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Cash or Deferred Arrangements (Section 401(k): Legal Issues and Plan Design

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I. Section 401(k): Cash or Deferred Arrangements (CODAs)

A. What is a Section 401(k) Plan?

A qualified cash or deferred arrangement, sometimes called a CODA or section 401(k) plan, is a special type of qualified profit sharing or stock bonus plan. In the usual profit sharing or stock bonus plan, an employer simply makes a contribution to the plan on behalf of an employee. The employer gets an immediate deduction for the contribution, the amount accumulates earnings tax-free in the plan's trust, and the employee is not taxed on any amount until it is actually distributed to him.

A section 401(k) plan is special in that the employee is given a choice as to whether to receive an amount in cash or to have it contributed to the plan on his behalf. Because of special tax rules, the employee is currently taxed only on the amount he chooses to receive in cash. The amount he chooses to have contributed to the plan is excluded from tax until distributed just like any other employer contribution to a qualified profit sharing or stock bonus plan.

B. Bonus and Salary Reduction Plans

Section 401(k) plans generally come in two types: bonus plans and salary reduction plans (or combinations of the two).

In a bonus plan, the employer typically declares a year-end bonus which the employees can receive in cash or have contributed to the section 401(k) plan, or they can take part in cash and part as a contribution to the plan.

In a salary reduction plan, the employer does not designate any bonus or other particular amount as subject to the section 401(k) cash or deferred election. Rather, he simply pays employees their salaries and wages and the employees decide whether to receive all of their pay in cash or to have their pay reduced and to have the amount of the reduction contributed to the section 401(k) plan.

In practical terms, an employee is likely to consider the contribution to a bonus-type plan to be made from "the employer's money." In the salary reduction plan, the employee is likely to think that the contribution is being made from "his own money," just as he makes contributions from his own money to a thrift or savings plan.
The problem is that in practice it is often difficult or impossible to tell the difference between bonus and salary reduction plans. Suppose that in the past the employer has given a 10 percent of pay bonus at year-end subject to the section 401(k) election. Suppose next year he eliminates the year-end bonus and instead increases everyone's salary by 10 percent and then allows them to reduce their salary up to the amount of the increase and have the reduction contributed to the section 401(k) plan. There really is no difference between the two.

Nevertheless, an issue arises in many areas of the law, both tax and nontax, as to whether salary reduction plans should be treated differently from bonus plans on the theory that salary reduction involves "employee money" whereas bonus plans involve "employer money." But see G.C.M. 38891 (1982) (distinction between salary reduction and deferring salary increase one of form, not substance).

C. What are the Advantages and Disadvantages of Section 401(k) Plans?

1. ADVANTAGES

The most obvious advantage of a section 401(k) plan is that it allows an employee flexibility in his financial planning in determining how much to take in current cash and how much to defer into a qualified tax-shelter arrangement. Salary reduction allows an employee to make a contribution to a plan out of his own salary to provide himself more retirement benefits than his employer is willing or able to provide. Since salary reduction contributions are not taxed, an employee may contribute through salary reduction the same amount he would contribute to a traditional thrift plan, except the employee would then save the income taxes he would have paid on the salary reduction amounts. That is, contributions elected by an employee are made with dollars that have already been taxed ("post-tax"), whereas such contributions to a section 401(k) plan are made with dollars that have not been taxed ("pre-tax").

Special section 401(k) rules on discrimination in contributions permit proportionately more contributions to be made for higher paid employees compared to lower paid employees than would be permissible under traditional profit sharing or stock bonus plans.

A section 401(k) plan can in many ways be used in similar fashion to an IRA, except that as much as $30,000 or 25 percent of compensation (whichever is less) may be put into the section 401(k) plan each year compared to $2,000 or 100 percent of compensation (whichever is less) for the IRA.

Salary reduction plans might also avoid the minimum 3 percent contribution requirement for top-heavy plans. This matter is discussed under Special Issues, herein.
2. DISADVANTAGES

The main disadvantage of a section 401(k) plan is that amounts in the plan used to meet the special section 401(k) antidiscrimination rules are more difficult to withdraw from the plan than amounts in traditional plans. Such section 401(k) amounts can only be withdrawn for death, retirement, disability, separation from service, attainment of age 59½ or hardship. “Hardship” under the present proposed regulations is also defined more strictly than it has been in the past for traditional profit sharing plans.

Section 401(k) plans may have stricter vesting requirements for employer contributions than traditional plans although the precise extent of the proposed section 401(k) vesting rules is not clear and this will depend on the design of the section 401(k) plan.

To the extent an employer already has a profit sharing or stock bonus plan, instituting a section 401(k) plan will involve additional start-up costs.

Depending on how the section 401(k) plan is designed, it may involve more administrative complexities and costs than a traditional plan. To the extent section 401(k) salary reduction is utilized, a participant’s earnings which are used as a basis for calculating pension benefits under a defined benefit plan would, without a change in the pension plan definition of compensation, be reduced. After lengthy consideration, the IRS has said it will permit salary reduction amounts to be included in the pensionable earnings base. Rev. Rul. 83-89, 1983-25 IRB 5.

Section 415 of the Code limits qualified defined contribution plan “annual additions” on an employee’s behalf to the lesser of 25 percent of compensation or $30,000. To the extent salary reduction is used, the Treasury regulations under section 415 currently require a reduction in the amount of compensation subject to the 25 percent limit, hence lowering the amount of contributions that can be made. However, the recent Social Security Amendments of 1983 treat section 401(k) contributions (including salary reduction) as wages for FICA purposes. It is arguable that Treasury will therefore treat salary reduction as compensation for 415 purposes.

The way the term “annual additions” is defined under section 415 actually permits an employee to contribute 6 percent of pay out of his own money in addition to $30,000 (of employee or employer money) contributed to his account. While post-tax contributions to a traditional thrift plan can be counted towards that 6 percent, salary reduction amounts are treated as employer contributions for these purposes and so are counted only under the $30,000 limit.

Since the limitations on deductions by the employer for contributions to qualified plans are also based on a percentage of compensation,
the remarks above on the effects of salary reduction on pension plans and defined contribution plans are equally applicable here.

Since the PAYSOP credit is based on a percentage of compensation as defined under section 415, salary reduction would also lower that credit.

Since salary reduction amounts are treated as employer contributions, they are fully taxable upon distribution, unlike employee contributions to a traditional savings plan.

D. History of CODAs

The history of CODAs begins with Revenue Ruling 56-497, 1956-2 C.B. 284. In this ruling the employer M company had a profit sharing plan under which all employees with three years of service were eligible to participate in the employer's annual profits. The profits shared were allocated among the employees in proportion to their compensation. Prior to the close of the calendar year, each employee was required to make an irrevocable election whether to take his share of the profits (a) in cash, (b) as a contribution to the plan, or (c) one-half in cash and one-half as a contribution.

The Service in Revenue Ruling 56-497 examined participation in the plan on a weighted basis (counting those contributing a one-half share as one-half and not counting those who did not contribute) and found that the plan did not meet the basic qualified plan coverage requirements (i.e., that a plan benefit 70 percent of all employees or 80 percent of eligible employees if 70 percent are eligible). The Service next considered whether the plan met the alternate qualified plan coverage requirements (i.e., that a plan cover a classification of employees found not to discriminate in favor of the "prohibited group"; officers, shareholders, highly compensated employees and, pre-ERISA, supervisors).

The Service observed that although higher paid employees participated more than lower paid employees, since all employees with three years of service were eligible to participate, and since over one-half of the actual participants were among the lowest paid two-thirds of employees (on the weighted basis), the plan's coverage was not discriminatory and so satisfied the qualified plan coverage requirements. The Service also noted that contributions for all employees fully participating were made as a uniform percentage of compensation and that contributions for those participating to the extent of half-shares were also a uniform percentage of compensation. Accordingly the plan met the qualified plan requirements as to nondiscrimination in contributions. As a result, the Service approved the plan as a qualified plan, entitling it to all the tax benefits of qualified plans.

This ruling showed that a qualified plan could include a CODA. It
also seems to indicate that employees would not be currently taxed on the amount they elected to have contributed to the plan on their behalf where they irrevocably elected such contributions prior to receiving their profit sharing amounts. It required as to coverage that one-half of the participants be among the lowest paid two-thirds of employees. It approved the plan even though the higher paid employees nearly all participated to the full extent whereas those electing one-half participation or no participation were generally the lower paid employees. The ruling established the principle that participation under a CODA was deemed to include only actually contributions to the plan rather than eligibility to make contributions or receive cash benefits.

_Hicks v. United States_, 205 F.Supp. 343 (W.D. Va. 1962), aff'd, 314 F.2d 180 (4th Cir. 1963), introduced the issue of constructive receipt. _Hicks_ involved a profit sharing plan qualified under section 401(a) of the Code. Forty percent of each employee's portion of the profits shared was automatically contributed to the plan. The other 60 percent would be paid to the employee in cash unless the employee elected in writing before December 1st of each year to have the entire 60 percent also contributed to the plan. The court applied general tax principles of constructive receipt and concluded that since an employee could have received the 60 percent in cash if he chose to, he would be taxed on the 60 percent as if he received it whether or not he had it contributed to the plan.

In Revenue Ruling 63-180, 1963-2 C.B. 189, the Service narrowed the applicability of the _Hicks_ case. The ruling recited a number of pertinent facts in the _Hicks_ case not mentioned in the court's opinion. First, the plan treated the elective 60 percent amounts as _employee_ contributions. Second, the trust kept a separate account for "employee contributions" (i.e., the 60 percent amounts) and the earnings thereon. Third, the 60 percent amounts could be withdrawn at any time subject to a 5 percent penalty while the 40 percent amount could not be withdrawn for five years. (Normally, employer contributions must stay in a profit sharing plan for two years or the employee must have five years of participation before such amounts may be withdrawn.) Fourth, upon resignation or discharge other than for cause, the employee received his 60 percent amounts minus a 5 percent penalty. The 40 percent portion did not vest at all for the first two years and then gradually vested from 5 percent after two years to 95 percent after 11 years for distributions prior to retirement. Fifth, in the event of discharge for cause, the employee still got the 60 percent portion less a 5 percent penalty, but only received so much of the 40 percent portion as the plan committee deemed appropriate.

In Revenue Ruling 63-180 the Service held that the 60 percent portion in the _Hicks_ case was in form and substance an _employee_ contribution. The Service further held that CODAs satisfying the re-
quirements of Revenue Ruling 56-497 (above) were distinguishable from Hicks. The ruling made clear that under Revenue Ruling 56-497 plans, elective contributions were to be treated as employer contributions and not taxed to participants until distributed in accordance with the usual qualified plan rules.

Revenue Ruling 68-89, 1968-1 C.B. 402 was issued by the Estate and Gift Tax Branch concerning the exclusion from the gross estate of qualified plan distributions and the question was whether a CODA was a qualified plan. The ruling affirmed that Revenue Ruling 56-497 and Revenue Ruling 63-180 were still good law.

Proposed Treasury Regulation section 1.402(a)-1(a)(1)(i), 37 Fed. Reg. 25938 (1972) first raised the salary reduction problem. The proposed regulation would have treated as an employee contribution any amount contributed to a qualified plan by the employee "if at his individual option such amount was so contributed in return for a reduction in his basic or regular compensation or in lieu of an increase in such compensation." By making such amounts employee contributions, the proposed regulation would have made them constructively received and so taxable to the employee at the time they were contributed to the plan. Since it is difficult to maintain any sound distinction between salary reduction and bonus plans, the publication of this regulation signaled a possible reversal in the Service's position with regard to CODAs. There was considerable question as to whether this proposed regulation, if enacted, would have been valid.

With the controversy surrounding the proposed 1972 regulation still pending, the matter was resolved by the enactment of section 2006 of ERISA. That statute provided for constructive receipt and current taxation of elective contributions to a CODA, whether bonus-type or salary reduction. It also barred the issuance of any final salary reduction regulations until January 1, 1977, to give Congress a chance to study the area. A grandfather provision permitted qualified plan CODAs in existence on June 27, 1974 to be governed by the pre-1972 law (i.e., Revenue Ruling 56-497, Revenue Ruling 63-180, and Revenue Ruling 68-89, without regard to the proposed 1972 regulation). A retroactivity limit was placed on any future salary reduction regulations so that they could not apply before January 1, 1977 for income tax purposes or before date of issuance for FICA or income tax withholding purposes. The provisions of ERISA section 2006 were extended to December 31, 1978 and then December 31, 1979 by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 1506, 90 Stat. 1739, and the Foreign Earned Income Act of 1978, Pub. L. No. 95-615, § 5, 92 Stat. 3097, respectively.

The Revenue Act of 1978 enacted sections 401(k) and 402(a)(8) of the Code, providing rules for allowing CODAs to be part of a qualified plan and providing that qualified elective CODA contributions
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would not be taxed to participants until distributed in accordance with qualified plan rules. Revenue Ruling 80-16, 1980-1 C.B. 82 then stated that CODA like the one in Revenue Ruling 56-497 would qualify as a section 401(k) plan and held that pre-1980 elective contributions to a CODA would not be subject to the section 401(k) distribution limitations if held in a separate account.

In 1981, the proposed section 401(k) regulations were published. 44 Fed. Reg. 55544 (daily ed. November 10, 1981). The Service shortly thereafter published a notice to the effect that a plan could not avoid prohibited discrimination by permitting withdrawals or "paybacks" of excess amounts or by recharacterization of elective pre-tax contributions as post-tax contributions. 47 Fed. Reg. 988 (daily ed. January 8, 1982). There has been a great deal of objection to this recharacterization notice and it is understood that the Service will reverse its position on this issue in the final regulations.

In Internal Revenue Notice 82-1, 1983-8 I.R.B. 35 the Service stated that taxpayers could rely on the proposed regulations and that the Service would apply the proposed regulations for purposes of issuing determination letters and rulings involving section 401(k) plans until final regulations were issued.

Section 324 of the recent Social Security Act made elective contributions to section 401(k) plans taxable as wages for FICA and FUTA purposes.

II. Basic Section 401(k) Rules

A. In General

A qualified profit sharing or stock bonus plan may include a qualified section 401(k) cash or deferred arrangement. Prop. Treas. Reg. § 1.401(k)-1(a)(1). (Note that only profit sharing and stock bonus plans may include qualified CODAs, not pension or money purchase plans.) The proposed regulations specifically permit the use of salary reduction in connection with qualified section 401(k) plans. The plan may also permit employer and employee contributions other than elective section 401(k) contributions. Prop. Treas. Reg. § 1.401(k)-1(a)(1).

The proposed regulations refer to contributions subject to the CODA election as "elective contributions." Prop. Treas. Reg. § 1.401(k)-1(b)(8)(iv). Elective contributions are treated as employer contributions. Some have questioned whether employer matching amounts on elective contributions are considered "elective" contributions since they are made only if an employee elects to make elective contributions. However, the definition of elective contributions in the regulations refers to amounts which an employee may elect to have contributed
or to have paid to him in cash. Prop. Treas. Reg. § 1.401(k)-1(a)(1). Since employer matches are not paid in cash to an employee, they should not be considered to be “elective contributions.”

Contributions to a section 401(k) plan other than elective contributions are called “nonelective contributions.” Prop. Treas. Reg. § 1.401(k)-1(b)(8)(iii). The term “nonelective” is a little misleading. It includes employee post-tax contributions, whether matched or unmatched. It also includes employer contributions (whether matching or not) other than those made at the employee’s election. The rules in the section 401(k) regulations cover all contributions to a section 401(k) plan whether or not they are made pursuant to a cash or deferred election.

B. Taxation

Section 402(a)(8) of the Code states that for purposes of Title 26 (i.e., income taxes, estate and gift taxes, employment taxes, excise taxes), qualified section 401(k) elective contributions are not treated as actually or constructively received by an employee nor as contributions made by the employee merely because the employee has the option of receiving the contribution in cash. This means that qualified section 401(k) elective contributions are treated as employer contributions for all tax purposes (although after 1983 they are subject to FICA taxes). (An exception is discussed below under the top-heavy rules.) This also means that employees are not currently taxed on elective contributions made to section 401(k) plans. Also, elective section 401(k) contributions are not excludable from income as employee contributions under section 72 upon distribution.

The “merely because” language suggests that under some circumstances elective contributions might be deemed to be employee contributions, constructively received and currently taxed. One such possible situation is that presented by the Hicks case discussed above. That is, if the plan designates elective contributions as employee contributions, they might be treated as such despite the section 401(k) rules. Section 414(h) of the Code says amounts contributed to a qualified plan will not be treated as employer contributions if designated as employee contributions. While it is tempting to describe elective section 401(k) contributions as “employee contributions” in a summary plan description, the above considerations may make it unsafe to do so until guidance on this issue is provided by the IRS. It is understood that the final regulations will require that elections to defer salary or bonuses under sections 401(k) and 402(a)(8) must be made before the participant would otherwise have received the amount deferred in cash. Any election made after that time would be considered constructively received under section 451 so the contribution to the plan would be
deemed to be an employee contribution. Elective contributions should be made by payroll reduction for these reasons. Cash deposits from employees should not be accepted.

The proposed regulations currently provide that a plan can have a CODA that does not meet the section 401(k) requirements and still qualify under section 401(a) of the Code. However, amounts subject to the election would be taxable to the employee in the year contributed to the plan. Prop. Treas. Regs. §§ 1.401(k)-1(a)(3), 1.402(a)-1(d). This could occur, for example, if the CODA did not meet the section 401(k) nonforfeitability and distribution rules.

Some have questioned the validity of this aspect of the proposed regulations. Under normal rules it is possible to design a plan giving employees elections as to whether to receive pay in current cash or as deferred compensation without making the employee currently taxable on amounts deferred. This is frequently done in the nonqualified deferred compensation area. See Rev. Rul. 69-650, 1969-2 C.B. 106, Rev. Proc. 71-19, 1971-1 C.B. 698. The legislative history may be read to require qualified plans with CODAs to meet the section 401(k) rules. See S. Rep. No. 1263, 95th Cong., 2d Sess. 78 (1978).

The validity of these regulations is particularly questionable in the case of money-purchase pension plans. Current legislative proposals would grandfather money-purchase pension plans which have CODAs. The possibility of legislation to permit CODAs for all money-purchase pension plans is also not ruled out. On balance it appears more likely than not, however, that the regulations would be upheld.

III. Nondiscrimination Rules

A. Basic Qualified Plan Rules: Section 401(a)

Qualified plans may not discriminate in terms of coverage in favor of the prohibited group: officers, shareholders, and highly compensated employees. Qualified plans must meet any of four coverage tests:

1. 70 Percent Test. The plan must benefit 70 percent or more of all employees.

2. 80-70 Test. The plan must benefit 80 percent or more of all employees who are eligible to benefit under the plan if 70 percent or more of all employees are eligible to benefit under the plan.

For purposes of these first two tests, employees who have not satisfied any age and service requirements for plan participation may be excluded.
(3) Classification Test. The class of employees covered is found by the Service not to be discriminatory in favor of officers, shareholders or highly compensated employees. For purposes of this test, employees who have not met any age and service requirements are not excluded. The determination of who is a highly compensated employee is determined on the basis of all the facts and circumstances. Treas. Reg. § 1.410(b)(1)(d)(1). The top one-third definition under section 401(k) does not apply here. This test has sometimes been said to require that the plan benefit employees in general or represent a fair cross-section of the employees eligible to participate. But see Federal Land Bank v. Commissioner, 74 T.C. 1106 (1980), appeal dismissed, 1981 P-H Federal Taxes ¶ 61,000 (4th Cir. March 6, 1981) (fair cross-section not required to pass this test).

(4) Tax Credit Employee Stock Ownership Plans (TRASOPs/PAYSOPs). A TRASOP or PAYSOP may pass any of the above three tests or, if it is the only qualified plan of the employer, may satisfy this fourth test, if it covers 50 percent or more of all eligible employees (excluding those who have not satisfied the age and service requirements, if any), and no more than 2 percent of any participant's compensation is allocated to his account during the year.

For purposes of the four coverage tests, the following groups of employees may be excluded:

(1) Collective Bargaining Unit. Employees not included in the plan who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that retirement benefits were the subject of good faith bargaining.

(2) Air Pilots. In the case of a trust established or maintained pursuant to an agreement which the Secretary of Labor finds to be a collective bargaining agreement between air pilots represented in accordance with Title II of the Railway Labor Act and one or more employers, all employees not covered by the agreement.

(3) Nonresident Aliens. Nonresident alien employees who receive no U.S.-source earned income from the employer.

A plan need pass the coverage requirements only one day in each quarter. I.R.C. § 401(a)(6).
Under section 401(a)(5) of the Code, a plan is not considered discriminatory merely because it covers only salaried or clerical workers, or because it excludes all employees all of whose earnings are below the Social Security wage base. Such classifications are not automatically acceptable, however.

A plan that meets the statutory qualification tests on its face might still be found to be discriminatory in operation and so disqualified. Rev. Rul. 71-263, 1971-1 C.B. 125.

An employer may designate two or more plans as a single plan in order to meet the 70 percent, 80-70 or classification tests. However, a TRASOP cannot be aggregated with any other plan. Treas. Reg. § 1.410(b)-1(d)(3). (PAYSOPs will probably be subject to the same exception).


An employee who is eligible to make contributions to a plan with matching employer contributions but who chooses not to contribute is not considered a "covered" employee in a non-CODA plan. Rev. Rul. 80-307, 1980-2 C.B. 136.

Qualified plans may not discriminate as to contributions in favor of officers, shareholders or highly compensated employees ("the prohibited group"). Section 401(a)(5) of the Code specifically permits contributions to be made as a uniform percentage of total compensation, or the basic or regular rate of compensation, even though this results in greater dollar amounts being contributed to higher paid employees than to lower paid.

If total, basic or the regular rate of compensation is not used, a uniform percentage may result in discrimination, as when bonuses for salaried employees are covered but not overtime for hourly employees. Generally, the discrimination test in such cases will compare the ratio of covered compensation to total compensation for rank-and-file employees and members of the prohibited group. Rev. Rul. 81-74, 1981-1 C.B. 175, Rev. Rul. 80-359, 1980-2 C.B. 136.

Section 401(a)(5) also specifically permits the exclusion of employees whose total earnings are less than the Social Security wage base, or the use of different contribution rates for wages under the wage base and wages over the wage base. However, plans using such Social Security differentials must comply with the Social Security integration rules in Treas. Reg. § 1.401-3(e) and Revenue Ruling 71-446, 1971-2 C.B. 187. See discussion below under Special Issues.

For plan years beginning after 1983, defined contribution plans (i.e., profit sharing, stock bonus) integrated with Social Security meet the antidiscrimination rules only if total employer contributions plus employer OASDI (i.e., FICA) contributions at the actual FICA tax rate
for each participant bear a uniform relationship to total, basic or the regular rate of compensation. I.R.C. § 401(1).

Plans may also take years of service into consideration in making contributions (i.e., 2 percent of pay for those with less than 5 years of service, 4 percent of pay for those with more) as long as prohibited discrimination does not result. Rev. Rul. 68-654, 1968-2 C.B. 179; Rev. Rul. 68-653, 1968-2 C.B. 177; Rev. Rul. 68-652, 1968-2 C.B. 176.


Matching plans present special problems. Matching plans may result in discrimination if higher matches are given for greater employee contributions, since lower paid employees may not be able to afford to contribute enough to get the higher matches. Rev. Rul. 80-307, 1980-2 C.B. 136. Matching plans are also unlikely to have employer contributions which are a uniform percentage of compensation. In a 100 percent matching plan, for example, a higher paid employee putting in 6 percent of his compensation will get a 6 percent match. A lower paid employee putting in only 3 percent will get only a 3 percent employer contribution. The extent to which such disparities in employer contributions favoring higher paid employees is permissible is not clear.

A plan will not be considered discriminatory merely because it provides for voluntary, unmatched employee contributions up to 10 percent of compensation. Rev. Rul. 80-350, 1980-2 C.B. 133. A plan may even provide such 10 percent voluntary contributions on top of mandatory employee contributions and voluntary employee matched contributions. Rev. Rul. 81-234, 1981-2 C.B. 89. Plans described above may still discriminate in practice. For example, if voluntary, unmatched contributions may be made only after employee matched contributions of 15 percent of compensation are made, the plan may discriminate if only higher paid employees can contribute more than 15 percent.

B. General Section 401(k) Rules

The proposed section 401(k) regulations provides two sets of anti-discrimination rules, the “General” rules and the “Special” rules. The General rules are discussed here, the Special rules below.

The General section 401(k) coverage rule is met if either the “eligible” employees or the “covered” employees meet the section 410(b)(1) coverage tests (discussed above). Prop. Treas. Reg. § 1.401(k)-1(b)(3). “Eligible” employees are defined as those eligible for employer contributions (whether or not elective) under the plan
for that year. Prop. Treas. Reg. § 1.401(k)-1(b)(8)(i). (Employees who may be eligible in later years, i.e., after completing a year of service, are not considered “eligible employees” for these purposes.) “Covered” employees are defined as those whose accounts are credited with a contribution (whether or not elective) under the plan for that year. Prop. Treas. Reg. § 1.401(k)-1(b)(8)(ii). This rule is different from the rules for other qualified plans. Under Revenue Ruling 80-307, 1980-2 C.B. 136, participants who are eligible to contribute but choose not to are not considered to benefit from the plan for purposes of the coverage test. Under the General section 401(k) rule, they may be counted.

The plan must satisfy the section 401(a)(4) rules against discrimination in contributions, considering either the eligible employees or the covered employees, whichever group was used to satisfy the coverage test. Normally an employer would prefer to use the group of eligible employees, the larger group, in order to meet the coverage tests. However, this will make it more difficult to pass the contributions test, since some eligible employees will not contribute, lowering the contribution average for their salary brackets. Therefore if the group of covered employees passes the coverage test, it will be easier to pass the contributions test.

In certain ways the General test is easier to meet and in some ways harder to meet than the Special test (discussed below). The Special test requires the plan to average in a 0 percent contribution for those not contributing whereas the General test allows the exclusion of non-contributing employees (assuming the covered employees pass the coverage test). On the other hand, the General test refers to section 401(a)(4) which generally requires contributions to be a uniform percentage of compensation whereas the Special rules specifically permit a higher percentage of compensation to be contributed on behalf of higher paid employees than for lower paid employees.

C. Special Section 401(k) Rules

The group of eligible employees must pass the section 410(b)(1) coverage tests (discussed above). For purposes of section 410(b)(1), all eligible employees are considered to benefit from the plan, whether or not contributions are made on their behalf to the plan. Again, this differs from the usual rule for qualified plans that noncontributing eligible employees are not considered to benefit for purposes of the coverage test. Rev. Rul. 80-307, 1980-2 C.B. 136.

To meet the Special contributions rules, a plan must satisfy the 1.5 test or the 2.5 test. The 1.5 test is satisfied if the Actual Deferral Percentage (ADP) for the eligible highly compensated employees (top one-third) is not more than the ADP of all other eligible employees (lower two-thirds) multiplied by 1.5.
Example: If lower two-thirds ADP is 4 percent, the maximum top one-third ADP is 4 percent × 1.5 = 6 percent.

The 2.5 test is satisfied if the top one-third ADP is not more than the lower two-thirds ADP multiplied by 2.5, and the top one-third ADP is not more than 3 percent more than the lower two-thirds ADP.

Example: If lower two-thirds ADP is 4 percent, the maximum top one-third ADP is the lesser of 4 percent × 2.5 = 10 percent, or 4 percent + 3 percent = 7 percent. Hence the limit is 7 percent.

The 1.5/2.5 tests may be integrated as follows:

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<thead>
<tr>
<th>If lower ( \frac{2}{3} ) ADP (LADP) is:</th>
<th>The maximum top ( \frac{1}{2} ) ADP is:</th>
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<tbody>
<tr>
<td>0%</td>
<td>0%</td>
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<tr>
<td>Greater than 0% and less than 2%</td>
<td>( \frac{2}{3} ) LADP × 2.5</td>
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<tr>
<td>At least 2% and less than 6%</td>
<td>( \frac{2}{3} ) LADP + 3</td>
</tr>
<tr>
<td>6% or greater</td>
<td>( \frac{2}{3} ) LADP × 1.5</td>
</tr>
</tbody>
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The term "highly compensated employee" is defined for purposes of ADP to mean any eligible employee who receives, with respect to compensation taken into account for that plan year, more compensation than two-thirds of all other eligible employees. Prop. Treas. Reg. § 1.401(k)-1(b)(8)(vii). The numbers of one-third and two-thirds of the eligible employees are rounded to the nearest integer. Prop. Treas. Reg. § 1.401(k)-1(b)(8)(vii).

Example 1: In a plan involving only two employees the higher paid employee would be treated as highly compensated. Since only other employees are counted, he will have more compensation than 100 percent of the other employees (not 50 percent).

Example 2: In a plan involving 100 employees, highly compensated employees are those with more compensation than 66 other employees (i.e., two-thirds × 99 others), not 67 (2/3 × 100).

Example 3: If a firm had five employees earning $100,000 and five earning $10,000, none would be considered highly compensated under this rule since none receives more than two-thirds of the others.

Example 4: If a firm had five employees earning different salaries over $100,000 and five earning $10,000, but the plan
only counted the first $10,000 of compensation, no one would be highly compensated under this rule because, generally, only compensation counted under the plan is considered.

The effect of having no one considered highly compensated would be that there would be no limit on the amount of ADP ratio deferrals employees could make. It is not clear how the IRS would deal with Examples 3 and 4, but it might invoke the discriminatory compensation clause discussed below. Note that the examples in the proposed regulation disregard the reference to other employees. The examples use a group of nine employees and consider the top three as highly compensated, the bottom six as the lower two-thirds. But if only other employees are considered, the lower two-thirds would be two-thirds multiplied by eight, giving 5.3, rounded to five as the nearest integer.

Note that the definition of “highly compensated” in the section 401(k) regulations only applies to ADP under the Special rules. Plans qualifying under the General rules must show no discrimination in favor of highly compensated employees as that term is used under section 401(a)(4), and for which there is no precise definition.

Because of the mechanical definition of “highly compensated employees” in the Special rules, it may include many employees not generally thought of as highly paid. If a company has a considerable number of very low paid employees, it might find the dividing line between the top one-third and lower two-thirds to be, for instance, at the $10,000 a year level. Since many employees earning just over $10,000 may not be able to afford to contribute to the plan, they will lower the top one-third ADP, making compliance with the antidiscrimination rules easier.

The lower two-thirds group is made up of all eligible employees other than the highly compensated employees.

The ADP for the top one-third and lower two-thirds for a plan year is the average of the ratios, calculated separately for each employee in such group, of the amount of employer contributions paid under the plan on behalf of each such employee for such plan year, to the employee’s compensation for such plan year. Prop. Treas. Reg. § 1.401(k)-1(b)(8)(v). Employer contributions include amounts contributed at an employee’s election, even if on a salary reduction basis. Who is counted? All eligible employees. For example, assume an employer has 130 employees, 110 in Division A and 20 in Division B. Assume that the plan covers only Division A and that 10 Division A employees have not met the age and service requirements for participation. The remaining 100 Division A employees are eligible to make contributions to the plan and hence are eligible employees. If only 85 actually make elective contributions to the plan, only those 85 are “covered” employees. The other 15 eligibles must be averaged into ADP at a 0 percent rate. The 20 Division B employees and 10 Division A employees who have not
met the age and service requirements are excluded from the ADP calculations.

It should also be possible in the preceding example to exclude Division B employees from the ADP calculations even if they are included in the plan as far as post-tax contributions go, if they are not permitted to make any elective contributions under the CODA part of the plan.

Employee compensation is defined under the proposed regulations as the amount taken into account under the plan prior to calculating the contribution made on behalf of the employee under the deferral election.

Example 1: Bonus Plan. Suppose an employer has a bonus-type section 401(k) plan. If an employee has a salary of $100, and the employer offers a 10 percent bonus equal to $10 subject to the section 401(k) deferral election, the proposed regulations would count $100 as compensation for ADP purposes.

Example 2: Salary Reduction Plan. Suppose an employer has a salary reduction-type plan, permitting deferrals of up to 10 percent of compensation. An employee earning $100 could defer $10. The language of the proposed regulations would still count $100 as compensation for ADP purposes. This gives the salary reduction format an advantage over the bonus format since the deferred amount is included in compensation.

Because of the proposed regulations' disparate treatment of bonus-type and salary reduction-type plans, the final regulations may contain a different rule. One possibility is to treat as compensation total compensation (including any amount subject to the deferral election) minus the maximum amount of deferral (whether or not actually taken). This would put bonus and salary reduction plans on an equal footing.

While the proposed regulations generally look only to compensation as counted under the plan, if such amount has the effect of discriminating against the lower two-thirds, a nondiscriminatory definition shall be determined by the IRS. Prop. Treas. Reg. § 1.401(k)-1(b)(8)(vi). The IRS might exercise this power if, for instance, the plan counted salaried employees' bonuses as compensation but not the overtime of hourly employees. The IRS might also use this to prevent the occurrence of the situations in Examples 3 and 4 discussed above under the definition of "highly compensated employee." In Example 3 (five employees earning the same $100,000 amount), the Service might try to redefine compensation so that each $100,000 employee would be deemed to earn more than the other $100,000 employees for purposes of determining who was highly compensated. In Example 4 (plan only counts $10,000), the IRS might count actual compensation. Beyond these instances, this nondiscriminatory compensation clause introduces consid-
erable uncertainty under section 401(k) which was intended to be mathematically precise and clearcut.

It is permissible for a plan to calculate plan compensation other than on a plan year basis if it is calculated on a reasonable and consistent basis. If the plan is on a fiscal year basis, the employer may wish to use the calendar year to determine compensation. The use of a half year's compensation does not seem to be barred as long as it is nondiscrimina-
tory (*i.e.*, year-end bonus might skew a half-year basis).

An employer could probably use the previous year's compensation. This might generally simplify the antidiscrimination calculations since less estimation would be involved, but a way to cope with new em-
ployees and terminating employees would have to be determined. If a plan requires three years of service to participate, the new employee problem could be reduced.

Another technique might be to use one year for the lower two-thirds and the next year for the top one-third. In this way, the lower two-thirds contributions and ADP could be determined before the top one-third had to make their deferral amount decisions. However, allocations for a year cannot depend upon participation in the plan after year-end, Prop. Treas. Reg. § 1.401(k)-1(b)(7)(i), and this might be inter-
preted to bar this technique.

**D. Section 401(k) Arrangements Alone**

Where section 401(k) arrangements exist alone, that is, where the plan consists only of election section 401(k) contributions, the plan can qualify by satisfying either the General section 401(k) rules or the Special rules.

**E. Combined Plans**

A plan including both elective and nonelective contributions can qualify by satisfying any one of three tests:

1. The combined elective and nonelective portions satisfy the General section 401(k) rules. The legislative history might be read to pre-

2. The nonelective portion satisfies the General section 401(k) rules and the elective portion satisfies the Special Rules.

3. The nonelective portion satisfies the General section 401(k) rules and the combined elective and nonelective portions satisfy the Special rules. For purposes of this test, the nonelective portion is counted under the Special rules only to the extent that the nonelective contribu-
tions are immediately 100 percent vested and nonforfeitable and subject
to the section 401(k) distribution limitations (discussed below). There is no provision for testing both elective and nonelective contributions solely under the Special rules. As is discussed below, it is hoped the final regulations will provide for this in the case of matching plans.

F. Nondiscriminatory Total Deferrals

The regulations provide a further nondiscrimination requirement for all section 401(k) arrangements: the total amounts subject to deferral on behalf of both the higher and lower paid employees must be nondiscriminATORY. Treas. Reg. § 1.401(k)-1(b)(6). This means that all employees must be able to defer the same percentage of compensation. That is, a plan could not allow the lower two-thirds to defer 10 percent while allowing the top one-third to defer 15 percent, even though 10 percent and 15 percent meet the 1.5 rule. Both groups would have to be able to defer the same percentage, whether or not they actually do. This does not mean both must have the same percentage subject to an election. The Preamble to the proposed regulations specifically contemplates allowing a 10 percent nonelective contribution and 5 percent elective contribution option for the lower two-thirds with the top one-third getting no nonelective contribution but a 15 percent elective contribution option.

G. Special Nondiscrimination Issues

Many employers are unaware that they can have two identical section 401(k) plans, one for salaried employees and one for hourly-paid employees, if each can pass the nondiscriminatory coverage test on its own. This may be helpful if it is anticipated that hourly employees will not participate much and so will lower the deferral ratios of salaried employees if they were all combined in a single plan. Since it is possible to exclude bargaining unit employees entirely for coverage purposes (if there is good faith bargaining) could the section 401(k) Special deferral rules be computed separately for bargaining unit employees and all other eligible employees even if they are combined in a single plan? Probably not, although this is not clear.

As discussed above, there is a limit on voluntary employee post-tax contributions to qualified plans of 10 percent of compensation. Rev. Rul. 81-234, 1981-2 C.B. 89; Rev. Rul. 80-350, 1980-2 C.B. 133. Are elective section 401(k) contributions counted towards that 10 percent limit? No. Is the compensation against which the 10 percent limit is measured reduced by section 401(k) elective contributions? The answer to this is not clear. Cf. Rev. Rul. 83-89.

As discussed above, matching plans face special problems. Since higher paid employees are likely to put in more employee contributions,
they are likely to get employer matching contributions which are a higher percentage of compensation than those for lower paid employees. As mentioned, this is problematic under section 401(a)(4), which generally requires contributions to be a uniform percentage of compensation at most.

Section 401(k) matching plans must test the matching portion under the General rules and so the problem may become acute, given the special restrictions required under section 401(k) to take advantage of section 401(k)'s allowance of higher percentage contributions for higher paid employees. Some feel that the Service may simply apply a 1.5/2.5 type test to the matching portion even under the General rules. Others fear the Service may apply a stricter test. Because of the particular situation of matching plans, the Service has been urged to consider revising the regulations to permit the combined elective and matching portions to be tested solely under the Special 1.5/2.5 tests. It is not likely that the final regulations will adopt this suggestion.

One possible solution may be to set up two plans, one for the section 401(k) contributions, another for the matching amounts. In this way discrimination problems with regard to the matches might be confined to the one plan without threatening disqualification of the section 401(k) plan as well.

Some plans may try to pass the coverage requirements of the classification test rather than the 70 percent of 70-80 tests. Such plans should consider *Federal Land Bank v. Commissioner*, 74 T.C. 1106 (1980), *appeal dismissed*, 1981 P-H Federal Taxes ¶ 61,000 (4th-Cir. March 6, 1981). That case involved a salary reduction matching plan and the court considered as one of the factors in the test for discrimination the group of employees eligible to participate, not just those actually participating.

**H. Time When Contributions Credited.**

For purposes of the General or Special section 401(k) nondiscrimination rules, contributions are considered made for a particular plan year if allocated to a participant's account as of any date within that plan year, and

(1) Such allocation is not dependent upon participation in the plan as of any date subsequent to that date (This does not mean ordinary nonvested amounts may not be counted under the General rules. Rather it applies to a case where, for example, allocations are made on March 1, 1983, “as of” December 31, 1982, and only participants who were in the plan in 1982 and are still in the plan on March 1, 1983 receive contributions. In such a case, the contributions could not be counted for 1982 since they depend on service up to March 1, 1983.).
(2) Nonelective contributions must be made within the section 404(a)(6) period (i.e., time for filing return plus extensions granted) applicable to the taxable year with or within which the particular plan year ends; and

(3) Under the proposed regulations elective contributions must be made to the plan no later than 30 days after the end of the plan year. Prop. Treas. Reg. § 1.401(k)-(1)(b)(7)(iii). (There has been a great deal of objection to this 30-day limit as being too short to be administratively practicable. There is some expectation that the Treasury will modify the regulations to provide for a longer period, perhaps even the section 404(a)(6) period, the same as for nonelective contributions.)

I. Nonforfeitability

Elective contributions and nonelective contributions used to satisfy the Special nondiscrimination rules and the earnings on both such amounts must satisfy the nonforfeitability rules of Proposed Treasury Regulation section 1.401(k)-1(c). Such contributions must be:

(1) Nonforfeitable (i.e., 100 percent vested) within the meaning of section 411(a) of the Code (without regard to section 411(a)(3), relating to certain permissible forfeitures);

(2) Disregarded for purposes of applying the vesting rules of section 411(a) to other contributions;

Example: Suppose an employee has $100 in his account and is 50 percent vested (i.e., $50 worth). This year he becomes 60 percent vested. If the employee makes a $10 elective section 401(k) contribution to the plan (or makes a $10 nonelective contribution which is counted for the Special rules), the plan must not only vest that $10 100 percent, but also cannot count it towards vesting in the rest of the account. Rather he must vest an additional $10 of other money so that the account contains $10 of vested elective section 401(k) money (or Special rule nonelective section 401(k) money) and $60 of other vested money, for a total of $70 vested.

(3) And, such contributions must remain nonforfeitable, even if there are other plan years in which there were no qualified deferrals under a cash or deferred arrangement (e.g., if the section 401(k) plan is converted into a regular profit sharing plan, the section 401(k) amounts must still remain 100 percent vested).

It is not entirely clear just what vested amounts would satisfy the nonforfeitability rules. The example in the proposed Treasury regulations under section 1.401(k)-1(c) says that elective contributions must
be nonforfeitable at all times. This is because elective amounts could have been received by the employee in cash, and so for vesting purposes should always be 100 percent vested.

For nonelective contributions used to meet the Special tests, the answer is less clear. If the plan provides that such amounts are immediately and always 100 percent vested, that would clearly satisfy the nonforfeitability rules.

If the plan provides for graduated vesting of nonelective contributions over a number of years, nonelective contributions made by participants who are 100 percent vested should be able to be counted under the statute. Section 401(k)(2)(C) seems to require only that elective contributions must be fully vested. While this aspect of the proposed regulations was protested, it is likely that the final regulations will not be different in this respect.

If the plan provides that a certain percentage (i.e., 50 percent) of every nonelective contribution will always be 100 percent vested and the rest subject to some form of delayed vesting, the 100 percent vested amount could be counted towards the Special 1.5/2.5 ADP tests.

If the plan provided that for the first year of participation, 20 percent of the nonelective contribution would be 100 percent vested, in the second year 40 percent, the third 60 percent, the fourth 80 percent, the fifth 100 percent, with all nonvested amounts subject to 10-year cliff vesting, would the 100 percent vested amounts be counted toward the Special 1.5/2.5 tests? They probably should be, although this is less clear.

Again, suppose the plan provides for graduated vesting and suppose that during the year $10 more already in the plan (from contributions in prior years) vest in an employee's account. Could such amounts be counted as nonelective contributions under the Special rules? No. Under the contribution timing rules, if a contribution is not counted for the year for which it is contributed, it may never be counted towards the Special 1.5/2.5 tests.

J. Distribution Limitations

CODAs are subject to the general qualification rules applicable to profit sharing and stock bonus plans (except to the extent modified by section 401(k)) and are also subject to the special rules of section 401(k).

The general rules are that the plan must provide a definite predetermined formula for distributing the accumulated funds after a fixed number of years, the attainment of a stated age, or the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. Reg. § 1.401-1(b)(1)(ii). A "fixed number of years" means at least two years. Rev. Rul. 71-25, 1971-2 C.B. 184.
Distribution may also be made after a specified period of participation, such as five years. Rev. Rul. 68-24, 1968-1 C.B. 150. “Hardship” is an event described in regulation section 1.401-1(b)(1)(ii) and provision may therefore be made for distribution because of “hardship,” subject to the rules discussed in II below. Rev. Rul. 71-224, 1971-1 C.B. 124.

The special section 401(k) rules are that amounts attributable to employer contributions made pursuant to the employee’s election may not be distributable earlier than upon retirement, death, disability or separation from service, hardship, or the attainment of age 59½, and will not be distributable merely because of completion of a stated period of participation or the lapse of a fixed number of years. Code § 401(k)(2)(B). In other words, prior to age 59½, distributions allowed under the general qualification rules after the elapse of a stated period are not permitted for elective CODA contributions; distribution on account of a stated age may not be sooner than age 59½; distributions on account of layoff are allowable only if it is a “separation from service”; and distribution on account of illness is allowable only if it is a “hardship.” Under the proposed regulations, these rules also must apply to nonelective contributions which are used to satisfy the special CODA nondiscrimination tests. Prop. Reg. § 1.401(k)-1(b)(ii) and (iv) and § 1.401(k)-1(d).

K. Hardship Distributions

According to Revenue Ruling 71-224, 1971-1 C.B. 124, the term “hardship” must be defined in the plan, the plan rules with respect to hardship must be uniformly and consistently applied, and the distributable portion must not exceed the employee’s vested interest.

Private rulings indicate approvals of plan provisions allowing distributions for a wide range of “hardship” events, including home purchase or renovation, education of the participant and his family, death of a family member, and loss of earnings due to illness, injury or layoff. See, e.g., PLR 7941026 (1979), PLR 7905028 (1978), PLR 7904097 (1978), PLR 7835062 (1978), PLR 7827050 (1978).

The higher education of a participant’s children and the purchase of a residence are mentioned in explanations prepared by the Joint Committee Staff prior to enactment and following enactment. See BNA Daily Report for Executives No. 176 at J-11 (1978) and Joint Committee on Taxation, General Explanation of the Revenue Act of 1978, H.R. 13511, 95th Cong. at 99 (1979).

Proposed regulation section 1.401(k)-1(d)(2) provides that a hardship distribution must be necessary in light of immediate and heavy financial needs of the employee, it 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, and the
determination of the existence of the financial hardship and the amount
distributed to meet the need created by the hardship must be made in
accordance with uniform and nondiscriminatory standards set forth in
the plan.

L. Loan Provisions

A loan provision must be structured and administered so as not to
adversely affect the qualification of the plan and compliance with
special rules of section 401(k). The IRS has ruled that a qualified
plan may contain a provision for loans to participants. Rev. Rul.
rulings state that:

(1) Loans must be adequately secured;

(2) Loans must bear a reasonable rate of interest;

(3) Loans must provide for repayment within a specified period of
time; and

(4) The loan provision must be administered in a uniform and
nondiscriminatory manner.

The exclusive benefit rule must be observed. Code § 401(a)(2);
Rev. Rul. 69-494, 1969-2 C.B. 88. If loans are participant-directed
investments, this problem may be mitigated. ERISA's 404(c). See
discussion below.

If a loan is treated as a distribution, unless there is a hardship or
the participant has reached age 59½, the plan will fail to meet the
special rules of section 401(k)(2)(B). Also, in this case repayments
could violate the 10 percent "rule of thumb" on voluntary contribu-
TEFRA changes below. The IRS has ruled that an adequately secured
loan bearing a reasonable rate of interest and providing for repayment
within a specified period of time will not normally be treated as a
distribution unless there is a tacit understanding between the parties
that collection is not intended or the transaction does not create a

If a loan is secured by an account balance, but at the time of default
there is no hardship or termination of employment and the participant
is under age 59½, a levy on the account balance may constitute dis-
tribution, thus violating Code section 401(k)(2)(B). This may mean
the loan is not adequately secured, creating qualification problems and
also violating the prohibited transaction rules. The ERISA limits on
annual additions must be met. Code § 415(c). Repayments of prin-
Principal do not count as annual additions. Reg. § 1.415-6(b)(3)(ii). Interest payments do not count as annual additions if allocated in the same manner as investment earnings, Rev. Rul. 75-481, 1975-2 C.B. 188, or there are participant-directed investments. Rev. Rul. 69-421, Part 5(r), 1969-2 C.B. 59; PLR 8152130, Sept. 30, 1981. If a loan is treated as a distribution, even if the participant has reached age 59½ or incurred hardship, repayment will count under Code section 415. But see discussion on TEFRA changes below.

Qualified plans must prohibit assignment or alienation. Code § 401(a)(13). Participant loans are a statutory exception to the extent exempt from the prohibited transaction rules.

A loan provision must be structured and administered so as to avoid violation of the prohibited transaction rules and to comply with the fiduciary responsibility rules of ERISA. A loan to a "party in interest" (which includes an employee) is a prohibited transaction under ERISA section 406(a)(1)(B). A loan to a "disqualified person" (which includes an employee receiving 10 percent or more of employer's wages paid, or an officer, director, etc.) is a prohibited transaction under Code section 4975(c)(1)(B). There is, however, a statutory exemption (ERISA § 408(b)(1) and Code § 4975(d)(1)) for loans which meet the following five requirements:

(1) Loans must be available to all participants and beneficiaries on a reasonably equivalent basis. ERISA § 408(b)(1)(A); Code § 4975(d)(1)(A). Availability on request should satisfy this requirement if there is full disclosure of such availability.

(2) Loans must not be available to highly compensated employees, officers, or shareholders in an amount greater than is available to other employees. ERISA § 408(b)(1)(B); Code § 4975(d)(1)(B). Availability of the same percentage of vested account balance will satisfy this requirement. See ERISA Conference Committee Report, H.R. Rep. No.1280, 93d Cong., 2d Sess. at 312 (1974).

(3) Loans must be at reasonable rate of interest. ERISA § 408(b)(1)(D); Code § 4975(d)(1)(D). The DOL says this is an objective standard, i.e., the loan must provide a fair return consistent with the prevailing rate, which is flexible depending upon what others in the lending business would charge depending on term, security, repayment provisions, etc. DOL Advisory Opinion 81-12A, January 15, 1981. State usury laws may mandate a lower rate, but the DOL says ERISA § 514 preempts these laws. DOL Advisory Opinion 81-70A, Sept. 9, 1981. But state law criminal penalties may not be preempted. See ERISA § 514(b)(4).
(4) Loans must be adequately secured. ERISA § 408(b)(1)(E); Code § 4975(d)(1)(E). If not in excess of the vested account balance, compliance involves a promissory note and a security agreement pledging the account balance. A U.C.C. financing statement is not required because a pledge is involved. U.C.C. § 9-302(1)(a).

But note that the vested account may not be adequate security if the plan cannot foreclose without violating section 401(k)(2)(B), unless the participant loses his job on default, other assets are available as security in lieu of foreclosure on his account balance, and/or foreclosure may be postponed (and interest will continue to accrue) until termination of employment.

(5) Loans must be made in accordance with specific plan provisions. ERISA § 408(b)(1)(C); Code § 4975.

A loan is a plan investment and plan investments must be prudent. ERISA § 401(a)(1). Relevant factors in determining prudence are diversification, liquidity, protected return, and opportunity for gain and risk of loss. DOL Reg. § 2550.404(a)-1(a). Directed investment accounts eliminate concern about prudence from the standpoint of the plan. ERISA § 404(c). A "broad range of investments" must be provided. ERISA Conference Committee Report, H. Rep. No. 1280, 93d Cong., 2d Sess. (1974) at 305-306. No regulations have been issued on what constitutes "individual control." See DOL Advisory Opinion No. 77-35, April 22, 1977.

M. TEFRA Loan Rules (Code § 72, TEFRA § 263)

For loans from qualified plans made after August 13, 1982, TEFRA tightens the rules, but without changing the present prohibited transaction rules and fiduciary standards. A loan—or an assignment or pledge of a participant's interest—is treated as a taxable distribution unless certain conditions are met. I.R.C. § 72(p)(1).

A loan will be treated as a taxable distribution to the extent the loan, together with any other outstanding loans made after August 13, 1982, exceeds the lesser of $50,000 or one-half of the present value of the employee's vested accrued benefit, but not less than $10,000. I.R.C. § 72(p)(2). For example, the maximum nontaxable loan for a participant with a $200,000 vested benefit is $50,000, and the maximum loan for a participant with a $15,000 vested benefit is $10,000.

For purposes of determining the dollar limits, all the plans of all employers aggregated by section 414(b), (c) and (m) of the Code (i.e., controlled groups, businesses under common control and affiliated
service groups) are counted as a single plan. I.R.C. § 72(p)(2)(C). The rules seem to permit an employee to get more than one loan from plans of unrelated employers with each loan separately subject to the limits.

There is no explicit bar against counting qualified voluntary employee contributions (QVECs) amounts toward the employee's vested benefit for loan limit purposes. The TEFRA rules also would permit loans and pledges of QVECs without tax consequences if the loans qualified under the new loan rules. This may not have been intended, however, so its future status is unclear. The Technical Corrections Act of 1983 would eliminate QVEC loans or counting QVEC amounts.

The amount of the limit is determined at the time the loan is made. If the value of the account decreases thereafter, it will not cause the loan to be treated as a distribution if the limits are thereby exceeded. Staff of the Joint Committee on Taxation, 97th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 296 (Comm. Print 1982) (“TEFRA Bluebook”).

Even a loan that meets the fiscal limits will be treated as a distribution unless the loan by its terms must be repaid within five years. A loan applied toward the acquisition, construction, reconstruction, or substantial rehabilitation of the participant's principal residence or the principal residence of one of his family members must be repaid within a "reasonable time." I.R.C. § 72(p)(2)(B). According to the TEFRA Conference Committee Report, a "principal residence" includes a house, apartment, condominium, or mobile home not utilized on a transient basis that is used, or will be used within a reasonable time, as a principal residence. H.R. Rep. No. 760, 97th Cong., 2d Sess. 620 ("Conference Report").

Whether a loan meets the five-year rule is determined on the date the loan is made. Conference Report at 619. A loan that is treated as a taxable distribution because the repayment schedule is too long does not become a nontaxable loan merely because it is repaid within five years. Id. If a loan that originally qualifies under the five-year rule is extended beyond the five-year period, the balance of the loan at the time of the extension is treated as distributed. Id. TEFRA does not require any particular repayment schedule within the five-year limit; therefore, it appears that "balloon" payment loans are permitted. TEFRA also leaves open the question whether the loan term can extend beyond the normal retirement date. Under prior law, the Service took the position that the normal retirement age was the outside limit on the term of a loan to avoid having the loan treated as a distribution. See Employee Plans Examination Guidelines Handbook § 614.3(3).

The Conference Report provides an exception to the new loan rules
when a plan invests in residential real estate mortgages as part of an 
"investment program" and the amount of the mortgage loan does not 
exceed the fair market value of the property purchased with the loan 
proceeds. Conference Report at 620. An investment program will exist 
when the trustees determine that a specific percentage or amount of plan 
assets will be invested in residential mortgages. The exception does not 
apply to investments made under individually-directed investment 
programs.

Although the Conference Report does not say so explicitly, the 
Senate Finance Committee Report and a floor statement by Senator 
Packwood indicate that the exception applies only if the mortgage loan 
is fully secured by the property purchased with the loan proceeds—and 
perhaps secondarily secured by the participant's account balance. While 
the Conference Report also states that the exception does not cover 
investment loans that benefit an officer, director, or owner, a colloquy 
between Senators Packwood and Dole on the Senate floor attempts to 
nullify the effect of this sentence.

The investment-loan exception is fairly narrow in scope. Like any 
other participant loan, an investment-type loan is subject to the pro-
hibited transaction rules as an extension of credit between the plan and 
a party in interest. If the exemption applies only when the program is 
limited to a percentage of plan assets, the statutory loan exemption, 
which requires that loans be available to all participants and bene-
ficiaries on a reasonably equivalent basis, may not be satisfied simul-
taneously. Therefore, as a practical matter, the investment-loan excep-
tion may be available only for loans that are exempted from the 
prohibited transaction rules under the Department of Labor's recent 
exemption covering certain mortgage loans, or participation interests 
in such loans, that are made or purchased at the discretion of an inde-
pendent "qualified real estate manager." See Class Exemption for In-
vestments in Residential Mortgage Financing Arrangements, Prohibited 
Transaction Exemption 82-87 (May 18, 1982).

According to the Senate Finance Committee Report, a loan will not 
be treated as a distribution for plan qualification purposes just because 
it is taxable under the new rules. Nonetheless, cash and deferred plans 
and pension plans are not free to structure loans without regard to plan 
qualification. 1 S. Rep. No. 494, 97th Cong., 2d Sess. 321. See also 
TEFRA Bluebook at 298.

For example, if a participant in a pension plan or a cash or deferred 
arrangement fails to repay a five-year loan that is secured by his ac-
count balance, a levy on the account before the participant terminates 
employment—or, in a cash or deferred plan, before age 59½ or the 
ocurrence of "hardship"—will affect plan qualification. See Rev. Rul. 
Similarly, if a five-year loan is extended beyond the original five-year term, the extension of the loan may indicate that collection was never intended and that a "distribution" has been made for both income tax and qualification purposes.

Loans treated as distributions by the new rules will normally be taxable under section 72. Accordingly, no tax will actually be paid unless the amount of the loan exceeds the amount of nondeductible employee contributions to the plan. There is an indication in the legislative history that special 10-year averaging, capital gain treatment, and rollover treatment would not be available for such loans. 1 S. Rep. No. 494, 97th Cong., 2d Sess. 320, n.2; TEFRA Bluebook at 297, n.2. While this would normally be the case, it is not clear whether such a bar on the various special tax provisions would apply if the whole account was involved so that a lump-sum distribution resulted. If the loan amount is treated as distributed, but the loan is still considered an asset in the employee's account, there could not be a distribution of the balance to his credit and so lump-sum treatment could not be obtained. Also unclear is whether this legislative history is meant to apply only to loans made taxable by the TEFRA rules, or also to loans treated as distributions upon default and those treated as distributions because they are shams.

Repayments of loans (including loans treated as distributions) are not to be considered employee contributions for purposes of the section 415 contribution limitations or the 10 percent limit on voluntary nondeductible employee contributions. 1 S. Rep. No. 494, 97th Cong., 2d Sess. 321; TEFRA Bluebook at 297. It is not clear whether this is meant to extend to loans treated as distributed because they were shams or because of the liquidation of an employee's account to pay off a loan upon default. Repayments of loans treated as distributions are added to the employee's basis in the plan so they will not be taxed again upon later distribution from the plan.

Loans to owner-employees (sole proprietors of unincorporated trades or businesses) or shareholder-employees of Subchapter S corporations (employees or officers who own more than 5 percent of the outstanding stock of the corporation) are still treated as prohibited transactions. I.R.C. § 4975(d).

Loans taxable at the time they are made will be subject to the pension withholding rules. Conf. Rep. at 584-85, TEFRA Bluebook at 237. No withholding is required on a loan amount that is treated as a distribution made on a date subsequent to the date on which the loan was made. TEFRA Bluebook at 238.

Although the new law applies generally to loans made after August 13, 1982, a loan that is outstanding on August 13, 1982 may be renewed or extended without being considered to be a new loan as long
as the loan must be repaid on or before August 13, 1983, and it is in fact repaid before that date. TEFRA § 236(c); Conference Report at 620.

Plans that are already offering participant loans may have to be revised if only nontaxable loans are to be available. But there is no apparent reason why taxable loans cannot be offered by a plan that can make in-service distributions, even if the participants are unlikely to want those loans.

N. TEFRA Distribution Rules

Under present law, qualified corporate plans have not been subject to any mandatory statutory requirements concerning the commencement of distributions and the periods of payout, like those applicable to Keogh plans and IRAs. Rather, the corporate plans have been governed by an administrative rule which required generally that the method of payout should cause the retiree to receive, over his life expectancy at retirement, more than 50 percent of the total present value of his benefits at retirement. Rev. Rul. 72-241, 1972-1 C.B. 108.

TEFRA specifies the latest permissible commencement date for distributions and prescribes a maximum payout period. Plans and IRAs must provide that:

1. Distribution commences by the later of age 70½ or retirement. Key employees in top-heavy plans must always commence distribution at 70½ without regard to retirement.

2. Distribution must be either in the form of a joint and survivor annuity with the employee's spouse or be made over a period that does not exceed the employee's—or the employee's and his spouse's—life expectancy.

3. If unpaid amounts remain at the death of the employee—or, if distribution has commenced under a form of payment that continues to the employee's spouse, at the death of the spouse—distribution must be completed within five years, unless the benefits commenced under a payout method that spreads payments over a period measured by the life expectancy of the employee and his spouse, in which case distribution may continue under that method.

4. It is not clear whether qualified plans can periodically recalculate life expectancy, as under the old Keogh rules, or only up to age 70½, as under the IRA rules.

These rules are effective for plan years beginning after 1983, but if a designation under the old rules is on file before the end of 1983, that designation will be honored even if it does not satisfy the new rules.
Although the incentive for a lengthy postponement of distributions is significantly reduced by the new limitation on the estate tax exclusion, some employees may wish to file a designation before 1984 to take advantage of the old rules for purposes of the $100,000 exclusion and the continued income tax advantages of deferral. Employers may also consider amending their qualified defined contribution plans prior to 1984 to offer the alternative of postponing the commencement of distributions until age 70 1/2 in accordance with the new statutory rule.

The present 10 percent penalty on pre-59 1/2 distributions to owner-employees will be extended to all key employees by the top-heavy rules after 1983.

O. Pension Withholding

Starting in 1983, plan distributions are subject to the new pension withholding rules. All plan administrators must be familiar with these rules although they are too lengthy to detail here. Amounts subject to the CODA option which an employee elects to receive in cash are not subject to the pension withholding rules because they are subject to the normal wage withholding rules. I.R.C. § 3405(d)(1)(B)(i).

P. Separate Accounting

All amounts held under a plan including a qualified section 401(k) arrangement are deemed to be elective contributions unless accounted for separately. This probably means that all such amounts are subject to the nonforfeitability rules and section 401(k) distribution limitations. It probably does not mean that employee contributions will be deemed to be elective contributions and hence employer contributions for purposes of the rules on taxation of distributions under section 72.

To avoid the above General rule, plans must provide for separate accounting. That portion of the employee’s accrued benefit (i.e., contributions and earnings) subject to the section 401(k) nonforfeitability rules and distribution limitations must be separately accounted for from other amounts, allocated investment gains and losses on a pro rata basis, and properly adjusted for withdrawals and contributions. Gains, losses, withdrawals, contributions, forfeitures, and other credits and charges (i.e., administrative expenses) must be allocated between the section 401(k)-limited and other amounts on a reasonable and consistent basis. A plan may allow participants to designate whether withdrawals are to be taken from the section 401(k)-limited account or from other amounts or else the plan must specify from which account withdrawals will be made if there is no designation.
IV. Special Issues

A. PAYSOPs

Employers would like to use a PAYSOP in conjunction with a section 401(k) plan. Since contributions to the PAYSOP are always fully vested, they could count towards meeting the 1.5/2.5 tests if the section 401(k) distribution restrictions were applied to them.

It is questionable whether it is permissible to integrate a PAYSOP with a section 401(k). Since there are no PAYSOP regulations out, one can only speculate. The TRASOP regulations offer some guidance, assuming the PAYSOP regulations will be comparable.

The TRASOP regulations permit a TRASOP to be a portion of a plan and for non-TRASOP contributions to be made to the plan. Treas. Reg. §§ 1.46-8(e)(4), (e)(8)(ii). The proposed section 401(k) regulations also permit qualified CODAs to be part of a plan providing for other contributions. Prop. Treas. Reg. § 1.401(k)-1(a)(1).

However, for coverage purposes, a TRASOP may not be aggregated with another plan. Treas. Reg. § 1.410(b)-1(d)(3)(ii). This would probably carry over to PAYSOPs as well. Hence, the PAYSOP would have to meet the coverage rules by itself as would the rest of any plan of which the PAYSOP is a part.

If a PAYSOP cannot be aggregated with a plan for coverage purposes, can it also not be aggregated with another plan for purposes of nondiscrimination in benefits under section 401(a)(4)? There is nothing which says this explicitly. Treasury Regulation section 54.4975-11(e)(1) bars aggregation for section 401(a)(4) nondiscrimination rules for a leveraged ESOP for purposes of the loan exemption to the prohibited transaction rules. Does this carry over to nonleveraged PAYSOPs?

Technical Information Release 1413 bars setting up a qualified plan that covers only employees with compensation in excess of $100,000 in conjunction with a TRASOP on the ground that that would circumvent the $100,000 allocation limitation. Question R-8. Nothing is said about instances not clearly attempting to dodge the tax rules.

There is a question whether aggregation for section 401(a)(4) contribution purposes is permissible. The bar on aggregation for coverage purposes is fairly ineffective without a similar bar with regard to contributions and as a policy matter the Service may object to using amounts for which a tax credit may be obtained towards the section 401(k) ADP tests. The Service's position has not been announced.

B. Social Security Integration

The preamble to the proposed regulations states that an employer's FICA contributions may not be taken into account for purposes of de-
terminating ADP under the 1.5/2.5 tests. There is a question as to whether the Service also means to prohibit section 401(k) plans from integrating with Social Security.

Under the Social Security integration rules, a defined contribution plan is properly integrated if it covers only compensation over the Social Security wage base, employer contributions do not exceed 5.7 percent (7 percent before 1984) of covered compensation, the plan provides benefits only upon retirement, death, or other separation from service, and all contributions are allocated on a nondiscriminatory basis when made.

Employees excluded under the wage base may be counted for coverage purposes under a properly integrated plan and a 5.7 percent contribution is imputed for them for section 401(a)(4) contribution nondiscrimination purposes. Treas. Reg. § 1.401-3(e)(1); Rev. Rul. 81-202, 1981-2 C.B. 93; Rev. Rul. 83-110, supra.

If section 401(k) plans may be integrated, the statement in the preamble would apparently bar the imputation of contributions to those under the wage base. Would such employees have to be counted as a zero percentage for ADP purposes, or would they be excluded from the ADP calculations? If excluded from ADP calculations, would they also be excluded for coverage purposes? The preamble statement does not seem to bar inclusion of the employer contribution for nondiscrimination purposes for contributions which are not tested by the 1.5/2.5 rules. Is the negative implication of the preamble statement that employee FICA amounts withheld on amounts electively deferred may be counted for purposes of the ADP tests?

Will the TEFRA amendment to the defined contribution Social Security integration rules cause the Service to change its position with regard to section 401(k) plans? Integration of a section 401(k) plan even if permitted may complicate administration of contributions since elective contributions will count as employer contributions for purposes of the 5.7 percent integration level. Plans integrating with Social Security must also tighten up distributions, permitting them only for retirement, death or other separation from service.

C. Top-Heavy Rules: Section 401(k) Plans Have Special Effects Under the Top-Heavy Rules

Top-heavy defined contribution plans must make a minimum contribution of 3 percent of compensation for non-key employees. However, if the maximum employer contribution for the key employee receiving the highest contribution is less than 3 percent, then a minimum contribution need not exceed such percentage. Where key employees receive no employer contributions in a year, no minimum contribution need be made for non-key employees.
This minimum contribution must be made even for employees who have failed to complete 1000 hours of service during the year, those who decline to make any contribution to a matching plan and those excluded under the wage base because of Social Security integration. Prop. Treas. Reg. § 1.416-1 (M-8).

Employer contributions attributable to “a salary reduction or similar arrangement” may not be counted toward the minimum contribution. I.R.C. § 416(c)(2)(C). It is not clear whether a distinction between salary reduction and bonus plans is intended here. The TEFRA Conference Report refers at one point to “a salary reduction cash or deferred arrangement.” Conference Report at 628.

Plans providing only for salary reduction contributions would, under the top-heavy rules, have no employer contributions for anyone, key employees or non-key employees, and so would not seem to have to make any minimum contributions. Salary reduction will reduce participants' compensation for purposes of calculating the 3 percent contribution.

The definition of key employee includes 1 percent owners with compensation in excess of $150,000. The definition of compensation used is the section 415 definition. Prop. Treas. Reg. § 1.416-1 (T-14). Accordingly, elective section 401(k) contributions would reduce such compensation.

D. Recharacterization and Payback

Because of the practical difficulties involved in administering the antidiscrimination rules, many section 401(k) plan sponsors wish to install failsafes to prevent disqualification. The two most common failsafes considered are recharacterization of highly compensated employees' elective deferrals from a pre-tax to post-tax status to the extent necessary, and a return of excess contributions to highly compensated employees or “paybacks.”

Shortly after the proposed regulations were published, the Service published a notice stating that recharacterization and paybacks would not be permitted. 47 Fed. Reg. 988 (daily ed. January 8, 1982). There was a great deal of protest about this and the Service will likely reverse its position on this issue. In the interim, section 401(k) plans including such failsafes have gotten determination letters from the Service approving the plans under section 401(k).

If an amount withheld from pay in Year 1 is paid back to a cash-basis taxpayer in Year 2 by virtue of a failsafe device, when will it be taxed to him? The Service might argue that it should be taxed in Year 1, hence altering the normal cash-basis accounting rules. This could cause a problem if the period for depositing elective contributions in the plan is extended to the full section 404(a)(6) period (time for
filing return plus extensions) and the payback occurs after April 15. Employees will presumably have to amend their returns if the Service takes the position of Year 1 taxation (which is likely).

E. Cafeteria Plans

Some employees plan to use section 401(k) plans in conjunction with qualified cafeteria plans under Code section 125. One design would automatically contribute dollars unused for fringe benefits under the cafeteria plan to the section 401(k) plan. The problem is that because of the absence of a cash option, such spillover amounts may not be qualified elective contributions. They therefore may be currently taxable to the employee. Furthermore, since the only deferred compensation permitted under a cafeteria plan is in conjunction with a section 401(k) plan where the employee may elect contributions under such a plan, it could be argued that such automatic contributions would not qualify under the deferred compensation rule and the cafeteria plan would be disqualified.

F. Spinoffs and Mergers

Plan administrators will want to give some thought to the implications of spinoffs and mergers for section 401(k) plans which occur in mid-year. The antidiscrimination calculations might suddenly be skewed. It is hoped that the Service will give some guidance on this issue, perhaps allowing plans to ignore the effects of the spinoff or merger until the year following its occurrence.

G. District Ruling Policy

The IRS districts do not currently have a uniform ruling policy with regard to whether plan determination letters will specifically approve a section 401(k) plan only under section 401(a) or whether they will include a statement that the plan also satisfies section 401(k). Naturally, a determination under both section 401(a) and section 401(k) should be sought, if possible.