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SECTION 401 (k) PLANS — WHY ALL THE FUSS?

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Because of the nature of the discussion at this session, the following outline form is used instead of the usual narrative form. The following members of the audience participated in the discussion:

- Thomas T. Lonergan, Vice President, Meidinger Incorporated
- Richard S. Hester, Sr., Vice President and Actuary, T.J. Kowalchuk Associates, Inc.
- John B. Massey, Partner, Meeks and Company
- Ralph J. Braskett, Chief Actuary, Hirochfeld Stern Moyer and Ross
- William A. Farguhar, Divisional Actuary, Meidinger Incorporated

Outline

- How did we get here?
- What's happening now?
- How do 401(k) plans work?
- What are the issues/problems?
  - Legal
  - Design
  - General 401(k) Rules
  - Communication
  - Administration
- Why should actuaries be interested?
- Who is likely to adopt a 401(k) plan?

401(k) - How Did We Get Here?

- Pre-1972, cash/deferred arrangements (CODA) were governed under IRS rulings, primarily applicable to cash/deferred profit sharing
  - 56-497 (1/2 who defer must be in lowest-paid 2/3)
  - 63-180 (clarification of 56-497)
  - 68-89 (estate tax treatment of distributions)

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- o December, 1972 IRS proposed regulations questioned favorable tax treatment of cash/deferred arrangements
- o ERISA Section 2006 in 1974 provided that new CODAs after 6/27/74 would not receive favorable tax treatment
- o Subsequent tax legislation prolonged ERISAs position, but protected existing CODAs
- o Revenue Act of 1978 [New Code Section 401(k)] authorized CODAs
  - Full vesting
  - Withdrawal restrictions
  - Discrimination tests
- o Proposed regulations in November, 1981 specifically recognized that CODA could be in the form of salary reduction

<u>401(k) - What's Happening Now?</u>

- o Awaiting final 401(k) regulations that should address:
  - Hardship definition
    - -- believed to be a stricter interpretation than had been used by IRS in the past
  - "Pay" used for discrimination test
    - -- proposed regulations state you may use "pay" before taking out salary reduction amount to determine average deferral percentage. Have heard IRS wants to change to pay after taking out salary reduction. Will make administration more difficult if a company has problems meeting the discrimination test because both numerator and denominator will change simultaneously
  - Treatment of excess contributions
    - -- can they be relabeled "after tax" contributions
    - -- can they be refunded to employee
  - Time for making contributions
    - -- within 30 days after close of plan year, which is practically impossible
  - Use of salary reduction amounts under other pay-related plans
    - -- welfare plans - LTD, STD, life insurance, etc. - okay to use
    - -- pension plans - aren't so sure. Again, a question the IRS is wrestling with

- o Feasibility studies under way
- o Some plan are operational, but most are targeted for 1983 implementation
- o Assessing impact of "TEFRA" on
  - 415 limits
  - Loan provisions
- o Concern with state income tax laws
  - Not all states follow federal tax laws. We'd like to make a case for why they should be required to do so:

    Employee X works entire career in a state that taxes salary reduction amounts, retires in state that didn't, receives distribution and entire amount is considered taxable. So he's taxed twice on the same dollars

401(k) - How Do 401(k) Plans Work?

Example 1

$20,000 Employee contributing 3% of pay

	Conventional Plan	Salary Reduction Plan
Salary	$20,000	$19,400
Plan contribution	600 (Ee)	600 (Er)
Employee tax savings (assuming 25% marginal rate and 1982 SS tax rate of 6.7%)		
- Federal income tax	--	150
- Social Security tax	--	40

Example 2

$100,000 Employee contributing 6% of pay

	Conventional Plan	Salary Reduction Plan
Salary	$100,000	$94,000
Plan contribution	6,000 (Ee)	6,000 (Er)
Employee tax savings (assuming 50% marginal rate and 1982 SS tax rate of 6.7%)		
- Federal income tax	--	3,000
- Social Security tax	--	0

Comments

- o Salaries are reduced
    - All by same percentage, with some taken in cash, or
    - By percentage chosen by employee
- o Employer contributes whatever was not taken in cash to plan
- o Employer contribution is not currently taxable income to employee
- o If thrift plan, employer contribution may still match all or a portion of salary reduction contributions
- o FICA, FUTA taxes not assessed on salary reduction contributions
- o Salary reduction contributions taxed only upon distribution

401(k) - What are the Issues/Problems?

Legal

- o Cash/deferred and salary reduction rules can be looked at as a form of "integration." Instead of integrating a private plan with Social Security, it's integrating one with current pay -- giving employees a choice. The low-paid employee, who takes cash rather than benefits under the private plan, is selecting something that is of the same value as the amount deferred by a high-paid individual at the time of deferral
- o 401(k) statute recast:
    - Plan must be a profit sharing or stock bonus plan
    - Plan must meet all of IRS Section 401(a) qualification requirements, with possible exceptions of coverage requirements of Section 410(b) and non-discrimination requirements of Section 401(a)(4)
    - Plan, with respect to employees <u>eligible</u> to participate, must meet Section 410(b) requirements either through 70/80 test or non-discriminatory coverage test
    - Plan must meet new non-discrimination tests of 401(k) regulations with respect to employees actually participating
    - Amounts deferred must be fully vested (non-forfeitable) and may not be distributed until retirement, death, disability, other separation from service or attainment of age 59-1/2 except in cases of "severe financial hardship"
- o 401(k) does not apply to money purchase plans -- yet. May be desirable to have it apply, since employer contributions to money purchase plans are not required to be made out of current or accumulated profits

- o Plans that are currently providing employer contributions at the new Section 415 levels for maximum annual additions, or where the employer's contribution is about 15% of pay, have no "room" for adopting the salary reduction concept

- o 401(k) concept should be embraced by an employer as part of long range benefits strategy -- not as a short term means of providing more to employees during poor economic times

Design

- o Salary reduction elections - How structured? All employees' pay reduced flat percent and then can elect to take some in cash - may become very popular if IRS won't allow salary reduction amounts to be considered pensionable earnings. However, most common is to permit employee to elect percentage by which his or her salary is reduced - making a payroll reduction election rather than a deduction election

- o Withdrawals - More restrictive now with respect to before tax contributions. May inhibit participation. For existing plans, can represent a rather difficult change for employees to accept. Need to work at freeing up other dollars - vested portion of matching employer contributions, previously made after tax employee contributions, etc

- o Loans - May permit loans. Now limited by TEFRA to the larger of $10,000 or 50% of vested value of account, but can't be more than $50,000 (Top heavy plans - can't really take advantage of loans at all)

- o Non-discrimination rules/tests - How to define them? How are they actually performed? We believe it's on a plan year basis, but many companies are testing throughout the year to monitor it as year progresses

- o Impact on other pay-related plans - mentioned earlier - awaiting regulations to say salary reduction amounts may be used as "pay" in other pay related pension plans.

- o Impact on Social Security benefits - Will reduce benefits for some employees. Most significant for lower paid, younger employees. In practice, doesn't seem to cause major concern on part of employees. If tax savings are invested, employee can make up for loss. Also, many employers with integrated pension plans - those that offset for Social Security benefits - will make up for a portion of the reduction in Social Security benefits

General 401(k) Rules

Nondiscrimination rules

- o General nondiscrimination rules

- Special 401(k) provision
  - Plan must satisfy one of the following tests
    - -- 1.5 test - the actual deferral percentage for the high-paid employees must not be more than the actual deferral percentage for all other eligible employees multiplied by 1.5
    - -- 2.5 test - when the excess of the actual deferral percentage for the high-paid employees over all other eligible employees is not more than 3 percentage points, the actual deferral percentage for the high-paid employees must not be more than the actual deferral percentage for all other eligible employees multiplied by 2.5
- Application
  - High-paid means top 1/3
  - Low-paid means lower 2/3
- Contribution limits

If Low-Paid Group Defers	High-Paid Group Can't Defer More Than
Up to 2%	Low-Paid percentage x 2.5
2% to 6%	Low-Paid percentage + 3%
Over 6%	Low-Paid percentage x 1.5

- Contribution limits (another way of expressing them)

If Low-Paid Group Defers	High-Paid Group Can't Defer More Than
1%	2.5%
2	5.0
3	6.0
4	7.0
5	8.0
6	9.0
7	10.5
8	12.0
9	13.5
10	15.0

<u>Communications</u>

- Complex features
- Get over impact of "salary reduction" terminology
- Convey company philosophy
  - Retirement savings
  - Flexible compensation
  - Other

- Mention possible drawbacks
  - Withdrawal restrictions
  - Reduced Social Security benefits
  - Tax deferral, not tax avoidance
- Need to stimulate participation, especially for lower two-thirds group

Administration

- Payroll/personnel system changes
- Need to track all those eligible
- Compliance monitoring
- Treatment of excess contributions
- Withdrawal administration
- More "buckets" if not a new plan
- Loan administration

401(k)-Why Should Actuaries Be Interested?

- 415 maximum limitations
- Comparability tests (Rev. Rul. 81-202)
- Actual deferral percentage (ADP) test
- Coordination with other pay-related pension plans

401(k) - Who Is Likely To Adopt?

- Companies with
  - Existing savings plans
  - Tax Reduction Act Employee Stock Ownership Plans (TRASOPs)/Payroll based TRASOPs (PAYSOPs)
  - Good payroll/personnel systems
  - Desire to encourage employee savings
  - Desire to initiate flexible compensation