GROOM LAW GROUP
CHARTERED

BENEFITS BRIEF

August 29, 2016

www.groom.com

If you have questions, please contact your regular Groom attorney or one of the attorneys listed below:

Michael P. Kreps
mkreps@groom.com
(202) 861-5415

David N. Levine
dlevine@groom.com
(202) 861-5436

Scott Mayland
smayland@groom.com
(202) 861-6647

Louis T. Mazaway
lmazaway@groom.com
(202) 861-6608

DOL Finalizes Regulation on State Automatic IRAs and Proposes Extension to Cities and Other Political Subdivisions

On August 25, the Department of Labor (the "DOL") issued a final regulation to clarify when an automatic IRA established through state law and administered by a state would not be covered by the Employee Retirement Income Act of 1974, as amended ("ERISA"), making it less likely that a court would find the state law to be preempted by ERISA. Also, in response to comments, the DOL has issued a proposed regulation that would allow certain political subdivisions to create and administer automatic IRAs. The DOL's regulatory effort in this area – spearheaded by President Obama and summarized below – has already sown the seeds for major shifts in the retirement system as a whole. Now, many states may proceed with implementation of their automatic IRA statutes.

The final regulation takes effect 60 days after its August 30 publication in the *Federal Register*. The proposed rule is subject to a 30-day comment period.

Background

Over the past few years, many states across the country have moved to enact legislation intended to improve retirement security by expanding access to, and coverage under, the private retirement system. To facilitate these state initiatives, President Obama directed the DOL to issue guidance to clarify the interaction between the state laws establishing these initiatives and ERISA.

Last November, DOL issued guidance, summarized briefly below, to address three types of state initiatives: (1) state run-plans, including state-run multiple employer plans ("MEP"), (2) state-established marketplaces for retirement plans, and (3) state automatic IRAs.

Interpretive Bulletin 2015-02

The DOL's first piece of guidance, Interpretive Bulletin 2015-02 (the "IB"), addressed state-run plans and state marketplaces. For example, Massachusetts has adopted a law to provide for a state-run plan that may be adopted by private-sector employers. And Washington and New Jersey have adopted legislation creating a marketplace that helps connect employers with private-sector providers offering retirement plans meeting certain requirements. The IB would facilitate both the marketplace and state-run plan approaches in the following ways:

- The IB clarifies the DOL's position that ERISA would not necessarily preempt state laws implementing state-run plans, provided that employers participate voluntarily and ERISA applies to the plan the employer adopts.

- The IB permits a state to run a MEP. The DOL has consistently said that employers participating in a MEP must have a common nexus, but the IB explains the DOL's position that employers have a nexus when they participate in a state-run plan. The state essentially creates a nexus because the state is tied to the contributing employers and their employees by a special representational interest in the health and welfare of its citizens.

- The IB sets forth DOL's views of ERISA sections 3(2), 3(5), and 514 as they apply to state-run master and prototype plans, state-run MEPs, and state-run marketplaces.

Proposed State Automatic IRA Regulation

The DOL's second piece of guidance was a proposed regulation on state automatic IRAs, *i.e.*, laws that require private-sector employers who do not offer retirement plans to automatically enroll their employees in IRAs administered by the state. Under the proposal, state programs that meet a long list of requirements would benefit from a "safe harbor" protecting them from ERISA coverage. Among other things, the proposed regulation required that the state automatic IRA program be established and administered by the state pursuant to state law, that employers play only a ministerial role in terms of enrolling employees and not making any employer contributions, and that employees be provided notice and the right to opt out. As of now, California, Connecticut, Illinois, Maryland, and Oregon have adopted laws providing for state automatic IRAs. The DOL received approximately 70 comments on the proposal.

Final State Automatic IRA Regulation

The final regulation on state automatic IRAs (to be codified at 29 C.F.R. § 2510.3-2(h)) generally retains the structure of the proposed regulation. The automatic IRA program must be established pursuant to state law, and the DOL has made clear that a state agency or instrumentality may administer the automatic IRA program in addition to the state itself. The state or a state agency must also select the investments available under the IRAs. While the state or state agency may contract with private service providers to operate and administer the automatic IRA program, the state or state agency must retain full responsibility.

As with the proposed regulation, the role of the employer is generally limited to forwarding employee contributions, providing notices and program information to employees, and providing information necessary to facilitate the operation and administration of the automatic IRA program. Employers may not make contributions to the program or incent employee participation in any way. As discussed below, the final rule makes it clear that an employer must be required to participate in the state program. An employer who voluntarily chooses to participate may be deemed to have established an ERISA plan (unless the DOL's longstanding IRA safe harbor is satisfied).

Employees must be provided the right to opt out of participation. Further, the state must establish a mechanism for the enforcement of employees' rights under the automatic IRA program.

The DOL also responded to several key issues raised in comments to the proposed regulation:

- Withdrawal Rights. The proposed regulation would have prevented states from imposing restrictions on withdrawals from employees' IRAs. Commenters argued this provision would have interfered with the states' ability to protect against "leakage" (*i.e.*, employees withdrawing savings before retirement) and provide investment options such as those with guaranteed returns as well as annuities that do not provide for immediate liquidity. In response, the DOL removed this condition from the final regulation.

- Tax Incentives and Credits. The proposed rule would have required that employers receive no consideration from the state aside from their direct costs in making the automatic IRA program available to their employees. The DOL loosened this requirement, allowing for tax incentives and credits to be provided to employers and permitting states to reimburse employers based upon a reasonable approximation of their direct costs.

- Security of Payroll Deductions. The proposed regulation required that states "assume responsibility for the security of payroll deductions." Some commenters were concerned that this condition would hold states strictly liable for payroll deductions, even when employers divert them through fraud or theft. The DOL retained this requirement but stated in the preamble that the state's responsibility is limited to establishing and following a process to ensure payroll deductions are transmitted in a timely manner. As an example, the DOL clarified that a state could rely on its wage theft laws to ensure employers transmit payroll deductions to the state automatic IRAs. Notably, however, the DOL chose not to impose its guidance on when employers must remit participant contributions to the IRA, deciding to leave such matters to the states.

- Voluntary Participation. The proposed regulation required that an employer's participation in the state automatic IRA program be "required by state law." Some commenters requested that the final regulation also permit employers whose participation is not affirmatively required by state law to participate on a voluntary basis. Further, commenters expressed concerns about employers whose participation is required due to the number of employees they have. (For example, an employer may be required to participate because it employs five employees where the statute requires that all employers with five or more employees participate. However, if the employer terminated one employee, it would not be required to participate under the state law.) In the final regulation, the DOL did not allow employers to participate on a voluntary basis. In the DOL's view, this act of discretion on the employer's part would create an ERISA-covered plan. However, the DOL opined that the employer may participate in the state automatic IRA program on a voluntary basis without creating an ERISA plan through compliance with the DOL's IRA Payroll Deduction Safe Harbor (codified at 29 C.F.R. § 2510.3(d)). In addition, the DOL indicated that an employer whose participation is no longer required due to a drop in the size of its workforce could also continue participation through compliance with the IRA Payroll Deduction Safe Harbor. Many conditions of the IRA Payroll Deduction Safe Harbor are the same as in the final regulation, but employees would be required to affirmatively elect to participate. The DOL takes the position that the safe harbor does not permit automatic enrollment.

Proposed Regulation for Political Subdivisions

The DOL's proposed regulation to provide a safe harbor for automatic IRAs run by political subdivisions would apply the same conditions as the final regulation for state automatic IRAs. The only issue still to be addressed is the definition of a "qualified political subdivision." Under the proposed regulation, a qualified political subdivision would be one that has a population equal to or greater than the least populated of the fifty states (currently Wyoming, with about 600,000 residents) and is not located in a state that has established a state-wide retirement savings program for private-sector employees. In addition, the political subdivision would need to have the authority to create the automatic IRA program under the law of its state.

The DOL invited comment on the appropriate definition of an eligible "political subdivision," which would not apply to ERISA's definition of "governmental plan" generally. The DOL also noted that it was not clear how many political subdivisions would be interested in creating an automatic IRA program because only three cities – New York, Philadelphia, and Seattle – have expressed interest to date.

The DOL said it is considering – and invites comments on – a third requirement, *i.e.*, that the political subdivision have a "demonstrated capacity to design and operate a payroll deduction savings program," such as maintaining an existing pension plan for employees of the subdivision.

Implications

The DOL's final regulation will provide certainty for states who are considering, designing, or implementing state automatic IRAs. In addition to the five states that have already passed legislation providing for such programs, many more may soon follow. Indeed, the California Assembly passed legislation days ago to adopt such a program, which still needs Senate approval and the Governor's signature.

While these state initiatives have the potential to greatly expand access to workplace retirement plans for many Americans, they also run the risk of subjecting employers to a patchwork of differing regulatory regimes. As a result, the growing state efforts may ultimately prompt Congress to act. Notably, President Obama has repeatedly proposed creating a federal automatic IRA that would impose a single set of rules across all of the states.