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LEGAL ALERT

Legal Alert: IRS Issues Final Rule on Automatic Enrollment

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The Pension Protection Act of 2006 (the "PPA") amended the Internal Revenue Code to facilitate automatic contribution arrangements (also referred to as automatic enrollment) in section 401(k) plans, as well as in similar plans under sections 403(b) and 457(b) in the case of tax-exempt and governmental employers. More recently, the Worker, Retiree, and Employer Recovery Act of 2008 ("WRERA") added similar provisions to the rules relating to SARSEPs and SIMPLE IRAs. In late 2007, the IRS had issued proposed regulations dealing with automatic enrollment. Now, the final regulations have been issued, incorporating comments that were received by the IRS on the proposals, as well as the changes that had been made by WRERA. The final regulations generally are effective for plan years beginning on or after January 1, 2008 (although compliance with the then-pending proposed regulations was acceptable). An eligible automatic contribution arrangement (EACA) is a plan provision which provides that, in the absence of an affirmative election by an eligible employee to the contrary, the employee is deemed to have made an election to reduce compensation by a specified amount and to have a contribution in that amount made on his or her behalf to the plan. The automatic contribution must then be invested in accordance with the "qualified default investment alternative" ("QDIA") requirements, regardless of whether the plan provides for participant direction of investments. Finally, each employee to whom the arrangement applies must receive annual notices explaining the EACA and the employee's options thereunder. In general, contributions to 401(k) plans must meet the actual deferral percentage (ADP) test for elective contributions, and the actual contribution percentage (ACP) test for employer matching (and employee after-tax) contributions. Amendments made by the PPA, effective for plan years beginning on or after January 1, 2008, provided design-based nondiscrimination safe harbors that apply to an EACA that provides for automatic contributions at a specified level and meets certain notice and other requirements. An arrangement that satisfies these requirements, referred to as a "qualified automatic contribution arrangement" (QACA), is deemed to satisfy the ADP (and, if applicable, the ACP) test. The PPA also made other changes that were needed in order to facilitate the use of automatic enrollment arrangements. Limited relief from the plan distribution restrictions is provided by Code section 414(w) in the case of an EACA. Specifically, within the first 90 days of "automatic" participation, an employee may withdraw the amount of elective contributions (and attributable earnings) made pursuant to his or her deemed election, from the first payroll period for which the EACA applied to the employee through the effective date of the election. The amount so withdrawn is includible in gross income for the year in which received, but the 10% additional tax under Code section 72(t) will not apply, regardless of the employee's age. This provision prevents an employee from being forced into plan participation simply because he or she may have missed an election deadline. However, employers using automatic enrollment have generally found that, once enrolled, employees tend to remain as participants, even after notification that they may opt out, and tend to leave contributions invested in the QDIA. In addition, along the same lines, the correction periods for return of both excess contributions (those in violation of the ADP test) and excess aggregate contributions (those in violation of the ACP test) were increased from 2-1/2 months to 6 months where the contributions were made under an EACA. In order to become "qualified" (i.e., a QACA), an EACA must satisfy minimum default contribution percentages that increase over time, starting at 3% of compensation for the first year, and increasing 1% per year to 6% of compensation in the fourth year and thereafter. In this regard, the final regulation clarifies that for purposes of determining the minimum percentage applicable for a period, the first year taken into account is the year in which the employee first has contributions taken out of pay and contributed under the *default* option. The final regulation also provides guidance on the application of the minimum percentage requirement in the case of a rehired employee. Specifically, the minimum percentage in such a case is determined without regard to whether the employee has continuously been eligible to make elective contributions under the plan. Therefore, the minimum percentage generally is determined based on the number of years (i.e., the period of time) elapsed since the date the employee first had default contributions made under the QACA.

In order to permit increases in the default percentage to coincide with salary increases or performance evaluations, the final regulation modifies the uniformity requirement otherwise applicable to QACAs, so that the default percentage be determined based upon periods other than calendar years (or plan years), beginning with the period in which the employee's first default contribution occurred. In response to expressed concerns over satisfying advance-notice requirements where employees are eligible to participate immediately upon hire, the final regulation provides that notice need not be provided prior to an employee's eligibility if impractical; instead, the notice will be considered timely if it is provided "as soon as practicable after" the date of eligibility, provided that eligibility date applies with respect to all deferrals (i.e., of all types of compensation that may be deferred) under the plan. The final regulation currently provides that only those employees who are specified in the plan as being subject to the EACA need be treated as eligible under the EACA. However, starting with plan years beginning after December 31, 2009, a plan containing an EACA may rely upon the extended 6-month correction periods (described above) *only* if *all* eligible employees are subject to the EACA for the entire plan year (or for the portion of the plan year for which they are eligible employees).

The regulation makes two changes to the withdrawal procedures where an employee wishes to "cancel" a deemed election. First, the plan may replace the 90-day period during which such withdrawals may be made with a shorter period, but not shorter than 30 days, though the withdrawal must continue to be made in accordance with the plan's ordinary timing procedures for processing and paying distributions. Then, a plan may also charge a fee for permitting such a withdrawal, but it cannot be more than the fee that applies to any other cash distribution; if there are no other fees imposed for distributions, then none can be imposed here.

The nondiscrimination safe harbor rules for QACAs became applicable for plan years beginning on or after January 1, 2008. The permissible withdrawal rules apply for plan years beginning on or after January 1, 2010. Starting in 2008, however, a plan must be operated in accordance with a good faith interpretation of Code section 414(w). For this purpose, a plan that operates in accordance with either the proposed regulation or the final regulation will be treated as operating in accordance with a good faith interpretation of Code section 414(w). If you have any questions regarding this new law or other benefits related issues, you may contact Jeffrey Ashendorf, jashendorf@fordharrison.com, 212-453-5926, Tiffany Downs, tdowns@fordharrison.com, 404-888-3961, or any other member of Ford & Harrison's Employee Benefits practice group.