GROOM LAW GROUP

MEMORANDUM

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Proposed IRS Regulations Provide Clarity For Automatic Enrollment Programs

I. Introduction

More Americans are funding their retirement benefits with their own savings by means of contributions to employer-provided retirement savings plans, such as plans established under Internal Revenue Code ("Code") sections 401(k), 403(b) and 457(b). Recognizing the importance of encouraging employees to save for retirement, policy makers and employers have wrestled with how to encourage employees, especially lower-paid and younger employees, to contribute to these plans. Even with the lure of "free money" in the form of an employer match, the unfortunate fact is that many employees do not sign up to become participants. This is often due to inertia on the part of the employee. The decision of how much to contribute to the employer's 401(k) plan, and how to invest the contributions, can be so intimidating that an employee may perpetually put off making the decision and, thereby, forego participation. In addition, saving for retirement may not be a priority for some employees, especially younger employees. Other employees, for example, lower paid employees, may believe that they cannot afford to save.

Before 2006, some employers were implementing an arrangement in their retirement savings plans whereby pre-tax contributions would be automatically deducted from an employee's paycheck and contributed to the savings plan unless the employee affirmatively elected otherwise. This arrangement typically became known as "automatic enrollment" or "auto-enrollment." The contributions were then invested in a default investment option selected by the employer until the employee filed an investment direction. The IRS first blessed this type of arrangement in 1998, as long as an employee was given an opportunity to "opt out" of the arrangement before contributions were deducted from his or her paycheck.[1]

Auto-enrollment arrangements proved to increase employee participation in retirement savings plans. As studies have shown, individuals are less likely to stop contributions once they begin than they are to affirmatively elect to make contributions. Therefore, auto-enrolled employees accumulate more retirement savings; their inertia results in increased retirement savings.

Building on the success of automatic enrollment, employers adopted a new design feature whereby the rate of contributions would automatically increase. Some employers timed the increase to coordinate with annual pay raises so the pay raise would mask the effect of the additional contributions.

However, many employers hesitated to implement auto-enrollment. Even though the IRS had blessed auto-enrollment in several Revenue Rulings, issues remained that made it unclear

[1] Revenue Rulings 98-30, 2000-8, and Revenue Ruling 2000-33.

whether an auto-enrollment arrangement was too risky to implement. One uncertainty was that some states had laws prohibiting an employer from deducting amounts from an employee's paycheck without the employee's affirmative written consent. It was unclear whether ERISA preempted this sort of law, or whether an employee could sue an employer for deducting pre-tax contributions from his or her paycheck without consent. In addition, employers worried that, even though an employee would be notified of the auto-enrollment and have an opportunity to opt-out before the contributions were deducted from his or her paycheck, the employee would only become aware of the auto-enrollment after the contributions had been deducted from his or her paycheck and contributed to the plan, where the qualification rules would prevent the amount from being repaid to the employee. Finally, employers worried about assuming fiduciary liability for the investment of automatic contributions.

In 2006, Congress gave a major boost to auto-enrollment when it passed the Pension Protection Act ("PPA"). The PPA addressed many of the issues that had been preventing employers from implementing auto-enrollment arrangements.[2] Proposed IRS regulations providing details of auto-enrollment under the PPA were published on November 8.[3] This memo describes automatic enrollment under the PPA, focusing on the recently published proposed regulations.

In addition, the Department of Labor ("DOL") published final regulations addressing the qualified default investment alternatives ("QDIA") and ERISA preemption on October 24, 2007.[4] This memo does not describe this guidance in depth, but does refer to it as it is relevant.

The PPA automatic enrollment provisions are effective, and the proposed regulations are intended to be effective, for plan years beginning on or after January 1, 2008. The proposed regulations provide that, until the regulations are finalized, plan sponsors may rely on them. If the final regulations are more restrictive than the proposed regulations, the more restrictive provisions will be effect on a prospective basis only. The IRS is requesting comments on the proposed regulations, which must be received by the IRS no later than February 6, 2008.

II. <u>Automatic Enrollment Under the PPA</u>

The PPA, which was signed into law on August 17, 2006, contained a number of provisions intended to encourage the establishment of automatic enrollment arrangements in employer retirement savings plans. In addition to expressly preempting state laws that forbid deductions from employee paychecks without affirmative consent, the PPA provided additional incentives for establishing an auto-enrollment arrangement. First, it provided a special rule whereby an employee could request the distribution of automatic contributions within 90 days after the contributions were made to the plan. Second, it directed the DOL to develop regulations, now finalized, describing safe harbor default investment funds to allow employers to avoid fiduciary liability with respect to the investment of automatic contributions. Finally, it provided a safe harbor from the nondiscrimination rules and exclusion from the top-heavy

[2] See section 902 of the PPA.

[3] 72 Fed. Reg. 63144 (Nov. 8, 2007).

[4] 72 Fed. Reg. 60452 (October 24, 2007).

requirements for certain auto-enrollment arrangements. These rules apply to automatic contributions arrangements for 401(k) plans and in some respects to, 403(b) plans and eligible 457(b) governmental plans.

The recently proposed IRS regulations describe the requirements that must be met in order for an auto-enrollment arrangement to be eligible for these special provisions (other than the ERISA preemption provision, which applies to any auto-enrollment arrangement). The proposed regulations distinguish two types of auto-enrollment arrangements: (a) an eligible automatic enrollment arrangement, referred to in the regulations as an "EACA", described in the proposed regulations under Code section 414(w); and (b) a qualified automatic contribution arrangement, referred to in the regulations as a "QACA," described in the proposed regulations under Code section 401(k)(13). The key distinction between the two is that the QACA automatically passes the ADP test on a design basis, similar to the safe harbor described in Code section 401(k)(12). The two types of auto-enrollment arrangements, as introduced in the proposed regulations, are described in Parts A and B below.

Please note that while many employers will decide to convert their auto-enrollment arrangement into either an EACA or a QACA, or both, in order to take advantage of the special features associated with them, there is no requirement that an automatic enrollment arrangement be either an EACA or a QACA. In fact, the preemption of state laws prohibiting the deduction of amounts from an employee's paycheck without written consent applies to all auto-enrollment arrangements, without regard to whether the auto-enrollment arrangement is an EACA or a QACA or uses a default investment that is a QDIA. (However, such an auto-enrollment arrangement remains subject to the same notice requirement that applies to a QDIA.)

A. Eligible Automatic Contribution Arrangements ("EACA")

1. What is an EACA? An EACA is an auto-enrollment arrangement that meets certain requirements "for a plan year." An IRS representative has said informally that an EACA may be implemented mid-year, but, in light of the language quoted in the prior sentence, this does not seem to be clearly supported by the proposed regulations.

Uniform Contribution Percentage Requirement. The default contribution rate must be a uniform percentage of compensation, which may increase automatically as an employee performs additional years of service. There does not appear to be any restriction on the minimum or maximum contribution percentage, or on the timing of the increase. For example, it appears that the automatic increase could be coordinated with the timing of annual raises. In addition, it appears that automatic contributions may consist of Roth contributions.

Notice Requirement. Each "eligible employee" must be given a notice that describes the auto-enrollment arrangement. There has been some confusion over whether the notice must be provided to all employees eligible for the employer's plan or only to those employees eligible for the auto-enrollment arrangement, i.e., those who have not affirmatively made a deferral election. Although the language of the proposed regulation itself is not entirely clear, the Preamble states that the EACA notice must be provided "to each employee to whom the EACA applies."

The notice must include the following information:

- the information required to be included in the Code section 401(k)(12) safe harbor notice, e.g., a description of the distribution rights, "to the extent these provisions apply to the arrangement." However, since an EACA is not an ADP testing "safe harbor," one might argue that the information required by the pre-PPA 401(k) testing safe harbor does not apply;

- the level of contributions that will be made on the employee's behalf if the employee does not act;

- the fact that the employee can elect not to have default elective contributions made to the plan or can elect to have a different amount contributed to the plan;

- a description of how the contributions to the plan will be invested in the absence of any investment election by the employee; and

- if the plan provides for the withdrawal of automatic contributions, as described below, a description of the employee's right to make a withdrawal of the amounts automatically contributed and the steps to take to make that withdrawal.

The Preamble provides that these requirements may not be met by reference to the SPD. It also provides that one notice may be used to meet the required EACA, QDIA, and preemption notice requirements. The regulations issued by the DOL regarding the notice required for the QDIA provides that this notice may not be provided with other notices, other than the preemption and EACA/QACA notices. Therefore, the combined notice should be provided as a separate document, although the document may be included with other notices, for example, in a year-end general mailing regarding the plan.

On November 15, the IRS posted on its website a sample notice that plan sponsors may use to meet these notice requirements. This notice is specifically for a QACA, described below, but can be modified for use with an EACA. In the preface to this sample notice, the IRS states that the DOL has agreed that this notice could be used to meet the QDIA and preemption notice requirements.

An annual notice must be provided within a reasonable time before the beginning of each plan year. A period of at least 30 days (and no more than 90 days) prior to the beginning of each plan year is deemed to meet this requirement. In addition, the notice must be provided to newly eligible employees no more than 90 days before the employee is first eligible to make elective deferrals under the plan, but no later than the date he or she becomes eligible. For a plan with immediate eligibility, this means that the notice must be provided to a newly hired employee on his or her first day of employment. Eligible employees must have a reasonable period of time after receipt of the notice to make an affirmative election. The notice can be in writing or can be delivered electronically, as long as the electronic transmission of the notice meets the existing IRS guidance on the electronic transmission of information.[5]

Investment Requirement. An EACA must provide that, until an employee files an investment election, automatic contributions and associated employer contributions are invested in a QDIA. By investing the employee's contribution in a QDIA, a plan sponsor obtains significant relief from fiduciary liability.

2. What Are the Advantages of an EACA? There are two advantages to an EACA. First, if a plan includes an EACA, it may distribute automatic contributions to a participant upon request, provided certain requirements are met. Second, if a plan sponsor adopts an EACA, the time period for performing the annual ADP test is extended. These advantages are described below.

Permissible Withdrawals. In some cases, employees who have had automatic contributions made to the plan on their behalf may decide that they do not want to make contributions to the plan and request that the contributions be repaid to them. However, the qualification rules that apply to a section 401(k), 403(b), or 457(b) plan generally would not permit distributions merely because an employee did not want automatic contributions made to the plan on his or her behalf.

The PPA provides an exception from these rules to allow, but not require, an EACA to permit an employee to withdraw automatic contributions, adjusted for earnings (including losses), made to a plan on his or her behalf. A plan may charge a fee for such a withdrawal, provided the fee is the same fee charged for other distributions. An employee's election is not subject to any of the notice and consent rules that usually apply to distributions.

The Preamble to the proposed regulations states that a plan is not required to extend this option to all eligible employees. Otherwise, the availability of this feature would be a "benefit, right, or feature," subject to nondiscrimination testing. An employer may provide in the withdrawal election a default election whereby the employee elects to make no elective deferrals to the plan. Presumably, this would be considered an affirmative election. However, the Preamble states that an employer may not provide for a default election whereby an employee elects never to participate in the plan because this would violate the contingent benefit rule.

The withdrawal election must be made no later than 90 days after the date the contributions would have been included in gross income. Presumably, this is the date that the contributions otherwise would have been paid to the employee. For example, if an employer has a 2-week payroll cycle and an employee’s paycheck is automatically reduced for EACA contributions for the payroll period ending April 30, the employee will have until 90 days after April 30 to elect to withdraw the automatic contributions. The withdrawal election will apply to all automatic contributions made through the last day of the payroll period that begins after the date the election is made; it appears that it is not permissible for an employee to elect to withdraw only a portion of the automatic contributions. The proposed regulations do not address

[5] Treas. Reg. §1.401(a)-21 details the rules regarding when notice can be given to participants electronically.

the timing of the distribution. Presumably, it should be reasonable to make distributions within the plan's usual time period for making distributions.

The returned amount is not eligible for rollover treatment and will be subject to income tax in the taxable year in which the distribution is made, to the extent taxable. There is no early distribution tax on these returned amounts. Finally, the distribution is reported on Form 1099-R. Any related matching contributions are forfeited; they cannot be returned to the employer or paid to the employee.

Additional Time to Perform ADP/ACP Tests. The withdrawal feature makes it impossible for an employer to perform the ADP and ACP testing within the required 2½ month period following the end of a plan year. For example, if a plan uses a calendar year plan year, and if automatic contributions are first made on behalf of an employee in December, the employee may request the return of these contributions as late as March. Therefore, the regulations provide that distributions of contributions to highly compensated employees necessary in order to pass the ADP and/or ACP tests can be made up to 6 months after the close of the plan year. This allows plan sponsors to delay performing the ADP and ACP tests for their 401(k) plans after all withdrawals of automatic contributions for a plan year have been made. Although not entirely clear, it appears that this extension is available whether or not a plan provides for employee withdrawals of automatic contributions as described above. Of course, now that plans are no longer required to distribute "gap period" earnings along with excess contributions, highly compensated employees will be able to maintain up to 6 months of post-year end earnings in the plan on distributed contributions.

B. Qualified Automatic Contribution Arrangements ("QACA")

A QACA is an auto-enrollment arrangement that is treated as automatically meeting the ADP and ACP tests on a safe harbor basis. The rules that apply to a QACA are similar to the rules that apply to the current 401(k) safe harbor. For example, a plan must be amended to provide for the QACA before the plan year during which it will be effective, and it must be effective for a 12-month plan year. However, not all the same rules apply. For example, the special "early participation" rule that allows a plan to meet the section 401(k)(12) safe harbor by disregarding employees who have not met the minimum age and service requirements does not apply. In addition, the following requirements must be met:

Eligible Employees Covered. Any eligible employee who has not made an affirmative election as of the initial effective date of the QACA, and any employee first becoming eligible for the QACA after the initial effective date, must be subject to auto-enrollment unless he or she affirmatively elects not to participate. The Preamble describes an affirmative election as a completed election form on which the employee elects an amount or percentage (including zero) of his or her compensation to be paid to the plan as elective deferrals.

Percentage of Compensation to be Contributed. The contribution percentage must be uniform for all eligible employees. The minimum contribution percentage is 3%, and increases by 1% each plan year, up to 6%. However, a plan may provide for a higher annual percentage, up to 10%. The initial minimum contribution percentage of 3% must remain in effect until the end of the first plan year following the plan year during which automatic contributions were first made to the plan. This means that an eligible employee on whose behalf automatic contributions are first made to a calendar year plan in mid-January would make automatic contributions at the minimum 3% for almost two years. There are two special rules regarding the contribution percentage:

- If an employer has an auto-enrollment arrangement in effect before the effective date of a QACA, the automatic contribution percentages in effect upon the implementation of the QACA may continue to apply, provided they comply with the QACA minimum contribution percentages; and

- If elective deferrals have been suspended for 6 months due to a hardship distribution, the plan must provide that, at the end of the suspension period, the plan will automatically resume elective deferrals at the rate in effect before the suspension.

Interestingly, a QACA requires that the contribution percentage increase on a plan year basis. This will undermine the ability of employers to coordinate the timing of annual increases with annual raises.

Required Employer Contribution. Similar to the Code section 401(k)(12) safe harbor, an employer must make an employer contribution to the plan on behalf of all non-highly compensated employees in order for the auto-enrollment arrangement to be a QACA. However, the level of match and vesting required under a QACA are more favorable to employers than those required under the Code section 401(k)(12) safe harbor.

- The employer contribution may be either a nonelective contribution or a matching contribution. The nonelective contribution must equal at least 3% of eligible employee's compensation. The matching contributions must equal (i) 100% of the contributions that do not exceed 1% of the employee’s compensation and (ii) at least 50% of the contributions exceeding 1%, but not 6%, of the employee’s compensation. Matching contributions will satisfy the ACP test on a safe harbor basis in accordance with the same rules that apply to matching contributions used to meet the Code section 401(k)(12) safe harbor.

- The employer contribution must be fully vested after no more than 2 years of service.

The employer contribution is subject to the distribution restrictions that apply to elective deferral contributions (except that they may not be distributed on account of a hardship).

One unclear issue is whether the employer must make a match on automatic contributions that are withdrawn by the employee if the match has not been made by the time the contributions are withdrawn. An IRS representative stated informally that this question had not been resolved.

Notice Requirement. It appears that the notice requirements apply to both an EACA and a QACA. As stated earlier, the proposed regulations are not entirely clear with regard to whether the notice must be provided to all employees eligible under the plan, or only those who have not made an affirmative deferral election and are, therefore, eligible for the EACA or QACA. In the case of a QACA, there would appear to be a stronger basis for providing the notice to all employees eligible for the plan. First, the QACA is a "safe harbor" design, and the required notice for the section 401(k)(12) safe harbor must be provided to all employees. Second, all employees will receive the employer contribution and, therefore, the information in the notice would be relevant to all participants. However, at this time, it seems reasonable to provide the notice only to those eligible employees who have not made an affirmative elective deferral election.

Investment Requirements. In contrast to an EACA, automatic contributions under a QACA are not required to be invested in a QDIA. However, in light of the protection from fiduciary liability associated with use of a QDIA, it is likely that employers will invest automatic contributions and associated employer contributions in a QDIA. Implementing a QDIA will also enable the plan to provide for employee-elected withdrawals available under an EACA.

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