CASH OR DEFERRED PLANS:
A CASE OF OVERREGULATION?

In 1978, Congress enacted new compliance standards relating to the qualified status of cash and deferred and salary reduction plans.1 Additional rules have been recently promulgated in the form of proposed-regulations2 which further detail the necessary requirements to obtain qualified plan status. Together, these rules provide strict and exact guidelines for satisfying the nondiscrimination rules3 in relation to contributions.

The advantageous tax treatment of employer contributions to qualified employee deferred compensation plans has always been a significant factor encouraging the increased use of these plans. Employers are permitted to contribute to these plans on a tax deductible basis as long as the plan satisfies certain qualification rules.4 Employees, however, who make contributions to these same qualified plans, whether on a voluntary or mandatory basis, are denied a tax deduction thus requiring contributions to be made with after-tax dollars, except under very limited circumstances.5 This dichotomy led many practitioners, prior to the enactment of the Employee Retirement Income Security Act of 19746 (ERISA), to establish qualified deferred compensation plans which permit an employer to contribute to a plan on behalf of an employee on a tax deductible basis in return for an agreement with the employee to accept a salary reduction or to forego the acceptance of a salary bonus or other taxable benefits.7 These plans became known as cash or deferred arrangements or salary reduction plans.

4. I.R.C. § 404(a) (1976); see Treas. Reg. § 1.404(a)-9 (1981), for applicable rules defining limitations on employer contributions to an employee's profit-sharing or stock bonus trusts. Similarly, employer contributions to a qualified deferred compensation plan for the benefit of an employee are not includible in an employee's gross income except for the years such contributions are distributed to him. Treas. Reg. § 1.402(a)-1(a)(1)(i) (1981).
5. Employees may contribute money on a tax deferred basis to individual retirement accounts, or to qualified deferred compensation plans which specifically provide for voluntary deductible employee contributions, I.R.C. § 219 (1981).
A detailed background will be presented on the use of salary reduction and cash or deferred arrangements; the present viability of such plans in light of rules enacted by the 1978 Revenue Act,9 as well as regulations recently promulgated9 pursuant to the 1978 amendments. Specific emphasis will be placed on an analysis of the new regulations in relation to the 1978 amendments and the legislative history of these amendments. Further analysis will focus on the practical impact of these new regulations on cash or deferred plans and the administrative problems they have created.

I. BACKGROUND

Cash or deferred arrangements and salary reduction plans are very similar in nature. The cash or deferred arrangement offers an employee the choice between accepting deferred compensation in the form of employer contributions to a qualified employee tax exempt trust, or electing to receive an equal or proportionate amount of the employer's contribution as a currently taxable cash benefit. This is accomplished through the use of either a defined benefit plan or, as is more common, through a qualified profit sharing or stock bonus plan.10 The salary reduction plan accomplishes the same purposes. However, contributions to a qualified plan are made on the basis of the employee specifically agreeing to reduce his current compensation or to forego any increase in compensation and have those amounts contributed to the plan.11

The use of these plans became prevalent in the 1960s, after the issuance of the 1956 Ruling12 and the Hicks Ruling.13 These rulings permitted the use of cash or deferred plans, provided that the plans remained in compliance with specific nondiscrimination rules.14 In ad-

10. Proposed Treas. Reg. § 1.401(k)-1(a), reprinted in 46 Fed. Reg. 55,545 (Nov. 10, 1981), would only permit these plans to be used in conjunction with profit-sharing or stock bonus plans.
14. In Rev. Rul. 56-497, supra note 12, a cash and deferred plan was deter-
dition to the discrimination issue, there was a question of whether these plans would violate the constructive receipt rules, thereby requiring the amount which the employee had chosen to defer through employer contributions to the qualified plan to be included in his gross income. Further doubt about the viability of these plans arose after the United States Court of Appeals for the Fourth Circuit, in Hicks, decided that deferred benefits chosen by employee-participants in a cash or deferred profit sharing plan were taxable as gross income to the employee. The terms of that plan specifically stated that all employee deferred contributions were to be characterized as employee contributions. Based on this distinguishing factor, the Hicks Ruling continued to support the qualified status of those cash and deferred plans which characterized contributions as employer contributions.

The viability of cash or deferred plans was questioned once again in 1972 when new regulations were proposed which would have revoked the gross income exclusion previously given to employees for elected employer contributions for salary reduction plans and called into question the same treatment of contributions made to cash or deferred profit sharing plans. These proposed regulations proved to be too sweeping for Congress. Consequently in the 1974 enactment of ERISA, Congress prohibited the issuance of salary reduction regulations in final form for a three year period. Congress also provided that all employer contributions made upon the option of the employee, or through a salary reduction agreement, were to be treated as employee contributions and thus taxable gross income; however, this rule was only to apply prospectively for plans established after the effective date of the

minded to be nondiscriminatory as to contributions and participation where over one-half of the plan participants were among the lowest paid two-thirds of all eligible employees. See Harwood Assoc., Inc. v. Commissioner, 63 T.C. 255 (1974).


17. Id. at 181, 185.


20. When enacting this prohibition, Congress took no position on the tax treatment of these plans. H.R. Rep. No. 807, 93d Cong., 2d Sess. 144, reprinted in 1974-3 C.B. 236, 379 (Supp.).
Provision. Plans in existence prior to the effective date were to be governed by the law as it was administered prior to the issuance of the 1972 regulations.

This status quo treatment of currently existing cash or deferred and salary reduction plans was extended by Congress through December 31, 1979, by two statutory enactments. Final disposition of the tax treatment of these plans was made when Congress passed the 1978 Revenue Act. The 1978 Act added new sections, 401(k) and 401(a)(8), providing rules under which all cash or deferred and salary reduction plans are to be administered. These sections permit cash or deferred plans to be used only in conjunction with profit sharing or stock bonus plans. This restriction also applies to the use of salary reduction plans. Administrators now have a choice of qualifying cash or deferred and salary reduction plans by complying with the new strict mechanical nondiscrimination rules as to contributions or the rules normally applicable to section 401 qualified plans. In addition, these plans must also satisfy the minimum participation rules generally applicable to deferred compensation plans. Recently, the IRS has proposed new regulations which further detail the necessary requirements to obtain qualified plan status. These regulations represent a restrictive interpretation of the 1978 amendments. Pending the final adoption of these proposed regulations, the IRS has announced that it will use these regulations as guidelines in issuing determination letters and rulings and that they may be relied on in drafting plans to meet the requirements of the 1978 amendments.

21. Id. Where shareholder approval is required for formal adoption of the plan, such approval must have been obtained prior to the effective date of the Act. Conf. Rep. No. 1280, 93d Cong., 2d Sess. 355, reprinted in 1974-3 C.B. 516.


II. NEW CASH OR DEFERRED AND SALARY REDUCTION PLAN, RULES, AND REGULATIONS

The provisions of the 1978 Revenue Act which effect the tax treatment of cash or deferred and salary reduction plans reflect the hybrid nature of contributions made to such plans. The employee election provisions, inherent within these plans, give contributions the status of employee contributions even though technically they are contributed by the employer for the benefit of the employee.\(^{31}\) This aspect of these plans caused Congress to enact provisions which continued the practice of requiring employee elected contributions to remain nonforfeitable.\(^{32}\) New provisions were added restricting the employee’s right to receive those benefits prior to retirement or on the occurrence of specific events.\(^{33}\)

The 1978 amendments provide that an employee’s right to his accrued benefits, derived from employer contributions made pursuant to the employee’s election, are to be nonforfeitable.\(^{34}\) In addition, these same contributions may not be distributed from the trust to the employee or other beneficiary, prior to the employee’s death, retirement, disability, separation from service, hardship, or the attainment of age 59 1/2.\(^{35}\) Similarly, a distribution may not be made merely by reason of the completion of a stated period of participation,\(^{36}\) nor by the lapse of a fixed number of years.\(^{37}\)

The proposed regulations define new compliance standards for permitting hardship distributions from the plan. Specifically, the regulations define hardship distributions as those necessitated by an employee’s


\(^{33}\) See infra text accompanying notes 35-37.


\(^{37}\) These restrictions do not normally apply to profit-sharing plans. Normally these type of plans provide for distribution of funds “accumulated under the plan after a fixed number of years, attainment of a stated age, or upon the occurrence of some event . . . .” Treas. Reg. § 1.401-1(b)(1)(ii) (1976). These restrictions on cash or deferred plans, however, are consistent with the goals of a pension plan which seeks to guarantee the availability of funds upon retirement. See Treas. Reg. § 1.401-1(b)(1)(i) (1976).
immediate and heavy financial needs. In addition, the amount to be distributed cannot reasonably be available from other resources of the employee. This latter provision has been openly criticized due to its vagueness and the substantial burden it places on administrators by effectively requiring them to make a detailed investigation of a participant’s personal finances to determine what resources are reasonably available to the participant.

This standard of hardship defined in the proposed regulation is more restrictive and represents a substantial departure from the hardship rules normally applicable to profit sharing plans. The proposed hardship rule focuses more on the timing and severity of the need rather than on the more traditional approach that looks at the reason for the requested distribution. Defining "immediate" and "heavy financial need," without further guidance, will likely be an uncertain process leading to subjective plan administration. It is clear that the IRS is seeking to prevent these employee elected contributions from being accessible without penalty prior to retirement. This has been accomplished by the creation of a more stringent standard which is not clearly defined for purposes of day-to-day plan administration. The lack of legislative history addressing this issue has made it difficult to discern Congressional intent. It is clear, however, that in the past when Congress desired to use a more stringent hardship standard, it specifically knew how to provide for one.

One of the most important changes in the regulation of cash or deferred and salary reduction plans made by the 1978 Revenue Act was the addition of comprehensive mechanical nondiscrimination tests. These plans may obtain qualified status by satisfying one of two mechanical nondiscrimination tests in addition to fulfilling the minimum

39. Id.
42. See generally Mazawey, Need for Certainty and Flexibility in Cash or Deferred Arrangements—Comments on Proposed Regulations Under § 401(k), 8 J. PENSION PLAN. & COMPLIANCE 90-95 (1982) [hereinafter cited as Mazawey].
43. I.R.C. § 457(b)(5) (Supp. IV 1980) (distributions from deferred compensation plans for state and local governments permitted when a participant is faced with an unforeseeable emergency).
participation requirements. The mechanical nondiscrimination tests were enacted as a supplement to the already existing nondiscrimination rules generally applicable to all deferred compensation plans. Cash or deferred and salary reduction plans may satisfy either set of rules to qualify for tax exempt status. The mechanical test's provisions, however, offer administrators a more exact means of determining the plan's qualified status and this will be the predominant method used to qualify this type of plan as compared to the usual nondiscrimination rules which focus on the actual provisions and operation of the plan to make this factual determination.

The two statutory mechanical discrimination tests are applied to determine whether the highly compensated eligible employees actually receive an impermissible percentage of the total elective benefits actually deferred by all employees. Highly compensated employees for this purpose are all those eligible employees who receive compensation in amounts greater than two-thirds of all other eligible employees. This determination of discrimination is made by comparing the actual deferral percentage (ADP) for all employees who are considered highly compensated (top 1/6) with the actual deferral percentage for all other employees (lower 2/3). The actual deferral percentage is derived by averaging the ratios of the amounts contributed by the employer and elected by each employee to be deferred for each plan year, to the employee's total compensation for the plan year calculated separately for each employee. An employee's total compensation is calculated

Example:

<table>
<thead>
<tr>
<th>Employee</th>
<th>Compensation</th>
<th>Elected Contribution to Plan</th>
<th>Cash Elected</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>30,000</td>
<td>1,500</td>
<td>0</td>
</tr>
<tr>
<td>B</td>
<td>15,000</td>
<td>300</td>
<td>450</td>
</tr>
<tr>
<td>C</td>
<td>10,000</td>
<td>300</td>
<td>300</td>
</tr>
</tbody>
</table>

The actual deferral percentage for each employee is calculated by comparing the share

49. I.R.C. § 401(k)(3)(B) (1978); Proposed Treas. Reg. § 1.401(k)-1(b)(8)(v), reprinted in 46 Fed. Reg. 55,545 (Nov. 10, 1981). Use of this test is illustrated in the following example. In this example an employee has a choice under a cash or deferred profit-sharing plan to elect to receive in cash up to 10% of his compensation or to defer that amount or portion thereof into the plan.
prior to the deferral of any elected contribution.\textsuperscript{50}

Using the actual deferral percentages for both groups of employees, the plan will not be considered to discriminate in favor of highly compensated employees if the ADP for highly compensated employees does not exceed the average ADP for all other employees multiplied by 1.5.\textsuperscript{51} The statute offers an alternative test which requires that the difference between the ADP for both groups not exceed three percentage points,\textsuperscript{52} in addition to the requirement that the ADP for higher compensated employees not exceed the average ADP for all other employees multiplied by 2.5.\textsuperscript{53} A plan will be considered qualified if it satisfies either of the tests enumerated above and the minimum participation requirements.\textsuperscript{54}

The proposed mechanical nondiscrimination rules are applied somewhat differently depending on whether the cash or deferred plan consists solely of employee elected contributions, or whether it combines the elective option with additional employer contributions not subject to a cash election option. Where a cash or deferred plan contains provisions for non elective employer contributions, the proposed regulations would permit these contributions to be considered in the

\begin{center}
\begin{tabular}{|c|c|c|}
\hline
Employee & Ratio of Contribution to Compensation & Actual Deferral Percentage \\
\hline
A & 1,500/30,000 & .05 \\
B & 300/15,000 & .02 \\
C & 300/10,000 & .03 \\
\hline
\end{tabular}
\end{center}

Applying the first test, this plan would not qualify because the ADP for highly compensated employees (5\%) is greater than the average ADP for all other employees multiplied by 1.5 (((.02 + .03) / 2) x 1.5 = 03.75). However, applying the second nondiscrimination test, the plan would be qualified because neither the ADP for highly compensated employees (5\%) is greater than the average ADP for all other employees multiplied by 2.5 (((.02 + .03) / 2) x 2.5 = 6.25\%), nor does the former exceed the latter by more than three percentage points. (2.5\% + 3\% / 5\%).


\textsuperscript{53} Id. This rule prevents a plan from permitting highly compensated employees from electing 3\% deferral benefits while all other employees elect to receive 100\% cash. See examples (2) and (3) Proposed Treas. Reg. § 1.401(k)-1(b)(9), reprinted in 46 Fed. Reg. 55,545 (Nov. 10, 1981).

\textsuperscript{54} I.R.C. § 410 (1976).
calculation of the deferral percentages. This effectively creates a safe harbor for employers who wish to make nonelective contributions for the lower two-thirds compensated employees. Specifically, the non-discrimination tests may be satisfied even if all highly compensated employees defer 100% of their elective shares and all other employees elect to take 100% of their benefits under the cash option. The computation of nonelective employer deferrals specifically excludes all amounts contributed by employers under the Federal Insurance Contribution Act. Use of this safe harbor, however, is specifically conditioned on the requirement that these nonelective contributions used to satisfy the discrimination tests must also satisfy the same nonforfeitable and withdrawal rules applicable to elective contributions. Normally, these nonelective contributions would be subject to a vesting schedule permissible under the minimum vesting standards. Employers subject to this vesting requirement are likely to respond by excluding employees from participating in the plan prior to the completion of their third year of service or attainment of age twenty-five whichever occurs later, since this is already permissible under the minimum participation standards when benefits are immediately 100% vested.

The preamble to the proposed regulations states that the promulgation of a fail-safe rule was never considered by Congress when it passed the 1978 Revenue Act. Applying the nonforfeitable and withdrawal

56. This fail-safe rule, however, cannot be used to justify discriminatory levels of benefits by, for example, providing 10% nonelective contributions to the lower one-third compensated group while providing 15% elective benefits to the higher compensated one-third group. The proposed regulation requires the total amounts subject to deferral to be nondiscriminatory. Proposed Treas. Reg. § 1.401(k)-1, reprinted in 46 Fed. Reg. 55,544-45 (Nov. 10, 1981) (Supplementary Information: Scope of Deferral Rules; Comments Accompanying Publication of Proposed Treas. Reg. § 1.401(k)-1). See infra text accompanying notes 72-76.
57. See 46 Fed. Reg. 55,545 (Nov. 10, 1981) (appearing in Supplementary Background: New Law—In General). This statement, appearing in the preamble of the new proposed regulations, raised an important issue of whether and to what extent may a cash or deferred plan be integrated with social security benefits. The IRS has not taken a position on this issue as of the date of publication of this article.
rules to nonelective employer contributions was considered consistent with the 1978 amendments. A closer look at the statute and its legislative history, however, requires a different conclusion.

To calculate the actual deferral percentage, the statute requires that "the amount of employer contributions actually paid over to the trust on behalf of each such employee for such plan year" is to be determined. The statute implicitly requires that all employer nonelective contributions be included in the deferral percentage calculation without any reference to whether those amounts are immediately 100% vested. Only employee elected contributions are explicitly required to be immediately 100% vested.

The legislative history offers evidence which clearly supports this conclusion. While the House and Senate Reports accompanying the 1978 Revenue Act are silent on this issue, the Joint Committee on Taxation addressed the issue in a 1979 government publication explaining the general provisions of the 1978 Act. The Joint Committee Print, in accord with the Senate and House Reports states that "all amounts contributed by the employer pursuant to an employee's election must be nonforfeitable at all times."

Indeed, a footnote appearing in the Committee Print explains how the actual deferral percentage should be determined. The footnote states that both mandatory and optional deferrals are intended to be taken into account in determining the actual deferral percentage. The Com-

63. Id.
65. JOINT COMM. ON TAX., 95TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE ACT OF 1978 (Comm. Print 1978) [hereinafter referred to as Committee Print].
68. Committee Print, supra note 65.
69. Id. Footnote two of the Committee Print states in full: In determining the actual deferral percentage of a participant, it is intended that both mandatory and optional deferrals are to be taken into account. Thus, a plan could be assured of satisfying the nondiscrimination requirement as to contributions if the employer contributions are allocated to participants in proportion to their base pay and at least two-thirds of the contribution allocated to each participant has to be deferred. However, it is not intended that a plan will be permitted to require a larger mandatory deferral percentage for lower-paid participants than it requires for higher-paid participants (e.g., it could not require 50-percent deferral for the lowest paid two-thirds of the participants and permit the highest paid one-third of the participants to defer whatever percentage they chose).
70. Id.
committee's explanation leaves out any mention of vesting requirements in reference to employer nonelective contributions. This is significant because the Committee Print requires these plans to satisfy all of the usual profit sharing or stock bonus plan qualification rules in addition to the formal requirements previously discussed. The fact that the 1978 amendments did not change the vesting requirements applicable to nonelective matching employer contributions would require, pursuant to the committee report, that the usual vesting rules applicable to profit sharing and stock bonus plans be applied. There is no basis upon which an immediate 100% vesting rule for these nonelective contributions can be sustained. Instead, the minimum vesting standard rules should be applied. Based on this analysis, this author recommends that the 100% vesting rule for employer nonelective contributions be dropped from the proposed regulations and to continue to permit the use of these contributions to satisfy the mechanical deferral tests as long as they comply with the minimum vesting rules.

The new regulations differ from the Joint Committee's explanation of the 1978 amendments in one other respect. In discussing the scope of the deferral rules, the preamble to the regulations states that the most important aspect of these plans is the total amount subject to deferral. Thus, the regulations would permit plans to require different mandatory contribution rates for the two classes of employees as long as the total amounts subject to deferral is nondiscriminatory. The Joint Committee Print, however, explicitly states that this type of practice would not be permitted. The use of nonelective employer contributions to satisfy the deferral percentage tests is specifically conditioned on the premise that a plan may not require a larger mandatory deferral percentage for lower paid participants than for higher paid participants. Thus, a plan could not permit highly compensated participants to elect any amount up to fifteen percent of salary while requiring lower compensated employees to accept a contribution of ten percent of salary without a right of election. The author suggests that the new regulations be amended to comply with the intentions of the Joint Committee on Taxation.

The use of nonelective employer contributions to satisfy the actual deferral percentage test is particularly useful where the cash or deferred arrangement is built into a thrift plan. In a thrift plan, the

71. Id.
73. Id.
74. Committee Print, supra note 65, at 83.
75. Id.
76. Id.
employee makes contributions (either voluntary or mandatory) to a plan with after-tax dollars, thereby preserving the accessibility of his contribution. These contributions are often made pursuant to a salary reduction agreement between the employer and employee.\textsuperscript{77} The employer, in return, makes contributions by matching, on a fixed percentage basis, the employee's contribution.\textsuperscript{78}

Larger employers may find that they can circumvent the new cash or deferred rules by having the built-in cash or deferred arrangement qualify with the rest of the thrift plan according to the general nondiscrimination rules.\textsuperscript{79} Care must be taken, however, to avoid discrimination as to contributions and participation by requiring lower compensated employees to make excessive mandatory contributions. Generally, mandatory contributions not exceeding six percent of compensation has been considered nondiscriminatory.\textsuperscript{80}

Employers using thrift plans, as part of their total compensation package, will find it increasingly advantageous to adopt a qualified salary reduction or cash or deferred arrangement within their thrift plan in order to offset any adverse effects that the new rules pertaining to individual retirement accounts (IRA)\textsuperscript{81} may have on the plan's qualified status. While thrift plans are often used by employers to encourage employee savings, they can easily and inexpensively be adopted for retirement purposes by adding a qualified salary reduction or cash or deferred arrangement. This not only will help prevent the outflow of contributions into IRAs, but also will enable participants to enjoy significant tax advantages otherwise unavailable with the use of IRAs. Some of these advantages include $5,000 death benefit exclusion\textsuperscript{82} and lump sum income averaging.\textsuperscript{83} It must be noted that many of

\textsuperscript{77} Under the new proposed regulations, salary reduction plans may obtain qualified plan status (thus avoiding the constructive receipt rules) only by complying with the proposed cash and deferred plan regulations. Proposed Treas. Reg. § 1.402(a)-1(d), reprinted in 46 Fed. Reg. 55,545 (Nov. 10, 1981). See supra text accompanying notes 12-18.


\textsuperscript{82} I.R.C. § 101(b) (1976).

\textsuperscript{83} Compare I.R.C. § 402(e) (1976); Treas. Reg. § 1.402(a)(1) (1966) (tax treat-
these same benefits are also available to employee stock bonus plans.\(^{64}\)

However, employer contributions made to a cash or deferred plan will constitute taxable wages for purposes of FICA taxes after 1983 and FUTA taxes after 1984. A special transition rule permits postponing the operation of this provision provided that appropriate elections are made by the employee prior to January 1, 1984.\(^{85}\)

It should be noted that the Securities and Exchange Commission has recently clarified its position concerning the issue of whether an employee's interest in a cash or deferred profit sharing or stock bonus plan constitutes a security, thus requiring registration of the plan under the 1933 Securities Act. The Commission has recently issued two decisions in the form of No-Action Letters setting forth its position that a 1981 Securities Act Release which stated that cash or deferred profit sharing and stock bonus plans are exempt from the registration requirements of the 1933 Securities Act does not apply to cash or deferred profit sharing or stock bonus plans with salary reduction provisions. It is the Commission's view that cash or deferred profit sharing or stock bonus plans with salary reduction provisions essentially permit an employee to acquire an interest in the plan which is now considered a security.\(^{86}\)

\(^{64}\) \textit{ment of distributions from I.R.C. § 401 qualified plans) with I.R.C. § 408(d) (1976) (tax treatment of IRA distributions).}

\(^{84}\) A cash and deferred arrangement can be combined with an employee stock purchase plan (a qualified stock bonus plan). Under I.R.C. § 423 (Supp. IV 1980), employees have the right to purchase employer securities with after-tax dollars at a modest discount without including the discount as gross income until the stock is sold. The employer receives no tax deduction for the discount.

Using a qualified cash or deferred arrangement, an employer can contribute funds to a tax exempt trust which purchases securities from the employer at a discount. These purchases are made with employee pre-tax dollars and the employer is allowed a deduction for the amount of the discount. When the employee receives the stock as a distribution, he is taxed on the discount while gains are taxed as capital gains.

\(^{85}\) Prior to March of 1983, such amounts would be excluded as FICA and FUTA taxable wages. See Lipsig I, \textit{supra} note 78, at 25, col. 1. The author states that he has received two 1981 unpublished private rulings from the IRS to this effect. On March 24, 1983, Congress passed the Social Security Amendments Act of 1983. Section 324(a)1 and (b)1 of the Act added to I.R.C. §§ 3121 and 3305 respectively to provide that employer cash or deferred contributions to the extent excluded from an employee's gross income pursuant to § 401(a)(8) or § 414(h)(2) shall be included as taxable wages for FICA and FUTA purposes. Section 203(b)(5)(C) of the Social Security Amendments Act of 1983 provides a transition rule which postpones operation of the law with regard to cash or deferred plans for one year upon the proper election to be made by an employee prior to January 1, 1984.

Another alternative, most favored by practitioners, would permit a withdrawal or recharacterization of excessive plan contributions.\textsuperscript{87} This type of safe harbor rule would allow excessive tax deferred contributions by highly paid individuals to be withdrawn or recharacterized in the form of voluntary taxable contributions, thus enabling the plan to satisfy the deferral tests.\textsuperscript{88} The IRS has responded to this suggestion for an additional safe harbor with a formal notice. Specifically, they stated that the proposed regulation does not permit the withdrawal or recharacterization of contributions to avoid prohibited discrimination.\textsuperscript{89} The recharacterization is the most favored safe harbor suggestion because it will not cost employers any money in the form of guaranteeing a minimal level of contributions. However, it is unlikely that such a safe harbor provision would be adopted because employees would not receive any additional benefits over that which is already required by the statute.\textsuperscript{90} In addition, this type of safe har-


\textsuperscript{88} See XIV Tax Notes 486-87 (1982).

\textsuperscript{89} One practitioner has proposed a compromise solution which would permit recharacterization of excess employee/employer contributions made on behalf of highly compensated employees only if the plan limits such contributions for the present year to the percentage which would have been permissible in the immediate preceding year based on the actual deferral percentage of the lower two-thirds participants for such prior plan year. Letter from Kirkland & Ellis to the Commissioner of Internal Revenue (Feb. 12, 1982) (unpublished letter commenting on Proposed Treas. Reg. § 1.401(k)-1, \textit{reprinted in} 46 Fed. Reg. 55,544 (Nov. 10, 1981)).

bor rule would create administrative difficulties in recomputing employee tax returns if a plan failed to qualify. Finally, such a rule would also require that the original employer contributions be fictionally recharacterized into employee contributions to avoid the prohibition of refunding employer contributions.91

III. PLAN ADMINISTRATION UNDER THE NEW RULES

The proper administration of cash or deferred arrangements is a vital aspect of a plan’s continued qualified status. While this is true for most deferred compensation plans, it is especially applicable to cash or deferred plans due to additional administrative requirements necessitated by the proposed regulation. Specifically, special consideration must be given to accounting procedures, timing of contributions, and employee deferral rates. These additional administrative requirements92 will have the effect of increasing the costs of creating and maintaining such a plan. While these additional costs may be substantial, they should not be considered prohibitive, especially in light of the many benefits which can be derived from the use of these plans.

The proposed regulations are effective for plan years beginning after December 31, 1979.93 Qualified plans which were in existence prior to this date, pursuant to the rules enacted under ERISA,94 are specifically permitted to maintain separate accounts for each employee

has proposed a safe harbor for plans which provide for 100% vesting after three years of service) or (where the IRS proposed a vesting safe harbor rule for the purpose of complying with I.R.C. § 411(d)(1) which would grant qualified plan status to those plans providing 100% vested nonforfeitable benefits to employees after three years of service).


92. See infra text accompanying notes 93-103.

93. Proposed Treas. Reg. § 1.401(k)-1(f), reprinted in 46 Fed. Reg. 55,545 (Nov. 10, 1981). Due to the additional requirements imposed by the new regulations, the IRS is currently reviewing requests for an interim rule covering the time period between January 1, 1981 and the final date the proposed regulation is adopted. See 47 Fed. Reg. 988 (Jan. 8, 1982). Such a rule is necessary for those plans which comply with I.R.C. § 401(k) but not with the additional requirements instituted by the new proposed regulation. Failure to adopt an interim rule will cause plans to lose their qualified status, thus requiring a large number of employees to recalculate their federal taxes for the interim tax years.

94. ERISA, § 2006(b) (1976).
not subject to the restrictions enacted by the 1978 amendments to plan years prior to January 1, 1980.\textsuperscript{95}

Additional accounting procedures must be adopted if the plan is qualified through the use of the safe harbor rules. Employer nonelective contributions which are used to satisfy the deferral tests are required to be administered in separate accounts. All gains, losses, withdrawals, and forfeitures and any other expenses experienced by the plan must be allocated to each of these separate accounts.\textsuperscript{96} Thus, a cash or deferred plan may consist of four accounts for each employee.\textsuperscript{97}

Plan administrators must also contend with the rules pertaining to the timing of contributions. Both nonelective, nonvested, and nonelective (100\%) vested contributions are subject to the normal timing rules applicable to employers.\textsuperscript{98} However, under the proposed regulations, employee elected deferrals are required to be allocated to participant accounts within thirty days after the end of the plan year.\textsuperscript{99} This rule effectively treats employer contributions as employee contributions.\textsuperscript{100} Such a rule will inevitably cause administrative problems in situations where the plan year coincides with the employer's fiscal year. It is unlikely that thirty days after the close of the fiscal year the employer will have sufficient information to calculate actual profits. Furthermore, plan administrators are equally unlikely to have completed a determination of which employees are eligible to participate in the plan.

The timing of an employer's contribution also directly affects the timing of the employee's receipt of any elected cash payments. This affects further the timing of the inclusion of these payments in the employee's gross income. Clearly, the IRS has an interest in requiring an employer to account for these contributions prior to the normal limitation period in order to prevent elected cash deferrals from being taxed in a subsequent year, despite the fact that even though the money was earned in a prior tax year, it was not constructively received. It is possible to settle these conflicting problems by changing

\textsuperscript{95} Rev. Rul. 80-16, 1980-1 C.B. 82.
\textsuperscript{97} Id. The four accounts would include the following: 1) an account for plan years prior to January 1, 1981; 2) an account for employer nonelective, nonvested contributions; 3) an account for employer nonelective, vested contributions; and 4) employee elected, vested contributions.
\textsuperscript{98} I.R.C. § 404(a)(6) (1976).
\textsuperscript{100} See Treas. Reg. § 1.415-6(b)(7)(ii) (1980).
the timing rules to a sixty or ninety day period. This time limitation would more reasonably reflect the administrative difficulties faced by both employers and administrators in this area.

The use of cash or deferred plans requires that the deferral rules be satisfied as a condition of obtaining qualified plan status. Compliance with these deferral rules, at a minimum cost, is one of the most significant factors affecting the willingness of both employers and employees to invest substantial amounts of money in this type of plan. The compliance with these deferral rules can be accomplished by either adoption of the safe harbor rules, or by closely administering and clearly defining limitations on deferral rates for highly compensated employees.

When the safe harbor rules are not adopted, administrators must concentrate on obtaining participation of lower compensated employees early in the plan year since the new regulations do not permit recharacterization of contributions made by highly compensated individuals at the end of the plan year. By requiring the lower compensated eligible group to elect an irrevocable cash or deferred benefit early in the plan year, highly compensated employees will be able to make a subsequent limited deferral election based on the percentage deferred by the lower compensated group so that the deferral tests will be satisfied. Limiting the deferral contribution of highly compensated employees in this manner would not be discriminatory since the end results would satisfy the nondiscriminatory deferral rules.

Another alternative, permissible under the current proposal, would require employers to wait until the end of the plan year to determine if the deferral tests have been satisfied. If the plan experience fails to comply with these tests, the employer would then be required to make additional contributions to employees in the lower paid group to the extent necessary to satisfy the deferral tests. In larger plans where there is substantial participation by the highly compensated (top %) group, this contribution requirement may create a disincentive to lower compensated employees to contribute to the plan due to the fact that they will receive a minimum contribution regardless of their failure to voluntarily elect plan contributions. This alternative also would create a cash contingency which may be unacceptable to employers since they may be required to make additional contributions over and above those provided for under the basic profit sharing allocation formula.

Smaller employers, however, who wish to maximize contributions

102. See supra text accompanying notes 89-91.
to the principles at a minimal cost of covering lower paid employees will find this alternative more attractive. This is particularly true in situations where there is a considerable difference between the salaries of covered employees and principles who have an ownership interest in the business. The mechanical nondiscrimination rules to not take the discrepancies in salaries into consideration. This results in relatively lower paid employees being included in the top one-third highly compensated group by virtue of their earning more than two-thirds of all other employees. These lower paid employees who are statutorily placed into the top one-third group will rarely elect employer contributions especially when they are required to be made on the basis of salary reduction. This will have the effect of lowering the average deferral percentage for the top one-third group, thus reducing the required amount an employer must contribute on behalf of the lower two-thirds compensated group for purposes of satisfying the fail safe rules. Hence, the principle can enjoy the average of a maximum contribution\(^{103}\) (when combined with a seven percent excess only integrated profit sharing plan\(^{104}\)) at a very minimal cost.

**Conclusion**

The new proposed cash or deferred arrangement regulations represent a restrictive interpretation of the 1978 amendments which restored qualified status to these plans. This restrictive approach may be reflective of the IRS' dislike for the partial removal by Congress of the Service's discretionary power to make discrimination determinations.

This restrictive approach has had its greatest effect on the promulgation of a safe harbor rule. Failure to follow Congressional intent, as expressed in the Joint Committee Print, has resulted in a more costly safe harbor rule. This is significant because new plans will need this certainty if employees are to be encouraged to invest in these types of plans. An inability to guarantee tax-exempt deferral may result in employees electing cash payments and depositing funds into IRAs. To avoid this, employers must sell the plan to their employees by point-

\(^{103}\) I.R.C. § 415(c) (1982), amended by The Tax Equity and Fiscal Responsibility Act of 1982 provides that contributions and other additions to a defined contribution plan (profit sharing plan) may not exceed the lesser of 25% of compensation or $30,000 subject to the maximum deductible limitations of I.R.C. § 404(a)(3) (1976) (maximum deductible contribution limited to 15% of compensation paid or accrued during the taxable year to all employees).

ing out the overall tax advantages as well as the risks of losing tax-exempt status of employee deferrals if this risk is not administratively eliminated.

Despite the additional administrative costs and restrictive rules, cash or deferred arrangements should become more popular if used in conjunction with thrift plans because of the minimal additional costs incurred. To what extent these additional costs and restrictions affect the more widespread adoption of these plans remains to be seen.

Allan Friedland*  

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* J.D. 1982, Delaware Law School of Widener University; B.S. 1977, Wharton School of the University of Pennsylvania. Associate in the law firm of Rose, Miner & Podolsky, P.C., Cherry Hill, New Jersey. Member of the Pennsylvania Bar.