UNITED STATES GOVERNMENT GENERAL ACCOUNTING OFFICE

# Memorandum

April 2, 1984 Released 4/10/84

TO : Assistant to the Comptroller General for Federal Retirement Matters - Clifford I. Gould

FROM : Acting General Counsel - Harry R. Van Cleve Harry R. Van Cleve

SUBJECT: Section 401(k) Salary Deferral Plan for GAO Employees, B-214157-O.M.

This memorandum responds to the questions you raised in your memorandum of January 17, 1984, concerning the possibility of establishing a Section 401(k) deferred compensation plan for GAO and/or other Federal Government employees.

Question 1: Does GAO have the authority to establish a salary deferral plan for its employees as provided under section 401(k) of the Internal Revenue Code?

Answer 1: The definitive answer to this question can only be provided by the Internal Revenue Service. However, we have reviewed the applicable statutes, regulations, case law and other authorities, and we have concluded that the better view is that a section 401(k) plan for GAO employees cannot be established without specific legislation.

Question 2: If the answer to the first question is yes, does GAO have the authority to match employee contributions to such a plan?

Answer 2: Although our answer to Question 1 makes a response to this question unnecessary, since we cannot provide an absolute answer to Question 1, we will answer Question 2. We conclude that even if GAO has the authority to establish a 401(k) plan, the provisions of 5 U.S.C. § 5536 (1982) would preclude GAO from matching employee contributions.

Question 3: If GAO does not have the authority, does OPM have the authority to establish a Government-wide salary deferral plan for all Federal employees?

B-214157-O.M.

Answer 3: In view of our answers to Questions 1 and 2, and your request for an expeditious response, we have not fully considered this question. In order to do so, it would be necessary to formally solicit the views of the Office of Personnel Management, and there is not sufficient time to do so now. While we believe that much of the analysis provided below would apply equally to a Government-wide salary deferral plan, if OPM should feel differently and proceeds with such a plan, we will reconsider our position in this matter.

Attached is an analysis which fully discusses these matters. If further legal assistance is required, we will be glad to render it.

Attachment

cc: Mr. Socolar, OCG
Mr. Barclay, OGC
Mr. Higgins, OGC
Mr. Faulkner, OGC
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Index & Files

## ANALYSIS

## QUESTION 1

### General Considerations and History.

Section 135(a) of the Revenue Act of 1978, Public Law 95-600, November 6, 1978, 92 Stat. 2763, 2785, now codified as 26 U.S.C. § 401(k)(1982), is the first provision of the Internal Revenue Code to give statutory recognition to "cash or deferred arrangements," more commonly referred to as 401(k) salary deferral, or salary reduction plans. Before we explain the provisions of section 401(k) a brief explanation of the "constructive receipt of income rule" will help provide an understanding of the purpose of section 401(k)

A basic concept of federal income taxation is the constructive receipt of income rule which provides that income, although not actually reduced to a taxpayer's possession, is constructively received by him in the tax year during which it is credited to his account, set apart for him or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during that tax year if notice of intention to withdraw had been given. See 26 C.F.R. §§ 1.451-2(a) and 1.446-1(c)(i) (1983). As a general rule, if an employee has the right to elect either to receive income currently from his employer or to defer receiving the income until some future year, he is considered to have received the income, for federal income tax purposes, in the year in which he makes the election. Thus, he is taxed currently on the income whether he elected to receive the money currently or to receive it at sometime in the future, and he is prevented from arbitrarily shifting his income from one year to another in order to reduce or escape federal income taxes.

The unique feature of a 401(k) plan is that it permits an employee to elect between (1) having his employer contribute a portion of the employee's salary directly to a 401(k) plan and not being taxed currently on that portion, or (2) receiving that portion in cash and being taxed currently on it in the year he receives it. The full text of section 401(k) and related sections which were enacted as section 135 of the Revenue Act of 1978 are attached to this Analysis as an appendix.

A 401(k) plan is a qualified cash or deferred arrangement which:

(1) is part of a profit-sharing or stock bonus plan meeting the requirements of 26 U.S.C.§ 401(a), i.e. a qualified profit-sharing or stock bonus plan;

(2) permits an eligible employee to elect to have the employer contribute a portion of the employee's salary to a trust under the plan or to have the amount paid to the employee in cash;

(3) is subject to certain restrictions on preretirement distributions of the amounts held by the trust which are attributable to employer contributions made pursuant to the employee's election; and

(4) makes the foregoing amounts nonforfeitable at all times. See Rev. Rul. 83-89, 1983-25 I.R.B. 5.

In essence, therefore, 401(k) plans must be part of a profit-sharing or stock bonus plan under which an employer's contributions of a portion of an employee's salary to a qualified trust on behalf of an employee will not be taxed to the employee because the employee had the option of receiving those contributions in cash or having them paid to the trust. 26 U.S.C. § 402(a)(8) (1982).

Subsequent to the enactment of section 401(k) the IRS issued proposed regulations on it. 48 Fed. Reg. 55544-55549 (November 10, 1981) . (For convenience we will cite them under their proposed Code of Federal Regulations section number as Prop. Treas. Reg.) The following year, IRS announced that these proposed regulations could be relied on by employers in establishing and administering their plans. Notice 82-1, 1982-1 C.B. 353. At present, no final regulations have been issued, and IRS has recently indicated that the time of their issuance cannot be estimated. 22 Tax Notes 361 (January 30, 1984).

B-214157-O.M.

Since the issue here is whether or not GAO may legally establish a 401(k) plan (and not how to design such a plan, or if such a plan should be adopted), we will not enumerate the advantages of the 401(k) plan here. Nor will we discuss the various forms such a plan could take. It should be clear, however, that whatever form a 401(k) plan may take, it must be part of a qualified profit-sharing or stock bonus plan, i.e., in order for the 401(k) plan to be eligible for certain tax benefits, it must be part of a plan that meets the qualifications imposed by 26 U.S.C. § 401(a) and the regulations thereunder. The question then becomes whether GAO could establish a qualified profit-sharing plan under 26 U.S.C. § 401(a).

<u>Qualified Profit-Sharing Plans under 26 U.S.C. § 401(a)</u>.

Title 26 U.S.C. § 401(a) (1982) provides, in relevant part, that:

> "[a] trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section -[if] * * *."

Section 401(a) then proceeds to list numerous other requirements. For our purposes, however, we need not discuss these other requirements or their applicability to GAO because they would be matters of plan design and implementation. Furthermore, it is beyond dispute that GAO could not establish a stock bonus plan. Accordingly, the only issue left for resolution in this section is whether GAO could establish a qualified profit-sharing plan, and, thus, a 401(k) plan.

At first appearance, the question of whether GAO, an instrumentality of the United States Government could establish a "profit-sharing" plan seems somewhat bizarre if one defines "profit-sharing" as used in section 401(a) in the traditional tax sense as referring to distributable gains of for-profit enterprises. However, if, as we shall see, the IRS has concluded that "profit" as used in a broad general accounting sense--that is, an excess of receipts over expenditures during a given period--can be the subject matter of a profit-sharing plan within the

B-214157-O.M.

ambit of section 401(a) of the Internal Revenue Code, then it becomes possible for nonprofit organizations and governmental entities to have a "profit." Before undertaking an examination of the definition of "profit" for the purposes of section 401 profit-sharing plans, however, we will examine the meaning of "employer" and "employee" as used in 401(a).

The terms "employer" and "employee".

Under 26 U.S.C. § 401(a) (1982) the qualified trust, for our purposes here, would have to be part of a, "profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries." A question has been raised as to whether GAO can be considered an "employer" having "employees" within the meaning of those terms in section 401(a).

Unfortunately, neither the Code nor its regulations give any generally applicable definition of "employer" or "employee." There are several definitions of these terms for specific purposes, but their scope is limited to specific chapters or even sections of the Internal Revenue Code.

After reviewing all of the specific limited purpose definitions of "employer" and "employee," it appears that application of the usual common-law rules of employee-employer relations would meet the tests for a qualified profit-sharing plan. Thus, we conclude that GAO and its employees could be considered "employer" and "employees" for the purposes of 26 U.S.C. § 401(a)

The definition of a section 401 profit-sharing plan.

Before dealing with the definition of the term "profit," we note that the definition of a profit-sharing plan is found in the IRS Regulations, not in the Code. It provides that:

> "A profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries. The plan must provide a definite

> predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurence of some event such as layoff, illness, disability, retirement, death, or severance of employment. * * * " 26 C.F.R. § 1.401-1(a)(1)(ii) (1983).

The regulations further provide that a profit-sharing plan is, "primarily a plan of deferred compensation, but the amounts allocated to the account of a participant may be used to provide for him or his family incidental life or accident or health insurance." Ibid. Additionally, under the proposed regulations for section 401(k) plans, it is possible to design a plan to be totally noncontributory on the employer's part.

The definition of the term "profit" for the purpose of a 401 profit-sharing plan.

The definition of "profit" used by IRS in relation to profit-sharing plans was liberal even before the enactment of section 401(k). However, with the issuance of I.R.S. General Counsel's Memorandum (GCM) 38283, February 15, 1980, the definition has reached its most liberal point. The question at issue there was whether a charitable organization, that was exempt from taxation under section 501(c)(3) of the Internal Revenue Code could establish a profit-sharing plan under section 401(a). In GCM 38283, IRS took the position that "profit" should be defined in the accounting sense of an excess of receipts over expenditures during a given period. The Memorandum recognizes that the legislative history of the profit-sharing provisions of section 401 shows that those provisions were considered only in the context of for-profit business corporations, and that general accounting principles also evolved in that setting. The Memorandum goes on to state that:

> "* * *While the legal character of the employer establishing the plan (e.g., a charitable organization, or a municipal

> corporation) may dictate certain limitations on its scope and coverage, the establishment of a plan and its qualification under section 401 are not precluded by the fact alone that the employer is an exempt charitable organization."

This does not specifically answer the question of the ability of GAO to establish a 401(k) plan. Additionally, even if we assume that GCM 38283 has application to GAO, and represents IRS policy, this Memorandum, at least in its current form, has only the legal effect which IRS may wish to give it, and may not even be used or cited as precedent. 26 U.S.C. § 6110(b) and (j)(3) (1982).

It is not clear how to apply this expansive definition of "profit" to GAO and/or the entire Government. If it were to be applied to the Government as a whole, clearly the Government is not going to have an excess of receipts over expenditures in the foreseeable future. If it is applied on an agency-by-agency basis, so that an agency has a "profit" if it returns appropriated funds to the Treasury at the end of a particular fiscal year, this could lead to the anomalous result of qualifying most or all of the agencies as "profitable" while the Government as a whole continued to have a 200 billion dollar deficit.

It is not anomalous to apply this concept of "profit" to state and local governments. Either by constitutional provision or statutory restriction many, if not most, state and local governments are required to balance their budgets each year. It is then not difficult to find that such governmental units could have an excess of receipts over expenditures for a defined period.

Other factors supporting the conclusion that GAO cannot establish a 401(k) plan.

The subject matter with which a 401(k) plan is concerned is deferred compensation, retirement, and savings for retirement purposes. These areas of law, especially in the case of Federal employees, have traditionally been, and still are, governed by statutes in which the Congress has explicitly authorized certain benefits for Federal employees and no other benefits. See e.g. American Postal Workers Union, AFL-CIO v. United States Postal Service, 707 F.2d 548 (D.C. Cir. 1983); Alaska Railroad, B-198903, August 6, 1981; 5 U.S.C. §§ 8301-8348 (1982). We note that the same holds true for other areas of Federal employee benefits, and GAO is without authority to modify or nullify these statutory provisions. B-210091-O.M., June 1, 1983; Alaska Railroad, B-198903, August 6, 1981 (health insurance). See also Kosmal v. Commissioner, 670 F.2d 842 (9th Cir. 1982); Hogan v. United States, 513 F.2d 170 (6th Cir. 1975), cert. denied, 423 U.S. 836 (1975) (Taxpayers were not deprived of equal protection or due process because some types of private pension plan contributions and other types of government employment benefits may be excluded from income. There are many distinctions between private sector pension plans and the Civil Service Retirement System for government employees so as to warrant separate classification and tax treatment of the latter to be found reasonable.) Furthermore, the legislative history of section 401(k) does not contain any indication that Congress intended the 401(k) plan to be applicable to Federal Government employees. See e.g. H.R. Conf. Rep. No. 1800, 95th Cong., 2d Sess. 206-207 (1978).

Along this same line two other general principles support the position that GAO cannot establish a 401(k) plan. First, the general rule of statutory construction is that specific legislation will control over general legislation on the same subject. 2A Sands, Sutherland Stuatory Construction, 4th Ed., § 51.05. Here the specific legislation establishing Federal employee pension and retirement plans controls over general tax legislation on the establishment of profit-sharing plans. Secondly, although it could be argued that it is unfair to exclude Federal employees from these benefits when virtually all other workers in the country could be eligible, the rule is well established that Federal employee benefits are governed strictly by the applicable statutes and regulations. William J. Elder, 56 Comp. Gen. 85 (1976). Furthermore, in Edgar T. Callahan, B-210657, November 15, 1983, 63 Comp. Gen. 31, the agency argued that an individual was entitled to certain statutory benefits because he was not specifically excluded from receiving those benefits. We rejected that analysis, and, instead, found that only those individuals specifically authorized by the statute to receive those benefits were so entitled. Moreover, we must be mindful of the significant tax revenue consequences to the Federal Government which will result from the application of a 401(k) plan to Federal employees.

It has also been contended that the authority given the Comptroller General under the General Accounting Office Personnel Act of 1980, Public Law 96-191, February 15, 1980, 94 Stat. 27, is sufficient to allow GAO to proceed with a 401(k) plan, no matter what other agencies may be permitted to do. While authority granted to the Comptroller General under this Act is considerably broader than that generally granted agency heads, that authority is not unlimited. In the report of the House Committee on Post Office and Civil Service that accompanied the GAO Personnel Act, the Committee made it clear that at least in the area of employee fringe benefits, GAO employees were to continue to be treated in the same manner as most Federal employees. The Committee report stated that:

> "The committee bill preserves the basic substantive rights of the employees of the GAO. In the area of pay and benefits, employees of GAO remain under the civil service retirement system, are eligible for the same medical and disability benefits, and are protected against a loss in pay from the change in personnel systems. Being subject to the retirement and insurance plans administered by the OPM, employees of the GAO would continue to appeal adverse rulings on these matters to the OPM. The infrequency and technical nature of these appeals suggests that no serious conflict of roles will result from preserving these rights. The alternative is to create a separate retirement and insurance system for employees of the GAO. The cost, time, and complexity of creating a separate system argues strongly against this alternative." H.R. Rep. No. 494, 96th Cong., 1st Session 4 (1979).

Thus, the authority of the Comptroller General to alter GAO employees' fringe benefits seems to be limited.

It also has been argued that since the Federal Reserve System and the Federal Deposit Insurance

Corporation (FDIC) have established 401(k) plans other Federal agencies should be able to do the same. There is a critical difference and that is the use of appropriated funds. We have held that the salaries of employees of both the Federal Reserve (Lieutenant Colonel Robert E. Frazier, B-212226, December 16, 1983, 63 Comp. Gen. ____), and FDIC (23 Comp. Gen. 83 (1943), are paid from assessments levied on the banks regulated rather than from appropriated funds. Since both agencies collect assessments and determine their own expenditures, it is possible for those agencies to have an excess of receipts over expenditures, and, thus, satisfy the "profit" requirement of section 401.

Another factor is that the law in the area of 401(k) plans is still too uncertain at this time to permit GAO to make decisions on which its employees could rely. We note that GCM 38283 itself observes that "the legal character of the employer establishing the plan (e.g., a charitable organization or a municipal corporation) may dictate certain limitations on its scope and coverage." The very matter of whether and to what extent the Federal government should regulate governmental plans, especially in the area of financial nondiscrimination, is a matter of some debate which is far from settled. See testimony of S. Allen Winborne, Assistant Commissioner, IRS, et al., CCH Pension Plan Guide, para. 25,542 (transcript of hearing for November 15, 1983 on order).

When all of the above factors and arguments are considered, we believe that the better view is that GAO does not have the authority to establish its own 401(k) plan.

QUESTION 2

The lack of authority for GAO to match employees' contributions to a 401(k) plan.

Title 5 U.S.C. § 5536 (1982) provides:

> "An employee or a member of a uniformed service whose pay or allowance is fixed by statute or regulation may not receive additional pay or allowance for the disbursement of public money or for

> any other service or duty, unless specifically authorized by law and the appropriation therefor specifically states that it is for the additional pay or allowance."

The annual rate of basic pay for the Comptroller General, the Deputy Comptroller General, and the General Counsel of GAO is set by statute, and the annual rate of basic pay for all other GAO employees is set by Comptroller General regulation. 31 U.S.C. §§ 703f(1) and (2), 731 and 732(c)(1).

On the basis of the foregoing statutes, any type of "matching contributions" by GAO would constitute "additional pay." Since there is no current specific authorization for this, any type of matching contributions by GAO would violate the provisions of 5 U.S.C. § 5536 (1982).

We conclude, therefore, that GAO currently lacks authority to match employees' contributions to a 401(k) plan if such a plan could be set up at GAO.

QUESTION 3

The possibility of OPM setting up a 401(k) plan for Federal employees.

Because of your request for an expeditious response, we have not formally contacted OPM to solicit its views in this area. Thus, while we cannot provide a complete answer on this point, we believe the reasoning used through most of this analysis would be equally applicable to a Government-wide plan. In the event OPM should feel differently and proceeds with such a plan, we will reconsider our position in this matter.

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B-214157-O.M.

APPENDIX

Section 135 of the Revenue Act of 1978, Pub. L. 95-600, November 6, 1978, 92 Stat. 2785-86, is now codified as follows: § 135(a), 26 U.S.C. § 401(k) (1982); § 135(b), 26 U.S.C. § 402(a)(8) (1982); and § 135(c), 26 U.S.C. § 401 note (1982).

Section 135 provides:

SEC. 135. CERTAIN CASH OR DEFERRED ARRANGEMENTS.

(a) IN GENERAL.—Section 401 (relating to qualified pension, profit-sharing, and stock bonus plans) is amended by redesignating subsection (k) as (l) and by inserting after subsection (j) the following new subsection:

"(k) CASH OR DEFERRED ARRANGEMENTS.—

"(1) GENERAL RULE.—A profit-sharing or stock bonus plan shall not be considered as not satisfying the requirements of subsection (a) merely because the plan includes a qualified cash or deferred arrangement.

"(2) QUALIFIED CASH OR DEFERRED ARRANGEMENT.—A qualified cash or deferred arrangement is any arrangement which is part of a profit-sharing or stock bonus plan which meets the requirements of subsection (a)—

"(A) under which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash;

"(B) under which amounts held by the trust which are attributable to employer contributions made pursuant to the employee's election may not be distributable to participants or other beneficiaries earlier than upon retirement, death, disability, or separation from service, hardship or the attainment of age 59½, and will not be distributable merely by reason of the completion of a stated period of participation or the lapse of a fixed number of years; and

"(C) which provides that an employee's right to his accrued benefit derived from employer contributions made to the trust pursuant to his election are nonforfeitable.

"(3) APPLICATION OF PARTICIPATION AND DISCRIMINATION STANDARDS.—

"(A) A qualified cash or deferred arrangement shall be considered to satisfy the requirements of subsection (a)(4), with respect to the amount of contributions, and of subparagraph (B) of section 410(b)(1) for a plan year if those employees eligible to benefit under the plan satisfy the provisions of subparagraph (A) or (B) of section 410(b)(1) and if the actual deferral percentage for highly compensated employees (as defined in paragraph (4)) for such plan year bears a relationship to the actual deferral percentage for all other eligible employees for such plan year which meets either of the following tests:

"(i) The actual deferral percentage for the group of highly compensated employees is not more than the actual deferral percentage of all other eligible employees multiplied by 1.5.

"(ii) The excess of the actual deferral percentage for the group of highly compensated employees over that of all other eligible employees is not more than 3 percentage points, and the actual deferral percentage for the group of highly compensated employees is not more than the actual deferral percentage of all other eligible employees multiplied by 2.5.

"(B) For purposes of subparagraph (A), the actual deferral percentage for a specified group of employees for a plan year shall be the average of the ratios (calculated separately for each employee in such group) of—

"(i) the amount of employer contributions actually paid over to the trust on behalf of each such employee for such plan year, to

"(ii) the employee's compensation for such plan year.

For purposes of the preceding sentence, the compensation of any employee for a plan year shall be the amount of his compensation which is taken into account under the plan in calculating the contribution which may be made on his behalf for such plan year.

"(4) HIGHLY COMPENSATED EMPLOYEE.—For purposes of this subsection, the term 'highly compensated employee' means any employee who is more highly compensated than two-thirds of all eligible employees, taking into account only compensation which is considered in applying paragraph (3)."

(b) TAXABILITY OF BENEFICIARIES.—Subsection (a) of section 402 is amended by adding at the end thereof the following new paragraph: 26 USC 402.

"(8) CASH OR DEFERRED ARRANGEMENTS.—For purposes of this title, contributions made by an employer on behalf of an employee to a trust which is a part of a qualified cash or deferred arrangement (as defined in section 401(k)(2)) shall not be treated as distributed or made available to the employee nor as contributions made to the trust by the employee merely because the arrangement includes provisions under which the employee has an election whether the contribution will be made to the trust or received by the employee in cash." 26 USC 401.

(c) EFFECTIVE DATE.— 26 USC 401 note.

(1) IN GENERAL.—The amendments made by this section shall apply to plan years beginning after December 31, 1979.

(2) TRANSITIONAL RULE.—In the case of cash or deferred arrangements in existence on June 27, 1974—

(A) the qualification of the plan and the trust under section 401 of the Internal Revenue Code of 1954; 26 USC 401.

(B) the exemption of the trust under section 501(a) of such Code; 26 USC 501.

(C) the taxable year of inclusion in gross income of the employee of any amount so contributed by the employer to the trust; and

(D) the excludability of the interest of the employee in the trust under sections 2039 and 2517 of such Code, 26 USC 2039, 2517.

shall be determined for plan years beginning before January 1, 1980 in a manner consistent with Revenue Ruling 56-497 (1956-2 C.B. 284), Revenue Ruling 63-180 (1963-2 C.B. 189), and Revenue Ruling 68-89 (1968-1 C.B. 402).

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[redacted]

B-214157-O.M. Apr. 2, 1984

1. GENERAL ACCOUNTING OFFICE
   Employees
     Compensation
       Deferred compensation plans

   WORDS AND PHRASES

   "Profit"

2. COMPENSATION
   Rates
     Limitations
       Imposed by statute

   GENERAL ACCOUNTING OFFICE
   Employees
     Compensation
       Deferred compensation plans