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Replicating 401(k) Plans in a UK Context

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"Qualified pension, profit sharing, and stock bonus plans" is the heading of §401 of the US Internal Revenue Code (IRC). From a UK perspective, this one section offers a wonderful combination of different sorts of employee benefit plan. It is only very recently that combining similar types of plan has become possible in the UK. For the purposes of this article I will be looking mainly at the 401(k) plan and, in particular, at the opportunities for employees to contribute to the plan, for employers to give matching contributions and for employers also to give bonus contributions.

There is a significant opportunity for US companies that have UK subsidiaries to extend their 401(k) plan design to these subsidiaries in a highly tax-efficient manner. Because of regulatory differences, an identical fit is most probably not achievable, but this article seeks to demonstrate that you can design a similar plan with significant benefits for both company and employees.

In my analysis of the UK Share Incentive Plan (SIP) I will consider the UK legislation and how it can mirror typical US plan design, though with even greater tax advantages, and then show how the Finance Act 2004, combined with the A-Day reforms of 2006, allows and encourages transfers of SIP shares to registered pension plans.

BACKGROUND TO US 401(k) PLANS

The 401(k) plan is set up under a trust arrangement independent of the employer and is typically managed by third-party providers. Broadly speaking, employees are given the opportunity of contributing a percentage of their pay to the plan. From the employee perspective the first advantage in contributing under this type of plan is that the deduction of pay is from pre-tax dollars and therefore a greater amount can be invested in the plan than would be possible if the employee invested personally using after-tax dollars. Secondly, it is typical practice for the employer to match the contribution of the employee using a pre-determined matching ratio. This amount is tax deductible for the employer and is not, at the time of contribution, taxable to the employee. All contributions can roll up inside the 401(k) plan account without deduction of any taxes and only when the employee comes to draw down the benefits from the account do income taxes become payable. The plan is designed to be a long-term retirement savings account and, in the event of withdrawals by the employee before age 59½, there will be an additional income tax penalty of 10%. On leaving service, withdrawals are not compulsory and the leaving employee can choose to retain the contributions in the former employer's plan or to roll the money over into a new 401(k) plan or an individual retirement account.

The maximum amount that an employee can contribute is US$15,000* a year and in addition to the employee contributions the employer may contribute up to US$44,000 in a year. These tax deferrals are significant and the IRC imposes a level of non-discrimination testing that to US companies is normal but to UK observers seems severe. The 401(k) plans need to satisfy non-discrimination tests each year: it is not enough simply that each employee is eligible to participate on similar terms but, rather, that the actual contribution of ordinary employees must be at a rate that is proportionate to that of highly compensated employees (those earning over US$85,000 a year or having a salary that is in the top quintile of salaries within the company). If the contributions are actually top heavy such that the highly compensated are paying a greater proportion of their pay than ordinary employees, the employer has to work to correct the position either by lowering the contribution limits for highly compensated employees and giving them refunds of part of their contributions or by contributing more to the accounts of ordinary employees.

TECHNICAL DESIGN FEATURES

Employee and Employer-Matching Contributions

An annual 401(k) benchmarking survey[1] provides a picture of typical practice among a group of some 830 US company participants. It shows an average pre-tax contribution rate of about 6% of employee pay and it is normal practice for the employer to make a matching contribution to the plan. The average matching formula is 68% of the first 6% of employee contributions. Some employers require that an employee must work for a

* £1 = US$2.03; €1 = US$1.37 as at 27 July 2007

period of six or 12 months before being eligible to receive a matching contribution but some 45% of surveyed employers give the employees immediate matching and 92% match after one year's service. In 2005/06 only 12% of employers gave the matching contribution in the form of shares in the company. This is part of the continuing change following the Enron case when many of that company's employees suffered significant losses as a result of having Enron shares in their 401(k) accounts. Even those 12% of employers who use their own shares for the matching contribution allow employees to switch the matching shares into a more diversified portfolio of investments.

The employer can decide at what rate the employer-matching contributions should vest in the employee. An employee leaving service before the vesting date would forfeit the unvested matching contributions. Typically these forfeited contributions are used by the company to reduce employer contributions. The vesting schedules for survey participants are shown in TABLE 1.

TABLE 1 US 401(k) Matching Contributions Vesting Schedule

Schedule	*No. of companies expressed as a percentage*
	%
Immediate full vesting	36
1-3 year cliff vesting	17
1-3 year graduated vesting	7
4-6 year graduated vesting	32
Other	8
Total	*100*

Source: 'Annual 401(k) Benchmarking Survey 2005/2006 Edition'

Employer Profit-Sharing Contributions

In addition to paying contributions on the basis of matching those made by an employee, the employer can also make contributions as a share of profits. In the survey the average profit-sharing cost, measured as a percentage of total compensation, was 4% and the median was 3%. Profit-sharing contributions are typically made on a discretionary basis by the employer having regard to the financial results of the year and some 74% of profit-sharing contributions are allocated proportionately to the pay of the employees. Only 9% of profit-sharing contributions are given in the form of company shares. The vesting schedule for profit sharing is frequently different from that for the matching contributions vesting and a longer period is required for full vesting, as shown in TABLE 2.

TABLE 2 Profit-Sharing Vesting Schedule

Schedule	*No. of companies expressed as a percentage*
	%
Immediate full vesting	22
1-4 year cliff vesting	12
5 year cliff vesting	14
1-4 year graduated vesting	5
5 year graduated vesting	25
6-7 year graduated vesting	19
Other	3
Total	*100*

Source: 'Annual 401(k) Benchmarking Survey 2005/2006 Edition'

Investment Options

The United States is the home of participant investment choice and most plans can offer a significant number of funds to choose from, including some lifestyle funds based on the time to retirement.

401(k) PLANS AND EMPLOYEE BENEFIT PLANS

Although very popular, 401(k) plans are, of course, not the only benefit plans offered by US employers. They sit alongside defined benefit pension plans (although many of these have been closed to new entrants), medical, dental, life and disability insurance plans and health-care plans, including Health Savings Accounts. The average cost of survey respondents' benefit plans comes to 28% of payroll, with only some 8% going into the average 401(k) plan as matching and profit-sharing contributions.

ANALYSIS OF THE UK SHARE INCENTIVE PLAN

Gordon Brown, UK Chancellor of the Exchequer at the time, had a hand in the design of the UK SIP and it is easy to see the influence of the 401(k) legislation of the United States. The SIP must be established under a trust, separate from the employer company. Typically, third-party administrators provide trustee and administration services. However, the details are somewhat different from those of a 401(k) plan and so are the tax breaks. The tax reliefs for the UK SIP are significantly greater than those for the 401(k) plan but SIP investments can be held only in the form of company shares. The risks are potentially greater than those of an investment in a diversified portfolio but these are compensated for by very significant tax reliefs, as follows:

- Gross income can be allocated to the plan (the same as in the USA).
- Dividends arising can be reinvested in the plan tax free (the same as in the USA) and after a specified holding period of five years (or less in the case of good leavers) the proceeds of the SIP can be taken completely free of taxes.
- The SIP is exempt from UK income tax and capital gains tax no matter to what value the account balance has grown.

The crucial difference is that in the USA income taxes are deferred but in the UK they can be eliminated. The shares can become tax free. Another design difference is that, when an employee leaves service in the UK, withdrawals of shares from the SIP are compulsory. As a result, the UK employee may have a liability to income tax and national insurance contributions (NICs) and the employer may have a liability to employers' NICs.

Partnership Shares

UK employees can defer up to 10% of their pay in the purchase of shares up to a limit of £1,500 a year, which is £125 a month. This comes from pre-tax and pre-NIC pay, saving the employee between 20% at the basic rate and 40% at the higher rate of income tax and, correspondingly, between 10% and 1% in NICs, and saving the employer 12.8% in NICs. The shares purchased by the employees are called partnership shares.[2]

Matching Shares

If an employee buys partnership shares, an employer can award matching shares for each partnership share acquired by the employee. The matching ratio can be a fraction of the share and can rise to a maximum of two matching shares for every partnership share, so an employee acquiring the maximum value of £1,500 worth of partnership shares can be given a maximum value of £3,000 worth of matching shares in any tax year. For a US employer a match of 50 cents in the dollar on the first 6% of contributions by an employee can easily be replicated with partnership and matching share awards. The employer will obtain a corporation tax deduction for the value of the matching shares awarded to employees and there is no income tax liability for the employee on the award of matching shares.

Free Shares

The UK equivalent of a profit-sharing award is free shares – shares that an employee receives without having to pay for them. Employers can give up to £3,000 worth of free shares each year to employees. The legislation provides two alternatives for awarding shares on the basis of performance which can be at the individual, team, divisional or corporate level. The first is where up to 80% of the shares awarded can be linked to performance. The highest performance award to any employee cannot be more than four times the highest award made to an employee under the similar terms basis. The second alternative is where all shares may be awarded by reference to performance as long as awards made to the employees in each performance unit are on similar terms to the other employees in that unit. The employer will obtain a corporation tax deduction for the value of the free shares awarded to employees and there is no income tax liability for the employee on the award of free shares.

Eligibility

The UK approach to non-discrimination testing is fundamentally different from that of the United States. Broadly speaking, the SIP needs to be offered on similar terms to all employees. It is up to the employees to decide whether or not to join the plan. The employing company can offer free shares, partnership shares without matching shares and partnership shares with matching shares. Any one of these can be chosen. Replicating a 401(k) approach with or without profit sharing is therefore easy. There is no comparison made as to contribution levels of highly paid employees with any other type of employee. A service period is not required for employees to be eligible to participate but the legislation provides that a service period of a maximum of 18 months may be imposed should the employer so wish.

Holding Period and Vesting Periods

Partnership shares always belong to the employee who can choose to withdraw them from the plan at any time and lose both tax relief and the matching shares that come with them if the matching shares have a vesting period. Provided that the partnership shares are left in the SIP for a five-year period, they will be free of all taxes on withdrawal. The matching shares and free shares can have a vesting period of up to three years – it is up to the employer to decide whether to impose a vesting period and how long it should be. Once again, it is very easy to replicate a 401(k) design except that full vesting cannot take longer than three years. Provided that matching shares and free shares remain in the SIP for five years, they emerge free of all taxes.

Dividend Shares

Employers can choose to offer dividend reinvestment for employees in the SIP. Dividends can be paid out to employees in the normal way, in which case they will be taxable, or they can be reinvested in dividend shares. The limit for dividend shares is £1,500 a year. Dividends of up to this amount can be reinvested tax free. Provided that the dividend shares remain in the SIP for a three-year period, they can emerge from the plan free of all taxes.

THE SIP LINKED TO A UK REGISTERED PENSION PLAN

The Finance Act 2004, in conjunction with the A-Day pensions implementation of April 2006, has given the opportunity for shares in the SIP to be transferred directly to a registered pension plan. Instead of employees being limited to making pension contributions of 15% of earnings in a year, 100% of earnings is now permitted. For the vast majority of employees it will be almost impossible to overfund their pension plans and the lifetime allowance limit in 2010 will be a monetary value of £1.8 million capital value or a pension of £90,000 a year. A transfer of shares from the SIP to a registered pension plan is treated as though it were the payment by the individual employee of a net of basic rate tax contribution to the pension plan. As a result, the individual will get tax relief on the market value of his/her shares on the date of transfer. Income tax relief is given in two stages. In the first stage the market value of the shares transferred is deemed to be a contribution net of basic rate income tax (soon to be at 20%) and the administrator of the pension plan will receive a cash payment from HM Revenue Commissioners (HMRC) of 20% of the gross value: 20/80ths or 25% of the net value of the shares transferred into the pension plan. The second stage of tax relief is given to the employee when a claim is made by filing a tax return at the end of the income tax year. A 40% taxpayer will receive an additional 20% of the gross value of the shares by way of a tax refund.

Investment

Most pension trustees will allow the employees to retain their contributions in the form of company shares if they so wish. Effectively an Additional Voluntary Contribution by the employee, they are not affected by the self-investment rules of UK pension funds which prohibit or discourage investments by the trustees in the shares of the employing company. However, it is likely that many employees will take the opportunity to diversify their holdings into lifestyle or managed funds operated by the pension fund, in a very similar way to that of their counterparts with 401(k) plans in the United States.

If this sounds too good to be true, remember that the employees could remove the shares from the SIP completely free of taxes after five years has passed. By transferring the shares into a registered pension plan

the employee will get an immediate uplift of 25% of the transferred value and potentially a further tax refund. However, the proceeds of the registered pension plan cannot be taken before age 55 and only 25% of the value can be commuted to a tax-free lump sum. The remaining 75% has to be used to purchase an annuity or other income stream which will be liable to UK income taxes.

SUMMARY AND CONCLUSION

The ability to transfer shares from the SIP to a registered pension plan is not just about getting an enhanced pension contribution, courtesy of the UK Chancellor of the Exchequer; it is also about the employer being able to communicate the design of the SIP and registered pension plan in a similar manner to the 401(k) plan being operated at a parent company in the USA. Once the shares have been transferred to the registered pension plan the employee will typically be able to diversify the holding as one would expect in a conventional pension plan. Thus, apart from the period of five years during which the assets of the SIP must be retained in the form of company shares, the longer-term strategy can be to introduce an employee benefits plan that gives significant tax advantages to both employer and employee and encourages the provision of adequate funds for an income in retirement. The transfer legislation of 2004 combines with the A-Day legislation of 2006 to provide a facility that enables replication of 401(k) plans in a UK context, but with better tax relief!

Security Laws, Tax Clearance and Communication

The UK approach to tax clearance is straightforward and approval of the plan rules and communication materials for the SIP must be given in advance by HMRC. Unfortunately the Prospectus Directive of the European Union has made things more difficult, rather than easier, and the old UK exemption from securities laws for employee stock plans is no longer applicable. US companies should seek specialist securities law advice before offering their UK employees the opportunity to participate in a SIP.

Once an employee has such choices, it is to be expected that the employer will provide good-quality communication materials and online modelling tools to assist employees in making appropriate choices. An education programme explaining the role of the SIP and the pension plan and how they can be integrated with other employee benefit plans operated by the employer would be of considerable assistance. Ω

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