefit Guaranty Corporation annuity rate). Others link interest rates to "internal" indices, such as returns on the plan's guaranteed investment contract or the rate charged by a company-sponsored credit union (chart 3). As in the case with lending institutions, employers adjust interest rates periodically. Survey data show that employers most commonly change rates either quarterly (35 percent of companies) or annually (34 percent of companies), although some adjust rates when the prime or GIC rate change.

Despite the somewhat more stringent requirements for loans from 401(k) plans, loan provisions may assume greater importance for participants, due to the new restrictions on hardship withdrawals and the additional 10 percent tax on most early distributions. Buck Consultants found that of those firms with no loan provision in their 401(k) plan, 38 percent were planning to add one to "facilitate access to 401(k) monies" (Buck Consultants, 1987). Fifteen percent of companies surveyed by Hewitt added a loan provision to their 401(k) plans, bringing to 59 percent the percent of companies that allow loans.

Nondiscrimination Requirements

Coverage—Because a 401(k) arrangement is a qualified retirement plan, it must comply with coverage and participation rules designed to ensure that highly
compensated employees do not disproportionately benefit from the plan. "Highly compensated" employees, prior to the 1986 Tax Reform Act, were considered to be the highest paid one-third of eligible employees.

TRA provides a more precise definition of "highly compensated," which became effective after December 31, 1986. Employees are so defined if at any time during the year or the preceding year, the employee (1) was a 5 percent owner of the employer; (2) earned more than $75,000 in annual compensation from the employer; (3) earned more than $50,000 in annual compensation from the employer and was a member of the top 20 percent of employees by pay during the same year; or (4) was an officer of the employer and received compensation greater than 150 percent of the dollar limit on annual additions to a defined contribution plan ($45,000 in 1987). The $50,000 and $75,000 thresholds are indexed for inflation.

TRA also provides new coverage tests, effective for plan years after December 31, 1988. Prior to TRA, the minimum coverage rules for qualified plans required plans to satisfy either a percentage test or a reasonable classification test. The percentage test required a plan to benefit 70 percent of all nonexcludable employees or at least 80 percent of nonexcludable employees eligible for benefits where at least 70 percent of all such employees are eligible (in other words, 56 percent of nonexcludable employees). The classification test required a plan to cover a "fair cross-section" of employees.

Under TRA, a 401(k) plan will satisfy the coverage rule through one of three tests:

(1) Percentage test—Seventy percent of all nonhighly compensated employees are covered by the plan.

(2) Ratio test—The percentage of nonhighly compensated employees covered by the plan is at least 70 percent of the percentage of highly compensated employees covered.

(3) Average benefits test—The group of employees covered by the plan satisfies the present-law classification test, and the average benefit provided to all nonhighly compensated employees (as a percent of compensation), including those not covered by the plan, is at least 70 percent of the average benefit provided to the highly compensated. In applying the third test, all plans maintained by the employer are taken into account.

For plan years beginning after December 31, 1988, a 401(k) plan must benefit at least 40 percent of all employees or 50 employees, whichever is less. An employee is treated as benefiting under the plan if he or she is eligible to make contributions to the plan. Also, beginning 1989 a 401(k) plan cannot require more than one year of service with the employer as a condition of participation.

Benefits—Congress has also been concerned that lower-paid employees receive benefits and contributions from a qualified employee benefit plan comparable to those received by higher-paid employees. All 401(k) plans must meet a special nondiscrimination rule called an "actual deferral percentage" (ADP) test in addition to satisfying the coverage rules. In general, the test compares the amounts that the most highly compensated employee must defer—a percentage of compensation—with the amounts that the remaining eligible employees defer.

The percentage of compensation that each employee is contributing to the plan is determined separately for the highly paid group of employees and for the lower-paid group. The percentages for each employee are totaled and averaged to get an average ADP for the group. The ADP for the high-paid group is then compared with the ADP for the low-paid group.

Until TRA, the percentage of pay contributed by the higher-paid group could have been 1.5 times the average percentage contributed by the lower-paid group, or 2.5 times if the actual difference was no more than 3 percentage points. The plan had to satisfy one of these two tests.

Congress narrowed the plan contribution differential between the two groups for plan years after December 31, 1986. For employees covered by a collective bargaining agreement, the provisions are effective for plan years beginning before the earlier of (1) January 1, 1989 or (2) the date on which the last of the collectively bargained agreement terminate (determined without
regard to any extension in the agreement). One of the two following tests must now be satisfied.

Test 1: The ADP for the highly compensated eligible employee may not be more than the ADP of the other eligible employees multiplied by 1.25.

or

Test 2: The ADP for the highly paid may not be more than the ADP of the eligible lower paid employees multiplied by 2 and not more than 2 percentage points more than the ADP of the lower-paid.

For example, if the average deferral percentage for the lower-paid group is 4 percent and the average deferral percentage for the higher-paid group is 6 percent, are the nondiscrimination rules satisfied?

Test 1: Because 6 percent (the average ADP of the higher paid) is greater than 5 percent (4 percent x 1.25), test one is not satisfied.

Test 2: Because 6 percent is not more than 8 percent (the average ADP of the lower paid multiplied by 2) and 6 percent (the average ADP of the higher paid) is not more than 2 percentage points more than 4 percent (the average ADP of the lower paid), test 2 is satisfied.

Because one of the tests has been satisfied, the nondiscrimination rules are, therefore, satisfied.

Table 4 illustrates the maximum average ADP’s allowed for the top-paid employees, assuming various average ADPs for the lower paid.

The new rules apply to employee elective and after-tax contributions, and employer matching contributions. The employer may choose to aggregate any type of contribution for the test, or test the types separately under forthcoming rules from the Treasury Department. If any contributions are aggregated to satisfy 401(k) coverage rules, then they must be aggregated for the nondiscrimination tests. If after-tax contributions are aggregated, additional rules apply. Apparently, Treasury plans to issue rules that would permit the alternative ADP test (test 2) to be used only once.

Excess contributions that would cause a 401(k) plan to fail the ADP tests can be distributed (with earnings) or be recharacterized as after-tax employee contributions in the year of deferral and taxed to the employee. When those excess contributions are subsequently distributed, they are treated as pretax contributions and taxed again.

The tighter ADP tests under tax reform will likely reduce the level of contributions of some highly paid employees. Most companies (54 percent) in Hewitt’s 1987 survey expect that some of their highly paid will have to cut back on their contributions to pass the new ADP test. Almost one-half (46 percent) of companies surveyed by Buck said that their 1986 plan would not pass the new tests. On the other hand, some benefit experts believe the new definition of “highly compensated” may cause some employees previously included in this category to fall in the lower-paid group. If these employees maintain or increase their contribution level, it could increase allowable contributions for other workers.

Vesting

Under a qualified 401(k) plan, an employee’s right to the portion of his or her accrued benefit based on any elective contribution and any employer contributions

Table 4

<table>
<thead>
<tr>
<th>If the Average ADP ADP for the Lower Paid Is:</th>
<th>The Maximum Average ADP Allowed for the Top Paid Will Be:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Test 1</td>
<td>Test 2</td>
</tr>
<tr>
<td>1%</td>
<td>1.25%</td>
</tr>
<tr>
<td>2</td>
<td>2.5</td>
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<tr>
<td>3</td>
<td>3.75</td>
</tr>
<tr>
<td>4</td>
<td>5.0</td>
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<tr>
<td>5</td>
<td>6.25</td>
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<td>6</td>
<td>7.5</td>
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<td>8.75</td>
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<td>8</td>
<td>10.0</td>
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<tr>
<td>9</td>
<td>11.25</td>
</tr>
<tr>
<td>10</td>
<td>12.5</td>
</tr>
</tbody>
</table>

used to satisfy the ADP tests must be immediately and 100 percent vested, i.e. nonforfeitable. Employer contributions that are not used to satisfy the ADP tests, however, do not need to be immediately and 100 percent vested. They must, however, vest in accordance with ERISA requirements. Beginning plan years after December 31, 1988, the vesting period must be either (1) 100 percent after 5 years of service or (2) 20 percent after three years and 20 percent each year thereafter until full vesting after seven years.

Master and Prototype Plans

Master and prototype plans are standardized plan arrangements with preapproved IRS provisions generally sponsored by banks, insurance companies, and professional and trade groups for adoption by employers. They enable an employer to more quickly establish a qualified retirement plan with a minimum of paperwork. TRA requires the Internal Revenue Service to begin accepting opinion letter requests with respect to master and prototype plans for 401(k) arrangements no later than May 1, 1987. In April, the IRS issued a model amendment for use by sponsors of master and prototype plans who want to add a 401(k) arrangement (Notice 87-34). The plan must be a previously approved profit sharing plan and the model 401(k) must be adopted on a word-for-word basis.

The purpose of the model amendment, according to IRS officials, is to provide a flexible and attractive document for plan sponsors who want a quick attachment to an approved plan. IRS officials referred to the model amendment as a “snap-on” to a basic plan document and adoption agreement.

The model 401(k) amendment must include an effective date that is not retroactive. The model includes provisions for separate accounting for elective deferrals, qualified nonelective contributions, voluntary employee contributions, and matching contributions. Other required provisions of the model 401(k) include: (1) the $7,000 limit on elective deferrals; (2) a prohibition on integration with Social Security; (3) nonforfeitability of elective deferrals, voluntary employee contributions, and qualified nonelective contributions; (4) restriction of hardship withdrawals to elective deferrals; (5) the definition of highly compensated employees; (6) the ADP test; (7) a mechanism by which a participant can notify a plan of excess elective deferrals and by which the excess deferrals can be distributed; (8) a mechanism by which excess contributions will be distributed and an explanation of the 10 percent tax on the employer for failure to distribute that excess within the required time period; (9) a mechanism for the proper ordering of the nondiscrimination test; and (10) provisions for satisfying top-heavy rules. Optional provisions are also included.

In July, IRS issued changes to Notice 87-34 that add new features to the model 401(k), including a provision for hardship withdrawals, which were permitted in the original model amendment only if the plan sponsor’s underlying profit sharing plan provided for them. Another feature allows the use of qualified employer matching contributions to meet ADP tests. The new features are described in Notice 87-51.

Effect of Plan Design on Plan Experience

The relationship between plan design characteristics and plan experience, particularly participation levels and contribution amounts, is largely unknown. Surveys by Hewitt Associates and TPF&C give some idea of the correlation between design features such as matching contributions, loans, withdrawals, and maximum salary reduction amounts to levels of participation and percentage of salary deferred.

Both TPF&C and Hewitt report a strong relationship between the prevalence of an employer matching contribution and employee participation levels. The rate of participation in plans with no match surveyed by TPF&C was 50 percent compared to an average of 66 percent in plans with an employer match. Hewitt reports a participation rate of 46 percent when employee contributions are matched versus a 41 percent rate without a match.

1 Until this date, vesting may be satisfied under one of three alternative rules. See chapter III in Employee Benefit Research Institute, Fundamentals of Employee Benefit Programs, 3rd ed. (Washington, DC: EBRI, 1987).
TPF&C finds very little effect on employee participation rates of loan provisions and hardship withdrawals. Hewitt, however, finds that 401(k) plans with a loan provision have a 6 percent higher participation rate than plans without loans, and plans with hardship withdrawals have a 9 percent higher participation rate than plans without. Provisions for employer matching contributions, loans, and hardship withdrawals also appear to encourage higher average deferral rates.

A March 1987 Hewitt survey found little redesign of 401(k) plans due to tax reform changes from 1986 to 1987. The most significant change, reported by 15 percent of the companies surveyed, was the addition of a loan provision. Also, 7 percent of the companies had eliminated after-tax contributions.

Employers trying to encourage greater participation and increase contributions by employees may want to add an employer matching contribution or increase an existing one, and/or add a loan provision.

Employers can increase matching contributions without substantially increasing costs by reducing the maximum employee contribution eligible for the match. For example, a company that offers a 50 percent match up to a maximum of 6 percent of pay could increase the match to 100 percent of 3 percent of pay. Costs would increase to some degree if the number of employees electing to participate increases and/or employees already participating raise their contributions to the maximum.

Prior to tax reform, adding a provision for hardship withdrawals, as noted above, helped increase participation levels and employee 401(k) contributions. However, the penalty tax imposed by tax reform on early retirement plan distributions makes 401(k) withdrawals much less favorable and is not as likely to help participation and deferral amounts as in the past.

A March 1987 Hewitt survey found little redesign of 401(k) plans from 1986 to 1987 (Hewitt, April 1987). The most significant change, reported by 15 percent of the companies surveyed, was the addition of a loan provision. Also, 7 percent of the companies had eliminated after-tax contributions.

401(k)s after Tax Reform

In separate sections, this Issue Brief has examined the impact tax reform may have on continued growth of 401(k) arrangements, on participation and contribution rates, and on the use of design features such as loans and employer matching contributions. Although the future of 401(k) arrangements is still unclear because of the changes made by TRA and by additional changes Congress may enact, many observers believe there continues to be a secure future for 401(k) plans, particularly if their value for retirement savings is communicated effectively by employers. Thirty-one percent of mid- and large-sized companies without a 401(k) plan that were surveyed in December 1986 said they expected to offer such a plan by the end of 1987 (Coopers & Lybrand, 1987). Over one-third of the companies with 401(k) plans surveyed by Hewitt Associates in March 1987 expected the percentage of participating employees would increase in 1987 (Hewitt, April 1987). And only one firm planned to drop a 401(k) feature as the result of tax reform, according to a survey by Buck Consultants (Buck Consultants, 1987).

The new emphasis on 401(k) plans as long-term retirement income funds will mean different investment decisions for some employees. The decreased individual tax rates under TRA may make 401(k) plans less attractive for some, but they could become more attractive to middle- and upper-income employees who will no longer be able to make tax-deductible contributions to IRAs. With the added complexity tax reform brings to 401(k) plans and other retirement plans, employers may want to provide information to help employees make retirement decisions. At the least, employers will need an effective communications program to assure continued understanding of and participation in 401(k) plans.

Also, the reduced limit on employee elective deferrals and after-tax contributions under tax reform could lead
to an increase in the use of unfunded deferred compensation plans for highly paid employees.

The concern of some employees about access to their money prior to retirement to meet family needs could be addressed, many observers believe, through a loan feature, although this could add to the administrative complexity of the plan.

In practice, lower-paid workers might benefit from the $7,000 limit if the company increases matching contributions. If a company currently matches employee contributions at the rate of 50 cents for each $1.00 of employee contribution up to 6 percent of compensation, for example, an employee earning $150,000 in past years could contribute $9,000 matched by $4,500 by the employer for a total of $13,500. Under TRA, the same employee can contribute only $7,000 matched by $3,500 by the employer (1/2 of $7,000), for a total of $10,500. If the employer makes up the difference through increased matching contributions, lower-paid employees will realize increased benefits.

On the other hand, the $7,000 limit on employee elective deferrals in actual practice may not be significant because many plans already limit contributions to 6 to 10 percent of compensation, which means that only employees with more than $70,000 in compensation would be affected. For many companies, that may only be a few employees.

Hewitt Associates found that 58 percent of the companies surveyed in March 1987 estimated that less than 5 percent of contributing employees would be affected by the $7,000 limit. However, 54 percent of the companies in the survey expected that some of their highly paid employees would have to cut back their level of contributions to the 401(k) plan to pass the new ADP test. Over 80 percent of the companies did not plan to make up for any reduction an employee might have to make to stay within the $7,000 limit or to meet the ADP test (Hewitt, April 1987).

Saving through a 401(k) Plan after Tax Reform

Some observers believe that tax savings through 401(k) arrangements could become less important because of the reduction in tax rates under TRA. Deferring maximum amounts may not be as attractive when the top rate is 28 percent instead of 50 percent. A strong argument can be made, however, for the continued attractiveness of deferred savings intended for retirement through 401(k) arrangements, especially when there is an employer matching contribution.

A strong argument can be made for the continued attractiveness of deferred savings intended for retirement through 401(k) arrangements, especially when there is an employer matching contribution.

Chart 4 presents a savings comparison for investments in 401(k) plans, nondeductible IRAs, regular after-tax savings vehicles, and tax-exempt bonds. Under the assumptions noted, after 20 years an initial investment of $1,000 yields $2,786 in a 401(k), 45 percent more than the same amount would yield in a regular savings and 26 percent more than in a nondeductible IRA. With an employer match of 50 percent, the accumulation more than doubles, for a gain of 117 percent over a regular savings vehicle. The tax savings from a 401(k) over other savings alternatives is magnified the longer the contribution is invested.

In general, the following observations can be made with regard to saving through a pretax 401(k) arrangement compared to other posttax vehicles.

(1) Under most circumstances a matching 401(k) contribution can be designed to assure that qualified plans produce a better retirement savings alternative than cash taken and saved.

(2) For individuals in the same tax bracket before and during retirement a "perfect" tax-exempt bond could produce equal returns to a 401(k) account (with no match).

(3) For individuals who are certain that they will leave funds in a tax-deferred account until retirement and
who expect to pay tax at no higher rate during retirement, a 401(k) would be better than either a nondeductible IRA or a fully taxable account.

(4) For individuals who will be in a lower tax bracket during retirement than when income is deferred, they can expect to accumulate more using a 401(k) arrangement, with or without an employer match, than using any of the nondeferral options.

(5) For individuals who may be in a higher tax bracket either later in a career or during retirement, the length of the deferral period determines whether or not a 401(k) is better than regular savings.

Although the upfront tax benefit from 401(k)s is now less attractive, they are still viable retirement savings plans. Most individuals are not affected by the new dollar limits or the new withdrawal rules and can make full use of these arrangements.

**Further Change**

In the last several years, Congress has been reviewing the federal role in retirement policy and ways to encourage increased savings for retirement. In April of this year, the Congressional Budget Office (CBO) released its study of the retirement system, *Tax Policy for Pensions and Other Retirement Saving* (Congressional Budget Office, 1987). One aspect addressed is the relative disadvantage that short-service workers have in accumulating retirement benefits compared to workers who remain with one firm most of their working lives. One option CBO discusses is to make tax-favored savings universally available to all workers through 401(k) arrangements. Employers would be required to offer 401(k)s but would not have to make matching or nonelective contributions. Matching contributions could be encouraged, says CBO, by ending IRAs, de-

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**Chart 4**

**Comparing 401(k)s and Other Savings Vehicles**

<table>
<thead>
<tr>
<th>Assumes:</th>
<th>Regular Savings</th>
<th>Nondeductible IRA</th>
<th>401(k)</th>
<th>Tax-exempt Bond</th>
<th>401(k) with Match*</th>
</tr>
</thead>
<tbody>
<tr>
<td>-$1,000 contribution</td>
<td>$1,925</td>
<td>$2,208</td>
<td>$2,786</td>
<td>$2,786</td>
<td>$4,179</td>
</tr>
<tr>
<td>20 year accumulation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7 percent earnings</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lump sum on or after age 59 1/2</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>28 percent marginal tax rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Employee Benefit Research Institute.

Note: For comparison purposes, this chart illustrates the value of one $1,000 contribution (after-tax) under given assumptions. An individual's total accrual at retirement will depend on a number of factors, including amount and frequency of contributions, accumulation period, total earnings, etc.

* 50 percent employer match.
ductible and nondeductible. The highly compensated would then be strongly motivated to persuade employers to offer matching contributions, CBO argues.

Making 401(k)s universally available, might be expensive, however, and disruptive of employer pension plan practices. CBO estimates the net revenue loss from universal 401(k)s (no IRAs) at $1.3 billion in 1988 rising to $2.3 in 1989 and $2.8 billion in 1990.

◆ Conclusion

401(k) arrangements provide a unique vehicle for retirement savings. 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. As with other qualified retirement plans, employers can deduct contributions to a 401(k) plan as a business expense on their income tax, and some view 401(k) plans as a way to maintain a competitive employee benefits package.

Maintenance of individual accounts and complex nondiscrimination rules can make record-keeping burdensome, and new restrictions on withdrawals may make 401(k) plans less attractive to small employers and employees. However, many observers believe that 401(k) plans still offer significant advantages to employees at all income levels because of the pretax salary reduction provision. They believe 401(k) plans may prove even more advantageous for long-term saving by employees than other savings plans when the 401(k) arrangement includes employer matching contributions, after-tax employee contributions, and/or loan provisions.

As policymakers focus on the issues of financing retiree health insurance and long-term care, the assets accumulated in 401(k) plans may come to be viewed as a natural source of funds to meet these needs. In that case, 401(k)s will become an even more important part of our total retirement economic security system.

◆ References


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