Electronic Dispatch

Employee Benefits Law Action Memo

January 2008

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NEW GUIDANCE ISSUED REGARDING AUTOMATIC ENROLLMENT AND DEFAULT INVESTMENTS IN DEFINED CONTRIBUTION PLANS

The Pension Protection Act of 2006 ("PPA") included provisions designed to encourage sponsors of 401(k) plans to add an automatic enrollment feature. Automatic enrollment is a mechanism under which an eligible employee who does not make an affirmative election to make pre-tax contributions to the plan is automatically enrolled in the plan at a specific pre-tax contribution percentage, unless the employee specifically opts out. The PPA also included provisions to provide protection to plan fiduciaries that invest a participant's account in certain default investment options in the absence of an affirmative investment election by the participant. Recently, the Internal Revenue Service ("IRS") issued proposed regulations regarding the implementation of automatic contribution arrangements and the United States Department of Labor ("DOL") issued final regulations regarding default investments.

Automatic Contribution Arrangements

While automatic enrollment in 401(k) plans has been permitted by the IRS for some time, a number of states, including New York, have wage withholding laws that generally prohibit an employer from withholding amounts from an employee's pay without their written consent. Despite the IRS's approval of automatic enrollment, many employers were reluctant to implement the plan feature due to concern that such state laws might be violated.

Attempting to eliminate the state law concerns of employers, as well as other objections toward wider implementation of automatic enrollment, the PPA provides that any state law that might be interpreted to prevent a 401(k) automatic enrollment feature is preempted by the Employee Retirement Income Security Act ("ERISA") if the following conditions are met:

- an employee is treated as having elected to make pre-tax elective deferrals in an amount equal to a uniform percentage of compensation until such time as the employee elects not to have such contributions made, or elects to have contributions made at a different percentage;
- an annual notice describing the automatic contributions is provided; and
- automatic contributions are invested in accordance with the DOL regulations regarding default investments (see "Qualified Default Investment Alternatives" below).

The IRS issued proposed regulations in November of 2007 to further implement the PPA's provisions regarding automatic enrollment. While not effective until finalized, employers may rely upon the guidance provided in the proposed regulations until the final regulations are issued. The proposed regulations describe two types of automatic enrollment arrangements: an eligible automatic contribution arrangement and a more complex qualified automatic contribution arrangement that passes certain nondiscrimination rules automatically (see below).

An eligible automatic contribution arrangement ("EACA") is an automatic contribution arrangement that provides participants who were automatically enrolled with a 90 day period (beginning on the date of the first automatic contribution) to revoke the automatic enrollment and receive a withdrawal of the elective deferrals that were made on the participant's behalf (plus any earnings). The withdrawn amount must be included in the recipient's gross income for the year received, but is not subject to the normally applicable 10% early withdrawal penalty. Any matching contribution associated with the withdrawn amount is forfeited. To qualify as an EACA, an automatic enrollment arrangement must satisfy the requirements described above, and the required notice must:

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- include an explanation of the right to have elective deferrals made on the participant's behalf or to elect deferrals at a different percentage, or to have no deferrals made;
- afford a reasonable period of time, after receipt of the notice, and before the first deferral is made, to make the election;
- explain how contributions will be invested in the absence of an affirmative investment election (contributions must be invested in a qualified default investment alternative); and
- include a description of the right to make a withdrawal of amounts automatically contributed and the steps to take to make that withdrawal.

The PPA also added a new nondiscrimination testing safe harbor effective January 1, 2008. The proposed IRS regulations refer to an automatic contribution arrangement designed to satisfy the safe harbor as a qualified automatic contribution arrangement ("QACA"). While a plan may provide for automatic enrollment without being a QACA, a plan that includes a QACA will be exempt from the actual deferral percentage and actual contribution percentage tests that otherwise limit the elective deferrals and matching contributions that may be received by highly compensated employees. To qualify as a QACA, a plan must satisfy the following additional requirements:

- In the absence of an affirmative contribution election, the plan must provide for an automatic elective contribution of at least 3% of compensation for the first plan year, 4% for the second plan year, 5% for the third plan year, and 6% for each plan year thereafter. While the plan could provide for a higher automatic contribution amount, the amount may not exceed 10%.
- The plan must make a "safe harbor contribution." This requirement can be satisfied by making a matching contribution of 100% of the first 1% of compensation contributed as an elective deferral, plus 50% of elective deferrals over 1% of compensation and up to 6% of compensation. Alternatively, the requirement can be satisfied by making a nonelective employer contribution equal to at least 3% of compensation, regardless of whether the participant makes elective deferrals. These contributions must be fully vested after two years.
- Within a reasonable period before each plan year, each eligible participant must be provided with a written notice regarding the QACA rules.

Qualified Default Investment Alternatives

Provided that the requirements of ERISA Section 404(c) are satisfied, plan fiduciaries of individual account particpant-directed plans generally are protected from claims of fiduciary liability which might arise out of the performance of the investment options selected by a participant. However, such protection is available only if the participant makes an affirmative investment election. While participants who fail to make an affirmative investment election are often invested in a default fund, prior to the PPA, there was no protection from fiduciary liability as a result of this default investment. The PPA provides relief to plan fiduciaries that invest a participant's account in a qualified default investment alternative ("QDIA") in the absence of an affirmative investment election by a participant. Pursuant to final IRS regulations effective December 24, 2007, plan fiduciaries will be afforded protection from liability that might otherwise arise provided the following conditions are met:

- Assets must be invested in a QDIA. The final regulations describe three types of investment products as QDIAs: (1) life-cycle or targeted-retirement-date funds; (2) balanced funds (i.e., a mix of equity and fixed income exposures consistent with a target level of risk appropriate for participants of the plan as a whole); and (3) a managed account (i.e., a mix of equity and fixed income exposures based upon the participant's age, targeted retirement date or life expectancy).
- Each participant on whose behalf an investment in a QDIA may be made must be furnished with a notice regarding the default investment provisions of the plan. The notice must be provided at least 30 days in advance of the first such investment, and at least 30 days in advance of each subsequent plan year. The advance notice requirement is intended to provide participants with the opportunity to opt out of the QDIA by making an affirmative investment election. The notice must describe:

1. the circumstances under which the account of the participant will be invested in the QDIA (i.e., in the absence of an affirmative investment election);
2. the investment objectives, risk and return characteristics, and fees and expenses associated with the QDIA;
3. the participant's right to direct the investment of his or her account to any other investment alternative available under the plan, without financial penalty; and
4. where the participant can obtain information regarding the other investment alternatives available under the plan.

- Selection of the QDIA under the plan is a fiduciary responsibility. Fiduciaries must exercise prudence in evaluating and selecting the QDIA, monitor its performance, and consider the associated investment fees and expenses.

Sponsors of 401(k) plans that currently provide for automatic enrollment should review their procedures to ensure that they are compliant with the rules set forth in the proposed IRS regulations. Other 401(k) plan sponsors may wish to consider adding an automatic enrollment feature to encourage increased participation and/or ease nondiscrimination testing concerns. Finally, plan fiduciaries who invest the accounts of a participant who fails to make an affirmative investment election in a default option should strongly consider compliance with the final QDIA regulations (plan sponsors utilizing an automatic contribution arrangement generally are required to follow the QDIA rules).

If you have any questions about this memorandum, please contact Aaron M. Pierce (315-218-8131, apierce@bsk.com) or any of the other members of our Employee Benefits Practice Group listed below.

In Central New York, call 315-218-8000 or e-mail:

Stephen C. Daley sdaley@bsk.com

Brian K. Haynes bhaynes@bsk.com

Richard D. Hole rhole@bsk.com

Ted Lewkowicz tlewkowicz@bsk.com

In the Capital District, call 518-533-3000 or e-mail:

Amelia M. Klein aklein@bsk.com

In Western New York, call 716-566-2800 or e-mail:

Darcie A. Falsioni dfalsioni@bsk.com

John C. Godsoe jgodsoe@bsk.com

In New York City and on Long Island, please contact any of the following members of our Labor and Employment Law Department:

On Long Island, call 516-267-6300 or e-mail:

Terry O'Neil toneil@bsk.com

In New York City, call 646-253-2300 or e-mail:

Louis P. DiLorenzo ldilorenzo@bsk.com