

GAO

Briefing Report to the Chairman,
Committee on Post Office and Civil
Service, House of Representatives

May 1987

FEDERAL RETIREMENT

Nondiscrimination Rules for Thrift Savings Plan



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May 22, 1987

The Honorable William D. Ford
Chairman, Committee on
Post Office and Civil Service
House of Representatives

Dear Mr. Chairman:

This report responds to your letter of March 24, 1987, requesting our review of Internal Revenue Code provisions which allow employees to defer until retirement taxes on amounts they contribute to employee savings plans. Your Committee had been advised that employee contributions to plans sponsored by state and local governments and certain nonprofit organizations were exempt from nondiscrimination rules applicable to plans established for employees of profit-making organizations and the federal government. In light of this, you asked that we review the matter as it relates to the federal thrift savings plan.

The federal thrift savings plan is one of a variety of savings plans authorized by the Internal Revenue Code which provide for deferral of taxes on employee contributions. These include plans available to profit-making organizations under section 401(k), plans generally available to schools and charitable organizations under section 403(b), and plans generally available to other tax exempt organizations, including state and local governments, under section 457.

The purpose of the nondiscrimination rules is to ensure that the plans are not designed to favor highly paid employees.¹ They do this by setting limits on the percentage of salary allowed to be deferred by highly paid employees based on the percentage of salary deferred by all other eligible employees.

¹The Internal Revenue Code contains several definitions of highly paid employees. The controlling definition for the federal workforce is employees with salaries over \$50,000 a year.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to identify differences in the statutory provisions for nondiscrimination tests applicable to the various types of savings plans authorized under the Internal Revenue Code. In conducting our study, we reviewed pertinent sections of the Internal Revenue Code and interviewed officials at the Department of the Treasury and the Internal Revenue Service. Our work was performed in accordance with generally accepted government auditing standards during March and April 1987.

NONDISCRIMINATION RULES MORE STRINGENT

The Tax Reform Act of 1986 tightened the nondiscrimination rules. These rules will apply to the federal thrift savings plan and savings plans in profit-making organizations established under section 401(k) of the Code. Under the old law, the percentage of salary deferrable by the highest paid one-third of all eligible employees in a plan could be as much as one and one-half times the percentage of salary deferred by all other employees.² After tax reform, the nondiscrimination rule limits the contributions of highly paid employees to not more than one and one-quarter times the percentage deferred by other employees.³

²In addition, an alternative rule that could be applied provided that the deferral percentage for the highly compensated employees could not exceed the lesser of (a) the actual deferral percentage for other eligible employees plus 3 percentage points or (b) 250 percent of the deferral percentage of the other eligible employees.

³In addition, an alternative rule under the Tax Reform Act provides that the deferral percentage of highly compensated employees may not exceed the lesser of (a) the actual deferral percentage of all other eligible employees plus 2 percentage points or (b) 200 percent of the deferral percentage of the other eligible employees.

CONTRIBUTIONS MADE TO STATE AND
LOCAL GOVERNMENT PLANS NOT TESTED

Tax laws governing savings plans established for public school employees of state and local governments under section 403(b) and for other state and local government employees under section 457 of the Code do not provide for nondiscrimination tests of employee contributions. However, the Tax Reform Act added nondiscrimination rules for 403(b) plans to ensure that they are not designed to favor highly paid employees. Under the new rules, which apply after December 31, 1988, such plans must pass one of the following tests:

- at least 70 percent of all non-highly compensated employees are covered by the plan,
- the percentage of non-highly compensated employees covered by the plan is at least 70 percent of the percentage of highly compensated employees covered,
- the covered employees qualify for the plan under a nondiscriminatory classification set up by the employer, or
- the average benefit (employer contribution) provided to non-highly compensated employees (as a percentage of compensation) must be at least 70 percent of the average benefit provided to highly compensated employees (as a percentage of compensation).

Neither past nor present tax law has applied nondiscrimination rules to section 457 plans. Treasury officials said this was because they are considered "unfunded plans" which have no such rules. An unfunded plan is one in which any funds set aside by the employer and the earnings on those funds are within the reach of creditors of the sponsoring organization rather than being set aside in a trust fund for the sole benefit of plan participants.

PARTICIPATION INCENTIVES FOR LOWER-PAID EMPLOYEES
IN FEDERAL AND 401(k) SAVINGS PLANS

Federal employees covered by the civil service retirement system (CSRS) have less incentive to participate in the thrift savings plan than employees covered under the new

federal employees retirement system (FERS) because the government does not match their contributions. Furthermore, many lower-paid employees⁴ will still be eligible to make tax-deferred contributions to their Individual Retirement Accounts (IRA). IRAs may be more appealing than the thrift plan because IRA funds can be placed in a variety of investments and can be withdrawn at any time subject to a 10-percent penalty. Funds in the federal thrift savings plan, however, cannot be withdrawn before retirement unless the employee leaves government service, transfers the money to an individual retirement account, withdraws the funds from that account, and pays a 10-percent penalty. Also, employees covered by CSRS are limited to investing their thrift plan contributions in government securities.

Consequently, the level of contributions of lower-paid federal employees, especially CSRS-covered employees, could be small enough to limit the level of contributions allowed for highly paid employees when the nondiscrimination tests are applied later this year.⁵ To overcome this type of problem in private sector 401(k) plans, Department of the Treasury officials said that many employers are adding matching provisions or increasing the matching percentage to encourage greater participation by lower-paid employees.

MATTERS FOR CONGRESSIONAL CONSIDERATION

If Congress wants to assure that all federal employees have the opportunity to fully participate in the thrift savings plan, it may wish to consider modifying the plan's provisions. One option would be to adopt the same nondiscrimination rules for the federal plan that were applied to 403(b) plans under tax reform. This would maintain employee eligibility and level of benefits requirements, but would exempt employee contributions from nondiscrimination rules. Another option could be to add an employer matching contribution provision for CSRS-covered

⁴Employees filing tax returns as single persons and generally having adjusted gross income of \$25,000 or less, or married couples filing joint returns with adjusted gross income of \$40,000 or less.

⁵The Internal Revenue Service has ruled that the nondiscrimination tests will be applied separately to CSRS and FERS employees.

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employees to encourage greater participation by these employees in the thrift savings plan.

As requested by your office, we did not obtain agency comments on this report. However, we discussed our findings with Department of the Treasury officials and they agreed with the facts as presented. Unless you publicly announce its contents earlier, we plan no further distribution of this report until 10 days from its issue date. At that time, copies will be sent to others who have an interest in this matter. If we can be of further assistance, please contact Ms. Rosilyn Kleeman on (202) 275-6204.

Sincerely yours,

W. J. Anderson

William J. Anderson
Assistant Comptroller General

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