The Sec. 401(k) Retirement Plan: General Attributes, Final Regulations, and a Simplified Illustration of the Plan

An Honors Thesis (HONRS 499)

by

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PURPOSE OF THE THESIS

This discussion of the Sec. 401(k) retirement plan is divided into three main sections. The first section describes the characteristics of the general plan. The second section presents the final regulations which were proposed by the Internal Revenue Service in 1988 and are effective in 1992. The third section is the author's point of view. It is an illustration showing the differences between investing in a 401(k) at age 23 versus at age 33. The illustration stresses the point that people should begin investing for their retirements at an early age. It also addresses the impact on the future value of a 401(k) of saving $600 per year versus $1,200 per year as well as the impact of matched versus unmatched contributions.

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INTRODUCTION

Internal Revenue Code Section 401(k) provides for the contribution of tax-deferred earnings from a person’s paycheck into a retirement fund. Section 401(k) was added to the Internal Revenue Code in 1978 and has grown faster than any other employee benefit plan (Hewitt Associates, 1988). A set of regulations was proposed by the Internal Revenue Service in 1988. The proposed regulations were modified and final regulations were released in July of 1991. Following will be a discussion of the characteristics of a 401(k) prior to regulations issued by the IRS. The characteristics to be discussed will be those that are relevant to the presentation of the final regulations. General attributes of the 401(k) will be addressed first. The general attributes will be followed by the advantages and disadvantages of investing in a 401(k). Finally, the types of investments in which money in a 401(k) may be invested will be addressed. The presentation of the final regulations which were proposed in 1988 and will be effective in 1992 will follow the characteristics of the 401(k). The regulations were provided by Coopers & Lybrand and will be broken into four sections. The first section will address nondiscrimination issues, the second corrective action issues, the third distribution provisions, and the fourth miscellaneous topics. Following the presentation of the final regulations will be an example illustrating the importance of investing in a 401(k) at an early age. The example will be from the perspective of a recent college graduate beginning a new job. It will show why such a person should begin investing in a 401(k) at the beginning of his career rather than waiting until a later time to invest.
CHARACTERISTICS OF THE 401(k) PRIOR TO FINAL REGULATIONS PROPOSED BY THE INTERNAL REVENUE SERVICE

GENERAL ATTRIBUTES OF THE 401(k)

There are basically two types of employer-sponsored retirement plans--defined contribution and defined benefit. Sec. 401(k) plans are defined contribution plans due to the fact that a specified amount of money is deducted from each participant's paycheck and is contributed to the 401(k). The amount of money in the 401(k) when the employee retires is the sum of all contributions to the plan and any capital appreciation and interest it has earned. In contrast, defined benefit plans require employers to pay employees a stated benefit when the employee retires (Securities Data Company, Inc., 1991).

The advantages of using defined contribution plans are that these "plans limit an employer's risks and liabilities, while also offering greater flexibility" (Securities Data Company, Inc., 1991). The returns on different types of investments may change over time, changing the funding needs of employers using the defined benefit plan. For these reasons employers as well as employees favor the defined contribution plans. A 1988 survey by Hewitt Associates indicates that the number of employers offering the 401(k) increased from 68% of surveyed employers in 1984 to 96% of employers in 1988--up 28% (Charles D. Spencer & Assoc., Inc., 1990b). The number of employees covered under 401(k) plans has increased from 4.85 million in 1983 to 20.8 million in 1988, according to a recent Employee Benefits Research Institute study (Securities Data Company, Inc., 1991).

A second feature of a 401(k) plan is that of matched versus unmatched savings. Eighty percent of the respondents in a survey conducted by Charles D. Spencer &
Associates said that they provided for employer matching contributions (Burzawa, 1990). Matching occurs when an employer agrees to contribute to the 401(k) a specified amount per dollar that the employee contributes to the 401(k). The most common matching rate is 50 cents on the dollar (Charles D. Spencer & Assoc., Inc., 1990b). “Matching contributions provide an incentive to join the plan” (Spencer, 1990). The contributions should be considered an addition to the total pay a person receives from the company. The employee must keep this in mind when investing his or her contributions. Some employees believe they are receiving a 50% return on their investment when employers contribute 50 cents on the dollar. An employee should continue to maximize the return on his investments since the 50% return is not part of the annualized yield on the 401(k) but is part of the employee’s total pay package (Montague, 1991c).

Once an employee has contributed to a 401(k) the question may arise as to when he will be able to obtain his money from the plan. “Sec. 401(k)(2)(B) provides that, for plan years beginning after December 31, 1988, amounts may not be distributed from the plan earlier than

- death;
- separation from service (including retirement);
- disability;
- hardship;
- age 59 1/2;
- required by a qualified domestic relations order (QDRO), with certain restrictions;
- plan termination (if no successor plan is established);
- date of sale by the corporation of substantially all of the assets used in its trade or business with respect to an employee who continues employment with the acquiring entity; or
- date of sale by a corporation of its interest in a subsidiary with respect to an employee who continues employment with such subsidiary” (Sturges, 1989).

A penalty of 10% is sometimes applied when early distributions from the plan are given. The 10% penalty is most commonly associated with hardship withdrawals.
Hardship withdrawals are qualifications which must be met before an employee can withdraw money from the plan and will be addressed at a later time. There are eight exceptions to the 10% early distribution penalty which allow an employee to withdraw money from his 401(k) without proving a hardship. The exceptions occur if distributions are:

- made on or after age 59 1/2;
- made on or after the employee/participant’s death;
- attributable to disability;
- part of a series of substantially equal periodic payments, made at least annually over the life expectancy of the employee or the joint life expectancy of the employee and his beneficiary, after the employee separates from service;
- made after separation from service on account of early retirement, as defined under the plan after attainment of age 55;
- for certain medical expenses;
- from certain ESOPs; or
- made pursuant to a QDRO” (Sturges, 1989).

Sec. 401(k) plans are open to any employee whose employer sponsors the plan. This includes low, middle, and high income employees. Most organizations are able to sponsor Sec. 401(k) plans with the exceptions of tax-exempt organizations and state and local government employers (Charles D. Spencer & Assoc., Inc., 1990a). About 70% of the eligible workers participate in the plans (Montague, 1991a).

From an organization’s point of view, “Small companies with stable work forces usually do very well with 401(k) plans” (Securities Data Company, Inc., 1991). Favorable characteristics of companies with 401(k) plans include a stable work force, one to 100 employees, profitable businesses which have been operating for at least six years, and businesses with a relatively consistent profit stream (Securities Data Company, Inc., 1991).

An employee participating in a 401(k) can contribute an indexed $7,000 per year, the base year being 1986 (Charles D. Spencer & Assoc., Inc., 1990a). The amount is indexed each year according to inflation. In 1991 an employee could contribute up to
$8,475, however the average yearly contribution is $2,000 (Montague, 1991a). This $2,000 takes into consideration the amounts contributed by all three income levels—low, middle, and high. A highly compensated employee is generally one who earns more than $57,000 per year (Geisel, 1990).
There are several advantages of participating in a 401(k) plan. The first advantage is that money contributed from each paycheck is on a pretax basis. This means that the money a person contributes now will not be taxed until the money is withdrawn from the plan, usually after retirement. Not only are taxes deferred, but by the time the person pays the taxes he is usually in a lower tax bracket due to decreased income. Therefore, the employee pays fewer taxes on his deferred income (Montague, 1991a).

An employee must avoid overcontributing to his 401(k). Even though the employee will be in a lower tax bracket when he retires, there is a 15% surtax on payouts of any form of retirement savings totaling more than $140,000 a year, indexed for inflation (Baldwin, 1992).

A second advantage is that contributions to a 401(k) are deducted from a person's paycheck. Employers handle the paperwork (Montague, 1991a). This frees the participant from making trips to the bank to cash checks or withdraw money in order to invest it. One disadvantage to the automatic pay deductions is that too much money may be deducted in a given year, and the employee may have to take some money out of the plan and claim it as income. This will be discussed when discrimination testing is addressed.

A third advantage of contributing to a 401(k) is that 65% of the plans offer a loan provision which allows an employee to borrow from his 401(k) (Burzawa, 1990). Two of the most common types of loans available are general purpose loans and home loans (Hewitt Associates, 1988). "The loan provision is particularly attractive to lower wage-earners who may have little savings and little borrowing power in case of an emergency" (Gage, 1987). Plans with loan provisions attract 10-15% more participants than those without. In attracting lower wage-earners to the 401(k), higher
wage-earners will benefit with respect to discrimination testing.

Effective October 18, 1989, all loans must satisfy five criteria. The criteria have been set by the Department of Labor. The first criterion is that "all loans must be available to all participants and beneficiaries on a reasonably equivalent basis" (Charles D. Spencer & Assoc., Inc., 1989b). This means that active employees as well as former employees must be allowed to participate in a loan program. When an employee borrows from his 401(k) he pays the principle plus accrued interest back into his plan through additional payroll deductions. Special repayment provisions are made for former employees since the employees no longer receive paychecks.

Second, loans "may not be made available to highly compensated employees in an amount greater than the amount made available to other employees" (Charles D. Spencer & Assoc., Inc., 1989b). This criterion adheres to the 401(k) belief that high-income employees should not receive additional benefits over low- or middle-income employees. Therefore, even though a highly compensated employee may have more money in his 401(k), the employee is not permitted to borrow any more than other employees.

A third criterion is that loans must be made following specific provisions as set forth in the 401(k) plan. "The loans must, at a minimum, include the identity of the administrator, the basis for loan approvals and denials, limitations on the types and amounts of loans offered, procedures or setting interest rates, what can be used as security, and what events will be considered a default and steps to be taken in such an event" (Charles D. Spencer & Assoc., Inc., 1989b).

Fourth, loans must bear a "reasonable rate of interest" (Charles D. Spencer & Assoc., Inc., 1989b). Most loans made prior to Department of Labor regulations offered interest rates at the prime rate (Charles D. Spencer & Assoc., Inc., 1990d). The Department of Labor regulations, however, stated that the interest rate of a loan should
be "commensurate with that charged on commercial loans by those in the business of lending money." Since the implementation of the DOL regulations the most common interest rate charged on a loan is the prime rate plus 1%. The lending rate charged by local banks is the second most common interest rate charged on loans (Charles D. Spencer & Assoc., Inc., 1990d).

The interest rates on loans may be adjusted. Interest rates were typically adjusted semiannually or annually prior to DOL regulations. "Monthly and quarterly rate adjustments have become more prevalent" since the issuance of the final DOL regulations (Charles D. Spencer & Assoc., Inc., 1990d).

The final DOL criterion is that the loan must be adequately secured. Plans can use up to 50% of the present value of an employee’s vested accrued benefit as security for a loan (Charles D. Spencer & Assoc., Inc., 1989b). Only 4% of all 401(k) plans allow plan participants to use collateral other than the money that is invested in their plan (Burzawa, 1990).

Sec. 401(k) plans allow employees to choose where the money in their plans is invested—the fourth advantage of Sec. 401(k). Most investors have several options to choose from. The options will be discussed later.

Employees use dollar-cost averaging when investing in a 401(k). Dollar-cost averaging occurs when an investor buys equal dollar amounts of an investment over a period of time. Dollar-cost averaging applies to 401(k)s because of the defined contribution nature of the plan. As discussed previously, equal dollar amounts are taken from an employee’s paycheck and contributed to his 401(k). With dollar-cost averaging, investors automatically buy more shares when prices are lower and fewer shares when prices are high. As a result, the average cost of the shares they buy is usually lower than the average price (Montague, 1991c). Dollar-cost averaging is recommended for people who plan to leave their money in their investment for a long
time, such as retirement accounts.

Yet another advantage to 401(k) plans is that they are portable. This means that an employee can transfer the plans from one company to another. An employee could also switch the funds into an IRA after leaving a job (Securities Data Company, Inc., 1991).
DISADVANTAGES OF INVESTING IN 401(k) PLANS

One disadvantage of 401(k) plans is discrimination testing. The purpose of discrimination testing is to make sure highly compensated employees do not benefit from 401(k)s more than employees who are nonhighly compensated. The test limits the disparity between the amounts contributed by each group. Companies use one of two tests to test for discrimination. The tests are the actual deferral percentage test (ADP) and the actual contribution percentage test (ACP).

The ADP test requires complicated computer calculations which figure, according to the amount of deferrals made by nonhighly paid employees participating in 401(k) plans compared to the amount of deferrals made by highly paid employees, how much highly compensated employees can contribute to their 401(k)s. Plans that fail the ADP test have had excessive contributions made to them. If highly compensated employees contribute more to their plans than the ADP says they can the employees will either receive a refund or recharacterize their deferrals (Charles D. Spencer & Assoc., Inc., 1989a).

The complicated nature of the ADP makes it difficult and expensive for small companies to implement the ADP, therefore discouraging companies from offering 401(k) plans for retirement. It can cost a large employer $100,000 just for the actuarial work involved in running the test (Charles D. Spencer & Assoc., Inc., 1990g).

The ACP test actually tests the ratio of contributions made to a Sec. 401(m) plan. The ACP test is often referred to when discussing the discrimination testing of 401(k)s, so it is addressed here. The ACP is basically the same as the ADP, however the ACP is based on employee contributions and employer matching contributions while the ADP is based on deferrals. A plan that fails the ACP is said to have excessive aggregate contributions. When an employee is able to participate in both a 401(k) and
a 401(m) the sum of the ACP and ADP cannot exceed an aggregate limit. Excessive deferrals occur when the sum does exceed the aggregate limit.

Besides being complicated and expensive, nondiscrimination tests are difficult to pass. Only 43% of the 259 employees responding to ADP questions on a survey conducted by Charles D. Spencer & Associates were able to pass the test without taking corrective measures (Burzawa, 1990). Corrective measures taken by some employers include limiting deferrals of highly compensated employees or making nonelective contributions to nonhighly compensated employees.

In order for highly compensated employees to be able to contribute more to their plans more nonhighly compensated employees need to participate in 401(k)s. Employers as well as fellow employees should encourage employees to save for their retirements (Harris, 1991). Employers can also offer to match employee contributions to the plan as an incentive to join.

One way employees have been able to pass nondiscrimination tests is through restructuring. As of September 17, 1990, employers were allowed to restructure testing groups so that more employees could pass the test. Testing groups must exhibit common attributes such as employment at the same job location or in the same job category. By restructuring, employees tested are compared to employees with similar jobs making it easier to pass the discrimination tests (Geisel, 1990).

A second disadvantage of investing in a 401(k) plan are the hardship qualifications which must be met before an employee can withdraw money from the plan. The eight exceptions which permit an employee to withdraw money from a plan without proving hardship were discussed earlier. If hardship exceptions do not apply to an employee with money invested in a 401(k) he can only withdraw money, before age 59 1/2, for one of the reasons on the following page:
"1. To buy a primary residence or to avoid eviction or mortgage foreclosure;
2. To meet college expenses for you, your child or your spouse;
3. To cover major medical expenses for a family member;
4. To pay for a family member’s funeral" (Carol Anderson Taber, 1989).

Before withdrawing money from a 401(k), an employee must prove that he has exhausted all other means to pay for his expenses. These means include bank and credit card loans, loans from a 401(k), liquidating assets, and insurance. Once an employee has proven his need for the money he must pay a 10% penalty and may not contribute to his 401(k) for one year.

In determining whether an employee has met the above hardship qualifications, employers must apply a facts and circumstances test or a safe harbors test. The facts and circumstances test allows employers some flexibility in determining whether a hardship exists. It is a judgment call. Safe harbors, however, rid employers of the need to make a judgment call. The test is based on the four hardship qualifications listed on the previous page. “Safe harbors force the employees to borrow whatever they can from other plans, and to suspend contributions and limit the amount deferred for a period after the withdrawal” (Charles D. Spencer & Assoc., Inc., 1989a).
INVESTING IN A 401(k)

Several factors must be considered when investing money in a 401(k). These factors include the amount of risk an investor is willing to take for a given return, the number of times an investor can change the specific investments he owns, and the investment options open to investors. These factors will be addressed in this section.

First, as with other investments, an investor can choose to invest in a portfolio which suits his risk and return expectations. Investors should ask themselves what rate of return they need to get where they want to go and how much risk they have to take to get that return. It is believed that young employees do not take enough risk. Younger employees can take more risk in their 401(k) investments because they have more time to "ride out volatility in the stock market" (Montague, 1991c).

In general, it is recommended that most of an employee's money should be invested in stock. It is still necessary to diversify, however. A 401(k) should be diversified among stock funds and interest-paying investments. A good mix for a young employee would be to invest 60-70% of his money in stock and the rest in investments which pay interest. As the investor gets older he should slowly switch to interest-paying investments (Montague, 1991c).

Next, companies differ with respect to the number of times an employee can change investments. Most 401(k) plans (38%) allow an employee to change investments quarterly, 23% allow monthly changes, and 22% allow semi-annual changes (Hewitt Associates, 1988). Although these three options are the most popular, some plans allow employees to switch investments daily.

Analysis & Technology (A&T) is one company that allows its employees to switch daily (Charles D. Spencer & Assoc., Inc., 1990c). As of June 1990, employees could switch from one investment offered by A&T to another via an 800 number. A&T's
employees use the service wisely (Charles D. Spencer & Assoc., Inc., 1990c). The participants do not make hasty investment decisions based on the fluctuating market. Studies found the investors use the 800 number sparingly. Of 55 inquiries a month, only six were regarding investment changes (Charles D. Spencer & Assoc., Inc., 1990c).

Finally, there are several investment options and combinations of investments for a 401(k) participant to choose from. Most plans offer three options, the most typical being employer stock, equity funds, and guaranteed investment contracts (GICs) (Hewitt Associates, 1988). Other options available to companies are government bonds or other fixed income, short-term securities, balanced funds, and life insurance. Employer stock, equity funds, and GICs will be explained in more detail.

Many 401(k)s allow employees to purchase employer stock as part of their 401(k) portfolio. Employee stock ownership plans (ESOPs) also allow employees to buy stock in the company they work for. Purchasing employer stock and participating in an ESOP are two different ways to invest in the company which the employee works for. When ESOPs are combined with 401(k)s they are entitled KSOPs. KSOPs, in other words, are ESOPs that include a qualified cash or deferred arrangement (Sellers, 1990). It is advised that an employee does not invest more than 10% of his retirement portfolio in his company’s stock. Studies show, however, that employees keep up to 16% of their retirement assets in their company’s stock (Willis, 1991).

There are two basic reasons it is advised not to invest too much money in an employer’s stock. One is that the investments in any portfolio should be well-diversified. Investing too much in one company would not meet this recommendation. The second reason is that an employee investing in the company he works for has a harder time selling his stock when prices fall. There is a loyalty to the company as well as the stock (Montague, 1991c). Also, the employee may lose his job as well as his
savings if the company the employee works for and has invested in runs into serious trouble.

Another factor to consider when investing in an ESOP is that federal rules allow an employee to sell at least 25% of his shares in an ESOP which were acquired after 1986 if he is 55 years old and has worked for the company for at least ten years. When the employee reaches age 60 he can sell another 25%. It is recommended to do so (Willis, 1991).

A second investment option is to invest in equity funds. Mutual funds are a good investment choice because of their well-diversified nature. When an investor puts money into a mutual fund he is actually investing in a number of stocks. The stocks in the mutual fund are diversified. Another advantage of investing in a mutual fund is that over the long term stocks have increased in value by 9% a year, out-performing fixed-income options (Quint, 1991a).

Growth stock funds and aggressive growth funds are two popular mutual fund choices. Growth stock funds buy stocks which are expected to have above-average earnings growth. Aggressive growth funds invest in small companies that may grow even faster than the growth stock companies. The aggressive growth funds are relatively risky, possibly off-setting the advantages of the higher return (Montague, 1991c).

A hint when investing in mutual funds: avoid switching frequently to the funds which have recently performed the best. Stay with funds that have the best long-term performances.

A third widely chosen investment option is a guaranteed investment contract, or GIC. GICs are backed by insurance companies and pay a fixed interest rate. The interest rate is about 8% for a 5-year GIC. Although the "G" in GIC says the investment is guaranteed it usually is not. In some instances GICs are covered by state insurance
but not adequately. Investors can lose their money if the GICs they invest in are not backed by a financially healthy insurance company. Many insurance companies in the 1980's invested in junk bonds and commercial mortgages which experienced heavy losses. The insurance companies no longer have the cash to meet commitments they made to policyholders. An investor should check the safety of the insurance company backing a GIC before investing in the GIC. If an employee is going to invest in a GIC it is recommended that he only holds "20-30% of his assets in a GIC portfolio that is 100% invested with a single issuer" (Willis, 1991). This recommendation is based on the general rule of diversification as well as the questionable safety of insurance companies.
Nondiscrimination Issues

The final regulations state that restructuring is not allowed after 1991, ESOPs and 401(k) plans must be disaggregated into separate plans when testing for discrimination, and plans covering both collectively bargained will have to pass nondiscrimination tests even though they are normally automatically deemed nondiscriminatory. These three issues will be addressed in the following section.

401(k) plans must be able to pass ADP and ACP nondiscrimination tests. The purpose of the tests is to make sure highly compensated employees are not allowed to contribute more tax-deferred money to their 401(k)s than nonhighly compensated employees. Prior to the final regulations, employers were able to restructure their 401(k)s so that more highly compensated employees would be able to pass the tests. The final regulations now prohibit restructuring of 401(k)s in order to pass ACP and ADP tests. This regulation will affect plans beginning after December 31, 1991. Plans beginning on or before this date, however, will be allowed to continue to be restructured.

The restructuring of 401(k)s beginning before January 1, 1992 must still be done on an employee group basis. Groups are based on employees sharing a common attribute. Some common attributes include employees with the same job category or location, employees with the same number of years of service, or employees paid on a salary versus hourly basis.

A group of employees possessing the same actual deferral ratio, used in ADP tests, does not constitute a group for restructuring purposes. If this were permitted,
nondiscrimination tests would be easily passed. Employers would be able to restructure according to whether or not employees defer earnings.

The final regulations state that 401(k) plans and employee stock ownership plans (ESOPs) must be disaggregated into separate plans when testing for coverage and nondiscrimination. If a highly compensated employee participates in both an ESOP and a 401(k), a separate ADP test must be used to test the 401(k) and the ESOP for discrimination. The 401(k) and ESOP must, therefore, each be able to pass the ADP. The two plans cannot be tested as one combined plan. A general rule prior to the final regulations stated that deferrals and contributions made by highly compensated employees must be aggregated in testing for discrimination. The final regulations override this rule.

The final regulations also address the issue of collectively bargained plans. Collectively bargained plans are plans that have been negotiated for an employee by an employee's representative and the employer. General nondiscrimination and coverage rules for qualified plans state that collectively bargained plans automatically pass the ADP and ACP tests. The final regulations say that it is not necessary for collectively bargained plans that include 401(k)s or 401(m)s to pass the discrimination tests.

Contradictory to the final regulations, because the ADP test is a required part of a qualified 401(k) plan, a collectively bargained 401(k) plan must pass the ADP test for deferrals to be made on a pretax basis. This regulation affects plans beginning January 1, 1993. Any plans beginning prior to January 1, 1993 will allow collectively bargained 401(k) plans to be eligible for pretax treatment even if the 401(k) fails the ADP test. Since collectively bargained 401(k) plans will have to pass the ADP test after December 31, 1992, the plans will be subject to annual testing even though the plans are normally automatically nondiscriminatory.
CORRECTIVE ACTION

The Internal Revenue Code limits the amount of money that can be deferred by an employee in a given year. As previously discussed, the amount that can be deferred is $7,000, adjusted for inflation. In 1991 up to $8,475 could be deferred. Final regulations state that in order for a 401(k) to be a qualified plan, participants’ deferrals must not exceed the limit set by the IRC. If more money is deferred than is allowed, the plan is supposed to be disqualified. The final regulations proceed to state, however, that a plan can avoid disqualification by making timely corrective distributions of excess deferrals.

The limit on elective deferrals regulation is contradictory. First the regulation states that a plan must not collect a deferral in excess of the limit set by the IRC. If an employee does contribute more to the plan than is allowed, the plan is supposed to be disqualified. The regulation then says the plan will not be disqualified if corrective action is taken to make the deferrals equal to the limit. If it is so important to keep the deferrals below the limit corrective action should not be allowed to be taken.

According to regulations proposed in 1988, in order to pass ADP or ACP tests a 401(k) plan may make corrective distributions of excess amounts contributed to the plan, may recharacterize the excess, or the plan sponsor may contribute additional amounts to nonhighly compensated employees. If an excess deferral has occurred, the excess amount must be distributed. “In making corrective distributions, income attributable to those amounts must also be distributed,” according to Coopers & Lybrand. The final regulations allow plans to use any reasonable method when allocating income to the excess amounts.

One controversial factor in allocating excess income contributed to 401(k)s is that of gap period income. Gap period income is income earned during the period from the
end of the prior plan year to the date of the distribution. Final regulations make it optional to allocate gap period income to the excess amounts. Recordkeeping is simplified when employers are not required to allocate gap period income.

One last factor to be considered when looking at corrective distributions is that of the §415 limits made by the Internal Revenue Code. The §415 rules contain procedures for correcting certain excess contributions. The procedures did not work when elective deferrals were included in the excess amounts. The final regulations say that if there is an error when determining the amount of deferrals that can be made, the amounts can be distributed so that excess amounts are reduced. Income that is not distributed will be considered an annual addition when applying the §415 limits.
DISTRIBUTION PROVISIONS

As stated in the "General Attributes of the 401(k)" section, distributions from a 401(k) may be made only under certain circumstances. The final regulations continue to support these circumstances but go into more detail when addressing certain types of distributions. The distributions to be discussed are hardship distributions, distributions made when plans are terminated, and distributions made when a company sells one of its subsidiaries or a substantial amount of assets of the company.

Safe harbor tests and facts and circumstances tests are used when determining whether or not a hardship has occurred and to decide if a plan participant may withdraw money from his plan. Safe harbors tests force an employee who is in need of money to borrow whatever he can from other plans before withdrawing from his 401(k). After doing so, an employee may only withdraw money from his 401(k) if he meets one of the four hardship qualifications.

The final regulations continue to support the use of safe harbors tests but clarify two points. One clarification applies to the hardship qualification which says money can be withdrawn from a 401(k) to cover the major medical expenses of a family member. The final regulations say that money can be withdrawn from a plan in order to obtain medical services. The expenses do not already have to have been incurred. The money just needs to be used to obtain the services.

A second regulation addresses the hardship qualification of withdrawing money from a 401(k) to meet the post-secondary educational expenses of an employee, his spouse, child, or dependent. Prior to the final regulations only enough money could be withdrawn to pay for the next semester's or quarter's expenses. The final regulations permit enough money to be withdrawn to cover the next twelve months of
expenses.

The final regulations also permit money to be withdrawn for two reasons that have not been discussed previously. First, amounts may be withdrawn from plans in order to pay income taxes. Second, any penalties that occur as a result of distributions may be paid using money from plans.

Regulations proposed in 1988 provided that a 401(k) could be amended before the end of the 1992 plan year in order to allow plans to provide nondiscriminatory and objective standards for hardship distributions without eliminating a distribution option. This was a temporary exception to "anti-cutback rules." The final regulations provide a permanent exception to the "anti-cutback" rules. The regulations now allow 401(k)s to be amended at any time to "specify or modify nondiscriminatory and objective standards for hardship distributions." The regulations were imposed because of the constantly changing needs of employees and employers and the changing economy.

One of several requirements made in IRS Sec. 401(k)(2)(B) regarding the distribution of money from a 401(k) states that amounts may not be distributed from a plan unless the plan has been terminated and no successor plan has been established. The final regulations continue to enforce this requirement but have modified the definition of "successor plan." The final regulations state that in order for a 401(k) to be considered a successor plan at least 2% of the employees eligible for the 401(k) when it is terminated must be eligible for another plan any time during the year prior and year following the termination of the plan.

Prior regulations said that if a distribution was made from a terminated 401(k) and there was a successor plan available, both the terminated plan and the successor would be disqualified. The final regulations provide that only the plan that was terminated would be disqualified. The successor plan would not.

Final regulations also say that distributions made when a plan is terminated must
be made in a lump sum. This means that an employee's account balance will be distributed within one tax year and may include the distribution of an annuity contract. This regulation is effective April 1, 1988.

When considering distributions made as a result of the sale of a subsidiary or substantially all of the assets of a trade or business, the final regulations provide that distributions may only be made if the purchaser does not maintain the 401(k) after the sale. If the purchaser, therefore, combines the seller's 401(k) with one of his own no distributions can be made. The facts and circumstances test is used to determine if a distribution should be made in connection with the sale. Final regulations say that distributions will only be treated as if made in connection with sales if the distributions are made by the end of the second calendar year after the calendar year in which the sales occur. Any distributions which may occur are made in a lump sum.
Several miscellaneous regulations have been included in the final regulations issued by the Internal Revenue Service. These miscellaneous provisions address the issues of cash or deferred arrangements applied to a partnership, the definition of compensation for purposes of the ADP and ACP tests, the contingent benefit rule, and the 10% excise tax on failure to correct excess contributions promptly. The final regulations on these subjects will be addressed in the following paragraphs.

Regulations prior to the final regulations allow the members of a partnership to vary the amount of contributions each partner makes. The contributions are considered cash or deferred arrangements and are subject to the requirements of a 401(k). Failure to satisfy 401(k) requirements would disqualify the 401(k) and make contributions to the plan taxable in that year. The final regulations support the prior regulations but add that a partner must elect to have specified amounts contributed to his plan at the beginning of employment or when he is initially eligible to join the plan.

The 1988 regulations required that a 401(k) consider all compensation earned by an employee during the full plan year when testing for nondiscrimination. Nondiscrimination is tested using the ACP or ADP tests. All compensation was considered even if an employee was only eligible for the plan for part of the year. The final regulations only consider compensation earned while the employee is eligible to participate in the plan.

The contingent benefit rule, under 1988 regulations, stated that benefits under any other plan, including nonqualified plans, were prohibited. A 401(k) would not be qualified if other benefits were contingent on an employee's elective deferrals. The final regulations allow benefits from nonqualified plans. Even if the nonqualified plan provides benefits in excess of the limit placed on dollars allowed to be deferred, the
401(k) will not be in violation of the contingent benefit rule.

Finally, as stated previously, employers must make corrective distributions if excess contributions or excess aggregate contributions have been made. Prior regulations required that excess contributions be made within 2 1/2 months after the end of the plan year in which they arise or the employer would face a 10% excise tax. Final regulations have extended the time for the payment of the tax until the last day of the 15th month after the plan year in which the excess contributions arise. This regulation allows employers time to correct the excess contributions before the tax is due. Previously, the 2 1/2 months fell approximately on the due date of the tax.
AN ILLUSTRATION SHOWING THAT INVESTING IN A 401(k) AT AN EARLY AGE IS BENEFICIAL

It is often difficult for people to realize the importance of investing for retirement at an early age. Retirement is difficult to imagine for a person 23 years old who is graduating from college and is just beginning a career. Age 65 seems so distant, and many people think they have plenty of time until they need to be concerned with retirement. Many people also believe that social security will support them after retirement. One should be aware that there will be fewer dollars per person in social security in the future. This will force people to support themselves by saving more independently and planning more carefully for their futures. The author would like to illustrate the effects of beginning to invest for retirement at age 23 versus beginning to invest at age 33, just 10 years later.

Two examples will be given to illustrate the effects of investing in a 401(k) at age 23 versus at age 33. The first will show how much money a person will have for retirement if he begins investing at age 23. The second will show how much a person will have if he begins investing at age 33. The examples will be calculated both without employer matching and with employer matching of 50 cents on the dollar. Each of the examples will be computed assuming $600 per year is contributed to the 401(k) by the employee. The examples will then be recomputed assuming $1,200 per year is contributed by the employee. These contributions are actually below the average contribution of $2,000 per year when considering low, middle, and highly compensated employees. The relatively low contributions are used because of the assumption that the person investing in the 401(k) has just begun a career. This person will not be as highly compensated as other employees and will not have as much money to contribute to retirement. The important point is that the employee does
contribute something to his retirement.

Numerous assumptions have been made in order to keep the illustration simple. Several of the assumptions need to be addressed before beginning the calculations. One is that it is important to remember that any money contributed to a 401(k) is tax-deferred until retirement. To keep calculations simple, taxes will not be addressed as part of these illustrations.

It is also important to realize that for the calculations the dollar-amount contributed to the 401(k) will remain constant for the entire time the person invests in the 401(k). In reality, a person may change the amount contributed to his 401(k) each year. The future value of the 401(k)s will most likely be less in these examples than they would be in reality. For example, assume a person graduating from college earns a salary of $24,000 per year and contributes $600 per year to his 401(k). In 20 years that person may be earning $70,000 per year. If this were so, the person would probably want to contribute more than $600 per year to his 401(k) and would increase the amount of his contributions, increasing the total amount of money in his retirement plan.

All calculations will use an annual interest rate of 9% which will be compounded annually. This is the long-term growth rate of stocks (Quint, 1991a). This is not a fixed interest rate and may vary in actuality.

To keep numbers simple, forty years will be used as the amount of time until retirement for the person who is 23. Thirty years will be used for the person who is 33. This will give a retirement age of 63.

As one can see from Table 1, there is a significant difference between the future value of the 401(k)s for the person who began investing at age 23 versus the person who began investing at age 33. There is also a significant difference between the future value of the 401(k)s when investing $600 per year versus $1,200 per year and when employers match contributions versus unmatched contributions. The author
hopes Table 1 will enable the reader to more easily visualize the advantages of investing in a 401(k) at an early age.

One last point must be made to encourage people to invest in 401(k)s when they begin their jobs. Consider a college graduate who begins to invest in a 401(k) as soon as he starts his job. The person will not 'miss' the money he invests because he is not used to having the money to spend. Starting to invest in retirement at a later age, however, cuts into the pay a person is used to receiving. Of course there are some disadvantages to investing in 401(k)s, however the author feels the advantages outway the disadvantages.
### Table 1

Results of a person 23 years old investing for retirement for 40 years:

<table>
<thead>
<tr>
<th>Amount Invested Per Year</th>
<th>Future Value Without Employer Matching</th>
<th>Future Value With 50% Employer Matching</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 600</td>
<td>$202,729.47</td>
<td>$304,094.20</td>
</tr>
<tr>
<td>$1,200</td>
<td>$405,458.94</td>
<td>$608,188.40</td>
</tr>
</tbody>
</table>

Results of a person 33 years old investing for retirement for 30 years:

<table>
<thead>
<tr>
<th>Amount Invested Per Year</th>
<th>Future Value Without Employer Matching</th>
<th>Future Value With 50% Employer Matching</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 600</td>
<td>$81,784.52</td>
<td>$122,676.79</td>
</tr>
<tr>
<td>$1,200</td>
<td>$163,569.05</td>
<td>$245,353.57</td>
</tr>
</tbody>
</table>
REFERENCES


Geisel, Jerry. "IRS to Allow Firms to 'Restructure' for 401(k) Tests--At Least for 1990." Business Insurance, (September 17, 1990), 1 and 46.


