

Section 401.—Qualified Pension, Profit-Sharing and Stock Bonus Plans, etc.

26 CFR 1.401(k)-1: Certain cash or deferred arrangements.

Qualified cash or deferred arrangement; participation. This revenue ruling describes certain criteria that must be met before an employee's compensation can be contributed to an employer's section 401(k) plan in the absence of an affirmative election by the employee.

Rev. Rul. 98-30

ISSUE

Will employer contributions to a profit-sharing plan fail to be considered elective contributions, within the meaning of § 1.401(k)-1(g)(3) of the Income Tax Regulations, made under a qualified cash or deferred arrangement, within the meaning of § 401(k) of the Internal Revenue Code, merely because they are made pursuant to an arrangement under which, in any case in which an employee does not affirmatively elect to receive cash, the employee's compensation is reduced by a fixed percentage and that amount is contributed on the employee's behalf to the plan?

FACTS

Employer X maintains Plan A, a profit-sharing plan intended to satisfy the requirements of § 401(a), including §§ 401(k) and 401(m). Under Plan A, any employee of Employer X, including an employee with less than one year of service, may elect to have Employer X make contributions on the employee's behalf to Plan A in lieu of receiving that amount as cash compensation that would otherwise be payable to the employee. The employee may designate the amount of these compensation reduction contributions as a percentage of the employee's compensation, subject to certain limitations set forth in the plan.

Under Plan A, a newly hired employee is immediately eligible to participate in Plan A. If the employee does not affirmatively elect to receive cash or have a specified amount contributed to Plan A, his or her compensation is automatically reduced by 3 percent and this amount is contributed to Plan A. An election not to make compensation reduction contribu-

tions or to contribute a different percentage of compensation can be made at any time. The election is effective for the first pay period and subsequent pay periods (until superseded by a subsequent election) if filed when the employee is hired or if filed within a reasonable period thereafter ending before the compensation for the first pay period is currently available. Thus, if an employee files an election to receive cash in lieu of compensation reduction contributions and the election is filed when the employee is hired or within a reasonable period thereafter ending before the compensation is currently available (and if the employee does not later elect to have compensation reduction contributions made), then no compensation reduction contributions for the first pay period are made on the employee's behalf to Plan A. Elections filed at a later date are effective for payroll periods beginning in the month next following the date the election is filed.

At the time an employee is hired, the employee receives a notice that explains the automatic compensation reduction election and the employee's right to elect to have no such compensation reduction contributions made to the plan or to alter the amount of those contributions, including the procedure for exercising that right and the timing for implementation of any such election. The employee is subsequently notified annually of his or her compensation reduction percentage and the employee's right to change the percentage.

Plan A provides that compensation reduction contributions are immediately nonforfeitable and, if the employee has not attained age 59½, cannot be distributed prior to the employee's retirement, death, or separation from service except in the case of hardship (as defined in the plan). Plan A also provides that, for each employee who has at least 1 year of service, Employer X will make matching contributions to Plan A on account of the employee's compensation reduction contributions up to a specified percentage of the employee's compensation. Plan A does not permit after-tax employee contributions.

Plan A provides that both matching contributions and compensation reduction contributions will be invested in accordance with the participant's election

among a broad range of investment funds held by the trustee or, if no investment election is made by the participant, in the trust's balanced fund which includes both diversified equity and fixed income investments.¹

LAW AND ANALYSIS

Section 401(k) provides that a profit-sharing or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan can meet the requirements of § 401(a) even if it includes a qualified cash or deferred arrangement. Section 401(k) also sets forth the requirements that a cash or deferred arrangement must satisfy in order to be a qualified cash or deferred arrangement.

Section 1.401(k)-1(a)(2)(i) defines a cash or deferred arrangement as an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a plan that is intended to satisfy the requirements of § 401(a). Section 1.401(k)-1(a)(2)(ii) provides that a cash or deferred arrangement does not include an arrangement under which amounts contributed under a plan at an employee's election are designated or treated at the time of contribution as after-tax employee contributions.

Section 1.401(k)-1(a)(3)(i) defines a cash or deferred election as any election (or modification of an earlier election) by an employee to have the employer either provide an amount to the employee in the form of cash (or some other taxable benefit) that is not currently available or contribute an amount to a trust (or provide an accrual or other benefit) under a plan deferring the receipt of compensation. Section 1.401(k)-1(a)(3)(iv) provides that a

¹The Department of Labor has advised Treasury and the Service that, under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), fiduciaries of a plan must ensure that the plan is administered prudently and solely in the interest of plan participants and beneficiaries. While ERISA § 404(c) may serve to relieve certain fiduciaries from liability when participants or beneficiaries exercise control over the assets in their individual accounts, the Department of Labor has taken the position that a participant or beneficiary will not be considered to have exercised control when the participant or beneficiary is merely apprised of investments that will be made on his or her behalf in the absence of instructions to the contrary. See 29 CFR § 2550.404c-1 and 57 FR 46924.

cash or deferred election does not include a one-time irrevocable election, made at the time an employee commences employment with the employer or upon the employee's first becoming eligible under any plan of the employer, to have contributions made by the employer on the employee's behalf to the plan (or to any other plan of the employer) equal to a specified amount or percentage of the employee's compensation.

Section 1.401(k)-1(e)(2) provides generally that a qualified cash or deferred arrangement must provide that the amount that each eligible employee may defer as an elective contribution is available to the employee in cash.

Section 1.401(k)-1(g)(3) defines elective contributions as employer contributions made to a plan that were subject to a cash or deferred election under a cash or deferred arrangement. Such contributions are elective contributions without regard to whether the cash or deferred arrangement is a qualified cash or deferred arrangement.

The definition of a cash or deferred election in § 1.401(k)-1(a)(3)(i) requires that the employee have an election between the employer paying cash (or some other taxable benefit) to the employee or making a contribution to a trust on behalf of the employee. The regulation does not require that the employee receive an amount in cash in any case in which the employee does not make an affirmative election to have that amount contributed to the trust. Thus, a cash or deferred election will not fail to be made under a qualified cash or deferred arrangement merely because, when an employee fails to make an affirmative election with respect to an amount of compensation, that amount is contributed on the employee's behalf to a trust, provided that the employee had an effective opportunity to elect to receive that amount in cash. The employee has an effective opportunity to elect to receive an amount in cash as required under § 1.401(k)-1(a)(3)(i) if the employee receives notice of the availability of the election and the employee has a reasonable period to make the election before the date on which the cash is currently available.

If Plan A were to permit after-tax employee contributions, then the amounts contributed to the plan would have to be designated or treated, at the time of the contribution, as pre-tax compensation reduction contributions or after-tax employee contributions.

Compensation reduction contributions made by Employer X to Plan A (including those made if the employee has not filed an election to the contrary) are amounts contributed pursuant to a procedure under which the employee receives a notice explaining his or her rights to have no compensation reduction contribution and, after receiving the notice, the employee has a reasonable period before the cash is currently available in which to elect to receive the cash in lieu of having an employer contribution made to the plan in that amount. Thus, an eligible employee has an effective opportunity to elect to receive cash or have a contribution made to the plan on the employee's behalf. In addition, compensation reduction contributions made under the plan are not contributions made pursuant to a one-time irrevocable election because the employee can change the election in the future. Consequently, the compensation reduction contributions under Plan A are made pursuant to a cash or deferred election and satisfy the requirement in § 1.401(k)-1(a)(3)(i) that the amount that each eligible employee may defer as an elective contribution be available to the employee in cash. The result would be the same if the plan required a period of service (permitted under § 401(k)(2)(D)) before an employee became eligible for elective contributions.

HOLDING

Where, as in this case, an eligible employee has an effective opportunity to elect to receive cash or have that amount contributed by the employer to a profit-sharing plan, those employer contributions made on the employee's behalf to the plan in lieu of receipt of cash compensation will not fail to be considered elective contributions within the meaning of § 1.401(k)-1(g)(3) made under a qualified cash or deferred arrangement within

the meaning of § 401(k) merely because they are made pursuant to an arrangement under which, in any case in which an employee does not affirmatively elect to receive cash, the employee's compensation is reduced by a fixed percentage and that amount is contributed on the employee's behalf to the plan.

PAPERWORK REDUCTION ACT

The collection of information contained in this revenue ruling has been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1605.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this revenue ruling is in the sixth paragraph in the section headed "LAW AND ANALYSIS." This information is required in order for certain employee elections to meet the requirements of § 401(k). The collection of information is required to obtain a benefit. The likely respondents are businesses or other for-profit institutions, and not-for-profit institutions.

The estimated total annual reporting burden is 1,000 hours. The estimated annual burden per respondent is 1 hour. The estimated number of respondents is 1,000.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal author of this revenue ruling is Roger Kuehnle of the Employee Plans Division. For further information regarding this revenue ruling, call the Employee Plans Division's taxpayer assistance telephone service at (202) 622-6074/6075 (not toll-free numbers) between 1:30 and 3:30 p.m. Eastern Time, Monday through Thursday.