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IRS Issues Final Regulations on Automatic Contribution Arrangements

On February 24, 2009, the IRS released final regulations relating to automatic contribution arrangements (also known as automatic enrollment) in individual account defined contribution plans. The final regulations adopt many of the provisions in the proposed regulations, but also include new provisions.

Background

The Pension Protection Act of 2006 (PPA) added provisions to the Internal Revenue Code (IRC) to facilitate automatic contribution arrangements (ACAs) in individual account defined contribution plans. (See our August 8, 2006 *For Your Information*.) Under an ACA, the employee is automatically enrolled and treated as having made an election to have a specified percentage of compensation contributed to the plan, unless the employee affirmatively elects a different amount or opts out of the plan completely.

PPA created two types of new automatic contribution arrangements. The first is a new safe harbor design for automatic enrollment plans called a “qualified automatic contribution arrangement” (QACA). Plans that meet QACA requirements in IRC Section 401(k)(13) will be deemed to satisfy the actual deferral percentage (ADP) and the actual contribution percentage (ACP) nondiscrimination tests that would otherwise apply to salary deferrals and employer matching contributions, as well as the top-heavy rules. To qualify as a QACA, the arrangement generally must satisfy design-based safe harbor requirements such as qualified minimum percentage amounts, an annual employee notice, and certain vesting for matching contributions.

The second is an “eligible automatic contribution arrangement” (EACA). Plans that meet the EACA requirements in new Section 414(w) may allow employees to elect to withdraw automatic contributions no later than 90 days from the date these contributions first start, without incurring the 10% early withdrawal tax. The EACA requirements include uniform default deferral rates and notices to employees that are generally similar to those for a QACA.

On November 8, 2007, the IRS issued proposed regulations relating to the automatic contribution arrangement provisions of PPA (see our November 29, 2007 *For Your Information*), which could be relied on until final regulations were issued.

IRS Final Regulations

The IRS issued final regulations on February 24, 2009. The final regulations largely adopt the proposed regulations, but include many noteworthy changes.

Qualified Automatic Contribution Arrangements (QACAs)

The final regulations, as applicable to QACAs, are effective for plan years beginning on or after January 1, 2008.

Qualified Contribution Levels. To satisfy QACA requirements, each eligible employee must be enrolled in the plan at a specified automatic contribution rate (i.e., qualified percentage), beginning with an initial *minimum* contribution rate of 3% of the employee's compensation. This minimum applies for the period beginning when the employee first has a deferral made under the default election through the end of the following plan year (initial period). After this initial period, the *minimum* qualified percentage must increase to 4%, 5%, and 6% by the end of each of the following three plan years and beyond. For example, if an employee were automatically enrolled on June 1, 2009, the deferral percentage would be 3% from June 1, 2009 through December 31, 2010, 4% for the 2011 plan year, 5% for the 2012 plan year, and 6% for the 2013 plan year and future plan years. Employers are permitted to set the contribution percentages at higher than the minimum contribution rates, but the qualified percentage cannot exceed 10% of compensation. The default election ends when an automatic enrollee affirmatively elects to opt out or to contribute a different amount.

The final regulations provide that the initial period begins only when an employee first has contributions made under a default election, so that if an affirmative election is in place, then an automatic deferral will not be made with respect to that employee. Once a default deferral election takes effect, however, that initial period sets the timing for the required minimum percentage rate increases, regardless of whether the employee is eligible to defer under the default election, such as during a period of suspension following a hardship withdrawal.

> ***BUCK COMMENT.*** *This will require sponsors of a QACA to automatically restore previous deferral rates after a suspension ends. This is not currently a universal administrative practice. Further, sponsors will be responsible for increasing the qualified percentage under the QACA, even for currently suspended participants, effective at the end of the suspension period.*

When PPA was enacted, sponsors questioned whether they could force employees to make new deferral elections when a QACA was first adopted. The final regulations give sponsors the option to set an expiration date for any affirmative elections in effect. Employees who do not make an affirmative election following the expiration of a prior election would then be automatically enrolled at the default percentage. For example, if an employer adopts a QACA in 2009 and the plan provides that all affirmative elections in effect on December 31, 2010 expire on that date, then in 2011, all eligible employees who do not make a new affirmative election will be automatically enrolled at the default percentage.

The IRS notes in the preamble that the regulations do not allow sponsors to treat all current employees who have not made any affirmative election as having made an election of 0% for purposes of excluding them from automatic enrollment. The regulations do provide employers some relief with respect to QACAs in the case of certain rehired employees. A plan with a QACA is permitted to ignore any prior default elections for purposes of applying the minimum percentages for employees terminated for at least one full plan year.

> ***BUCK COMMENT.*** *Employees with breaks of participation of one plan year or more will be treated as new automatic enrollees and will start a new initial period for purposes of the automatic default percentage (e.g., 3%).*

The Uniformity Requirement. To qualify as a QACA, the minimum default percentages must be applied uniformly. The proposed regulations specified that the qualified percentage generally must apply to all eligible employees, but included certain exceptions such as when the minimum qualified percentage varied due to the employee's years of plan participation. The final regulations expand this exception by allowing the default percentage to vary based on whole and partial years since participation in the QACA began.

> ***BUCK COMMENT.*** *This expansion means that a QACA may increase the default percentage in the middle of a plan year to coincide with salary increases and performance evaluations as long as the provision is applied uniformly for all employees and the minimum percentage requirements are still met.*

QACA Annual Notice Requirements. Employers must provide a safe harbor notice to each employee eligible to participate in the QACA "within a reasonable period before each plan year." The proposed regulations deemed this requirement satisfied if the general Section 401(k)(12) safe harbor notice timing requirements were met along with some additional QACA requirements. Thus, a QACA notice provided at least 30 days but no more than 90 days prior to the beginning of each plan year would satisfy the requirements, and newly-eligible employees would have to receive notice no earlier than 90 days before, and no later than, the date of eligibility. The proposed regulations allowed the notice to be provided on the date of hire for new hires in a plan with immediate eligibility.

In response to comments that there should be some leeway for new hires, the final regulations provide that whether the notice satisfies the timing requirement is based on all the relevant facts and circumstances. If the notice cannot be provided on or before the eligibility date in the plan, it will be deemed timely if it is provided "as soon as practicable" after that date and the employee is allowed to defer from compensation earned beginning on the eligibility date. In other words, if the notice is provided before the pay date for the payroll period in which the employee becomes eligible, it will be deemed timely. This rule also applies for 401(k) safe harbor plans that are not QACAs. However, the final regulations specify that the default election must not be effective any later than the earlier of (1) the pay date for the second payroll period after notice is provided and (2) the first pay date occurring at least 30 days after notice is provided.

Other Guidance. The final regulations make some other clarifications –

- For plan years beginning on or after January 1, 2010, compensation for purposes of default elections is safe harbor compensation as defined in regulation 1.401(k)-3(b)(2).
- Nonelective and matching contributions under a QACA are not eligible for hardship withdrawal.

Eligible Automatic Contribution Arrangements (EACAs)

Once automatically contributed to a plan, pre-tax deferrals can generally be distributed only in hardship situations, upon severance, upon disability, or in service after attainment of age 59½. PPA added Section 414(w) to the Code to enable, but not require, Sections 401(k), 403(b) or 457(b) plans that meet the requirements of an EACA to permit employees to withdraw certain automatic contributions penalty-free. The final regulations on EACAs apply to plan years beginning on or after January 1, 2010. However, EACAs should be operated in good faith compliance for plan years beginning January 1, 2008. The EACA requirements are generally similar to those for a QACA regarding uniform deferral rates and notices.

EACA Covered Employees. The final regulations provide that an EACA need not apply to all employees eligible to make a deferral election under the applicable plan, but only to those employees who under the terms of the plan are covered employees. Further, the plan must state whether an employee who makes an affirmative election remains covered under the EACA, and if so, the employee must continue to receive the required annual notice before each plan year. However, if the EACA does not cover all eligible employees under the plan, then the plan may not use the extended 6-month period granted under PPA for correcting any excess contributions and excess aggregate contributions without incurring the 10% excise tax.

Uniformity Requirement. The EACA default election must be a uniform percentage of compensation, similar to a QACA. The final regulations provide that if a plan has more than one EACA to cover separate divisions of employees, each EACA must be aggregated and have the same percentage of compensation as the default election. However, there is an exception to the uniformity requirement if the separate EACAs have different deferral rates for different employee groups and the groups are mandatorily disaggregated under Section 410(b).

> ***BUCK COMMENT.*** *Thus, a plan may provide separate EACAs, even under the same plan, for different groups of employees, such as collectively bargained and noncollectively bargained employees.*

Timing of Withdrawal Election. Like the proposed regulations, the final regulations provide that the 90-day election period for withdrawals begins to run on the date the deferral amounts would have been included in the employee's gross income if the amounts had not been contributed. The final regulations now provide that a plan is permitted to set an earlier deadline, as long as the election period is at least 30 days. The effective date of the election cannot be later than the earlier of (1) the pay date for the second payroll period beginning after the election is made and (2) the first pay date that begins at least 30 days after the election is made. For purposes of determining the date of the first default elective contribution that triggers the 90-day election period, the plan is permitted to treat employees who did not have default elective contributions for an entire plan year as if the employee had never had such contributions for any prior plan year.

Withdrawal Fees and Date of Distribution. The final regulations continue to provide that the withdrawal distribution may be reduced by any fees that otherwise apply to distributions under the plan but clarify that the plan cannot charge a higher fee for an EACA withdrawal than it would charge for any other distribution under the plan. They also clarify that this distribution must be processed and distributed the same as any other distribution under the plan.

Forfeiture of Matching Contributions. The proposed regulations provided that matching contributions with respect to default elective contributions that had been distributed pursuant to a permissible withdrawal election must be forfeited. The final regulations provide that any matching amounts actually allocated must be forfeited, adjusted for gains and losses. The final regulations further clarify that no match is required to be contributed if the elective deferrals on which the match is based are withdrawn prior to the date as of which the matching contribution would have been allocated.

Tax Consequences and Reporting of Withdrawal. The amount of withdrawal is included in the employee's gross income for the taxable year in which the distribution is made. The amount of the withdrawal is reportable on Form 1099-R, disregarded for purposes of the limit on elective deferrals under Section 402(g), and is exempt from the early distribution tax under Section 72(t).

Timing of EACA Notice. Employers must provide a notice to each employee eligible to participate in the EACA "within a reasonable period before each plan year." The final regulations generally adopt similar EACA notice requirements as for QACAs. A notice is deemed timely if it provided to each eligible employee at least 30 days, and no more than 90 days, before the beginning of each plan year. For an employee who becomes eligible after the 90th day before the beginning of the plan year, the notice may be provided no more than 90 days before and no later than the date the employee becomes eligible. As in the case of QACAs, if the notice cannot be provided on or before the date the employee becomes eligible, the final regulations allow the notice to be provided as soon as practicable after the date the employee is eligible to make deferrals or becomes covered under the plan.

> ***BUCK COMMENT.*** *Employers should provide the notice as soon as administratively possible and before the pay date for the pay period in which the employee becomes eligible for default deferrals.*

Content of EACA Notice. With respect to content, the EACA notice requirements are generally similar to those for a QACA, except that the EACA notice must also explain the employee's right, if any, to make a permissive withdrawal and how to elect to do so.

Mid-Year Implementation of an EACA. The final regulations clarify that a new EACA may not be implemented in the middle of a plan year. However, employees who first become covered under an EACA as a result of a change in employment status may be added mid-year, as long as the notice timing requirements are met.

***BUCK COMMENT.** A sponsor can add employees who become eligible mid-year under an existing EACA (e.g., new hires or the acquisition of a new employee group due to a corporate reorganization).*

EACA Default Investments. As originally enacted, PPA required the plan to invest default elective contributions in a qualified default investment alternative (QDIA) as outlined in DOL regulations. However, due to a recent change in the law eliminating this requirement, it is no longer reflected in the final regulations. The EACA notice must contain a description of how contributions under the EACA will be invested in the absence of any investment election by the employee.

Conclusion

The regulations provide significant guidance to employers looking to encourage participation in their individual account defined contribution plans by providing automatic contribution arrangements. Buck's consultants are available to help you implement automatic enrollment features, including developing plan specific notices to meet the requirements under the final regulations.