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A legal update from Dechert's Employee Benefits and Executive Compensation Group

IRS Issues Proposed Rules and Sample Notice Regarding Automatic Enrollment Arrangements

The Internal Revenue Service ("IRS") has issued proposed regulations on the requirements for automatic enrollment arrangements, permitted by the Pension Protection Act of 2006 (the "PPA"), with respect to 401(k) plans, 403(b) plans, and 457(b) governmental plans. These arrangements first become available for plan years starting on or after January 1, 2008. In addition, to assist plan sponsors in satisfying the notice requirement contained in the proposed regulations, the IRS has posted a sample automatic enrollment notice on its web site. This new guidance and model form will help employers adopt and set up these arrangements at the earliest possible time.

Statutory Background

Prior to the PPA, the IRS had issued guidance permitting employers to establish automatic enrollment arrangements in 401(k) plans and other tax-favored programs. Under these arrangements, the plan or program has a default rule, under which employees who fail to make an affirmative election are automatically enrolled in the plan or program and make contributions at a specified percentage or level of pay. These arrangements became increasingly popular, as they helped employers increase participation in 401(k) plans and other programs, and provided a way to encourage employees to save for their retirement.

Effective for plan years beginning on or after January 1, 2008, the PPA added sections 401(k)(13) and 401(m)(12) to the Internal Revenue Code (the "Code"). These sections establish "qualified automatic contribution arrangements" ("QACAs") for 401(k) plans, in the form of a cash or deferred arrangement that automatically provides salary reduction contributions, for eligible employees who do not affirmatively elect otherwise, at a specified percentage of pay. A QACA will automatically meet the Code's nondiscrimination requirements for salary reduction contributions (the actual deferral percentage or "ADP" test) and for matching contributions (the actual contribution percentage or "ACP" test), and will not be subject to the Code's top heavy rules, if it contains certain specified provisions. These necessary provisions include:

- those for automatic salary reduction contributions made at uniform, minimum, and increasing percentages of pay for employees who fail to make an affirmative election;
- an employee's right to elect out of making automatic salary reduction contributions;
- minimum matching or nonelective contributions which must vest after no more than two years of service and are subject to distribution restrictions;
- limitations on the amount of any matching contributions; and
- timely notice of employees' rights under the QACA.

Also effective for plan years beginning on or after January 1, 2008, the PPA added section 414(w) to the Code. This section provides certain rules for a 401(k) plan, 403(b) plan, and 457(b) governmental plan, which include an "eligible automatic contribution arrangement" ("EACA").

Similar to a QACA, an EACA is a cash or deferred arrangement that automatically provides salary reduction contributions, for eligible employees who do not affirmatively elect otherwise, at a specified percentage of pay. The rules of section 414(w) provide relief from certain distribution restrictions, as well as from the 10 percent "early distribution" tax of section 72(t) of the Code, for an employee who elects to withdraw certain automatic salary reduction contributions from the EACA shortly after they have been made. This withdrawal rule is intended to allow an employer to avoid the accumulation of small account balances in a plan with an EACA feature. Section 414(w) requires that an annual notice be provided to eligible employees regarding their rights under the EACA.

ERISA Concern/Sample Notice

The PPA amended the Employee Retirement Income Security Act of 1974 ("ERISA") to preempt any state law that would directly or indirectly prohibit or restrict the inclusion in any plan of an EACA. The PPA further amended ERISA to require that a notice be provided to each employee covered by the EACA. The specific timing and content rules for the notice required under ERISA with respect to EACAs are very similar to those for the notices required under the QACA rules and section 414(w) of the Code. Therefore, these three notices may, for practical purposes, be treated as one and the same and covered in a single document. Another similar notice that may be covered by this single document is the notice required under ERISA with respect to certain default investments.

Recently, the IRS posted a sample "Automatic Enrollment Notice" on its web site (www.irs.gov) for use in connection with a QACA and/or EACA. According to the Notice, the DOL has indicated that use of this sample notice may also be used to satisfy the ERISA notice requirements described above. Please note that the Notice will need to be modified and expanded as necessary to accurately reflect the provisions of an employer's plan.

The Proposed Regulations

Under the proposed regulations, an arrangement is a QACA if it is an automatic contribution arrangement and meets the plan provision, plan year, safe harbor contribution, and notice requirements described below. A QACA is automatically treated as meeting the ADP test and, if matching contributions are made, the ACP test.

An "automatic contribution arrangement" is an arrangement that provides that, in the absence of an eligible employee's affirmative election, a default rule applies under which the employee is treated as having made an election to have salary reduction contributions made at the arrangement's "qualified percentage" of pay. The default rule ceases to apply if the employee makes an affirmative election, in which he or she chooses to have salary reduction contributions made in a different amount than under the default rule, or to have no salary reduction contributions made.

An arrangement's "qualified percentage" is a percentage that (i) is uniform for all employees, with certain exceptions discussed below; (ii) does not exceed 10 percent; and (iii) equals or exceeds the QACA minimum percentages. In turn, the "QACA minimum percentages" are, for any employee: (i) three percent, for the period that begins on the day the employee first participates in the automatic contribution arrangement and ends on the last day of the following plan year (the "initial period"); (ii) four percent, for the first plan year immediately following the initial period; (iii) five percent, for the second plan year following the initial period; and (iv) six percent, for all subsequent plan years.

The proposed regulations allow the qualified percentages to differ among employees due to:

- the number of years of an employee's participation in the arrangement;
- a particular employee's affirmative election of a rate of salary reduction contributions which exceeds the QACA minimum percentage for that employee;
- the need to comply with the Code's limits under sections 401(a)(17) (dollar limit on pay taken into account), 402(g) (dollar limit on salary reduction contributions), and 415 (limit on all contributions); or
- a six month suspension of salary reduction contributions due to a hardship withdrawal.

An arrangement must contain plan provisions that satisfy the rules for qualifying as a QACA. These provi-

sions include those that specify the default percentages that will apply (i.e., the percentages of pay that will be contributed as salary reduction contributions for the employees) and whether the safe harbor contribution will be the nonelective contribution or the matching contribution (as discussed below). Further, the arrangement must specify that it intends to automatically meet the ADP test by qualifying as a QACA. The arrangement cannot provide that ADP testing will be used if the requirements for being treated as a QACA are not satisfied. A similar rule applies with respect to the ACP test.

To be applicable for any plan year, the required plan provisions discussed above must be adopted before the first day of that year, and generally must remain in effect for the entire plan year. Thus, to use the QACA rules in 2008, a calendar year plan must be amended to include the required plan provisions by December 31, 2007.

For each plan year, a QACA must provide a minimum amount of nonelective contributions or matching contributions. If the arrangement will provide nonelective contributions, then for each plan year, the employer is required to make a nonelective contribution on behalf of each eligible non-highly compensated employee (an "NHCE"), which is equal to at least 3 percent of the employee's pay. If the arrangement will provide matching contributions, then for each plan year, the employer is required to make matching contributions on behalf of each eligible NHCE in an amount determined under the following "basic matching formula": the sum of: (i) 100 percent of the employee's salary reduction contributions which do not exceed one percent of his or her pay; and (ii) 50 percent of the employee's salary reduction contributions which exceed one percent, but not six percent, of his or her pay. In lieu of using this basic matching formula, the arrangement may use an "enhanced matching formula," under which each eligible NHCE receives matching contributions in an aggregate amount that, at any rate of salary reduction contributions by the employee, is at least equal to the aggregate amount of the matching contributions the employee would have received under the basic matching formula.

Any employer contributions under a QACA, which are attributable to the nonelective or matching contributions, made to meet the safe harbor contribution requirement:

- are subject to the same restrictions on distributions which apply to elective deferrals made under a 401(k) plan (except that they may not be withdrawn because of hardship); and
- must be 100 percent vested after the employee has completed at least two years of service.

Under the proposed regulations, each eligible employee must be given notice of his or her rights and obligations under a QACA. The notice must describe, among other things:

- the level of salary reduction contributions which will be made on the employee's behalf if the employee does not make an affirmative election;
- the employee's right under the arrangement to elect to not have salary reduction contributions made on his or her behalf, or to elect to have such contributions made in a different amount or percentage of pay than under the default rule; and
- how contributions under the automatic contribution arrangement will be invested.

Generally, the notice must be provided at least 30 days, and no more than 90 days, before the beginning of each plan year.

The proposed regulations implement new section 414(w) of the Code by providing rules under which employees are permitted to elect to make a withdrawal of certain salary reduction contributions (and earnings) from an "eligible automatic contribution arrangement" ("EACA"). An EACA is an automatic contribution arrangement under an applicable employer plan which satisfies the uniformity, notice, and default investment requirements discussed below.

An "automatic contribution arrangement" is one that provides a cash or deferred election under which, in the absence of an eligible employee's affirmative election, a default election applies. Under this default election, the employee is treated as having elected to have salary reduction contributions made on his or her behalf at a specified percentage of pay (the "default salary reduction contributions"). The default election ceases to apply to an employee if he or she makes an affirmative election to not have any default salary reduction contributions made on his or her behalf, or to have salary reduction contributions made in a different amount or percentage of pay than under the default election. An EACA generally must provide

that the default salary reduction contribution is a uniform percentage of pay. The proposed regulations require that each eligible employee be given notice on an annual basis of his or her rights and obligations under an EACA. The notice must essentially include the same information as the annual notice required under a QACA, except that it must describe the employee's right (if any) to make a permissible withdrawal and the procedures to exercise this right. The notice must be furnished within the same time frames as the QACA notice.

Under an EACA, default salary reduction contributions must be invested in accordance with the new default investment regulations issued under section 404(c)(5) of ERISA.

The idea behind permissible withdrawals is to help an employee elect out of the EACA, even after contributions have started on his or her behalf. Under the proposed regulations, if the EACA so provides, any employee on whose behalf default salary reduction contributions have been made may elect to withdraw such contributions (and the earnings attributable thereto), in accordance with the following rules as to the timing of elections and the amount of the withdrawal.

An employee's election to withdraw default salary reduction contributions must be made no later than 90 days after the date that the first default salary contribution was made to the EACA on the employee's behalf. This date is the first day on which the pay subject to the default election under the EACA would otherwise have been included in the employee's gross income. The amount of the default salary reduction contributions being withdrawn by an employee must be equal to the total amount of the default salary reduction contributions made under the EACA on the employee's behalf through the effective date of the election (adjusted for allocable gains and losses to the date of the withdrawal). The amount of the withdrawal may be reduced by any generally applicable fees. However, the EACA may not charge a fee for a withdrawal under section 414(w) of the Code other than a fee that applies to other distributions from the EACA.

Under the proposed regulations, the amount of the withdrawal is includible in the employee's gross income for the taxable year in which the withdrawal is made. The withdrawal is not subject to the additional ten percent "early distribution" tax of section 72(t) of the Code. The amount of the withdrawal is reported on Form 1099-R but is not an eligible rollover distribution.

Any matching contributions, which were made with respect to the salary reduction contributions being withdrawn, must be forfeited. Further, a forfeited matching contribution is not a mistaken contribution or other erroneous contribution, and thus it cannot be returned to the employer or be distributed to the employee. Rather, the forfeited contribution must remain in the plan and be treated in the same manner as any other forfeitures so remaining.

Sections 401(k)(13), 401(m)(12), and 414(w) of the Code are effective for plan years beginning after 2007. The IRS proposes that the regulations be effective at the same time. Employers may rely on these proposed regulations for guidance pending the issuance of final regulations.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/employeebenefits.

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