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IRS Proposes Rules on Automatic Contribution Arrangements

The IRS has released proposed rules providing guidance on automatic enrollment arrangements in 401(k) cash-or-deferred arrangements (CODAs), 403(b) tax-sheltered annuities, or 457(b) governmental plans. Section 401(k) plans that adopt qualified automatic contribution arrangements (QACAs) – a new design-based safe harbor created by the 2006 Pension Protection Act (PPA) – will be deemed to have satisfied the tax code's special nondiscrimination tests that would otherwise apply to employee elective deferrals and employer matching contributions. In addition, such plans generally will be exempt from the top-heavy rules. The proposed regulations also address the PPA's new permissible withdrawal rules that permit 401(k), 403(b), or governmental 457(b) automatic enrollment plans to allow a participant to withdraw certain default elective deferrals, and include guidance on the law's provisions relating to corrective distributions.

The **regulations**, which are scheduled to be published in the November 8, 2007, *Federal Register*, are proposed to become effective for plan years beginning on or after January 1, 2008, and may be relied upon pending the issuance of final rules. If the final regulations' provisions are more restrictive than those in the proposed rules, they will be applied prospectively. Comments on the proposed rules should be submitted to the IRS by February 6, 2008.

Overview of the PPA's Automatic Contribution Provisions

The PPA included several provisions to facilitate employer adoption of automatic enrollment in 401(k) plans, as well as similar features in 403(b) tax-sheltered annuities and 457(b) governmental deferred compensation plans. Under such arrangements, an employee is automatically enrolled in a plan unless he or she affirmatively elects not to participate, and the plan may escape some nondiscrimination testing by qualifying for a "safe harbor" by adopting specific plan design features.

For plan years beginning on or after January 1, 2008, a plan qualifying as a QACA will be deemed to satisfy the actual deferral percentage (ADP) and actual contribution percentage (ACP) nondiscrimination tests, as well as the top-heavy rules that generally prohibit owners and other key employees from disproportionately benefiting under the plan. The safe harbor requires a plan to satisfy several criteria, including: the uniform application of a minimum and escalating percentage of automatic elective deferrals to each eligible employee who fails to elect otherwise; the ability of each participant to elect out of the plan or to make elective deferrals at a different level; minimum employer matching or nonelective contributions on behalf of each eligible nonhighly compensated employee; vesting requirements for employer matching or nonelective contributions; distribution restrictions; and notice to participants.

In addition, the PPA allows "eligible automatic contribution arrangements" (EACAs) to adopt a permissible withdrawal provision to return, under certain circumstances, default elective deferrals to participants without the distributions being subject to the 10% early withdrawal tax that normally would apply. In general, to be an EACA, an arrangement must: allow the participant to elect to have the employer make contributions to the plan on his or her behalf; in the absence of such an election, make certain automatic contributions to the plan by the employer on behalf of the participant equal to a uniform percentage of compensation; satisfy the requirements of ERISA §404(c)(5) with respect to default investments; and provide specific information in a notice to participants.

QACAs under the Proposed Regulations

In general, the existing requirements applicable to current-law safe harbor plans (i.e., those satisfying certain contribution, notice, and vesting requirements) will also apply to QACAs. Thus, for example, a plan may limit an eligible employee's elective deferral under the QACA as long as each eligible nonhighly compensated employee may elect to defer an amount that is sufficient to obtain the plan's maximum matching amount for the plan year.

For QACAs, key areas of guidance included in the proposed regulations are:

- *Application of the uniformity requirement* – To be a QACA, a plan must uniformly apply the qualified percentage (i.e., an initial minimum automatic elective deferral of 3% of compensation through the end of the plan year following the year of initial participation, increasing by 1% for each of the next three plan years, not ever to exceed 10% of compensation) to all eligible employees. The proposed regulations clarify that the qualified percentages are minimums and that a QACA can provide for higher percentages (but not more than 10%). Additionally, the QACA will not fail the "uniformity" requirement if the plan: varies the elective deferral percentage based on the number of years an employee has participated in the plan; does not reduce the rate of elective deferral under a participant's prior election that is in effect when the QACA becomes effective; or limits the amount of elective deferrals so as not to exceed the limits on compensation, elective deferrals, or benefits and compensation (under §§401(a)(17), 402(g), and 415, respectively). A plan also will not fail the uniformity requirement if it suspends employees from making elective deferrals for six months after they take a hardship distribution.

- *Clarification of "affirmative election"* – The proposed regulations allow current employees who were eligible to participate in the CODA immediately before the QACA's effective date and who have an election in effect on the QACA's effective date to be excluded from the plan-specified deferral percentages.

- *Notice requirement* – Plans will satisfy the PPA's timing requirement to provide notices "within a reasonable period before each plan year" by furnishing the notice to participants at least 30 days (and no more than 90 days) before the beginning of each plan year. The notice must explain the QACA and inform participants of the opportunity to elect out of the program or to change their deferral percentages from the QACA's qualified percentages. To facilitate this notice requirement, the IRS will post a sample notice on the web site in a fews days.

Permissible Withdrawals of Automatic Contributions

The proposed rules also provide guidance on returning default elective deferrals to participants. This PPA provision is available as an option to all plans with EACAs, allowing 401(k), 403(b), and governmental 457(b) arrangements to return amounts requested by a participant within 90 days of the first elective deferrals to the EACA. Returned amounts must be distributed with earnings, if any, and are treated as taxable income in the year distributed (but are not subject to the early withdrawal tax). If elective deferrals are withdrawn, employees will also forfeit any applicable employer matching contributions associated with the withdrawn amounts.

Under the proposed regulations:

- a plan sponsor need not offer the permissible withdrawal feature to all employees eligible under the EACA, but also may not condition employees' right to receive a distribution on whether or not they elect future elective deferrals;
- the 90-day window for making the withdrawal election begins on the date the amounts would have been includible in the participant's gross income if the amounts were not contributed, and the effective date of the election cannot be later than the last day of the payroll period that begins after the date of the election;
- the distribution generally is the employee's account balance attributable to the default elective deferrals, adjusted for gains and losses, and may be reduced only for generally applicable fees (i.e., the plan may not charge a different fee for this distribution than it would for other distributions);
- any employer matching contributions forfeited on account of the distributed amounts must remain in the plan and be treated under the plan terms as any other plan forfeitures (i.e., the amounts may not be returned to the employer); and
- withdrawn amounts – except for designated Roth contributions – are includible in the employee's gross income (and reported on Form 1099-R) in the year of distribution but are not subject to the 10% additional early withdrawal tax (under §72(t)).

Corrective Distributions of Excess Contributions

The proposed regulations also reflect the PPA amendments to §4979, which permit an EACA to distribute excess contributions and excess aggregate contributions to participants within six months (rather than two-and-one-half months) after the close of the plan year in which the contributions were made. This provision, which will affect corrective distributions made in 2009, gives plans a longer period to make corrective distributions to avoid the imposition of the 10% excise tax on the employer. The amounts so distributed need not include income allocable to the period after the end of the plan year (i.e., the "gap period income") but are included in the employee's gross income for the taxable year in which they are distributed.

Separate DOL Oversight

The Department of Labor (DOL) also exercises jurisdiction over some issues related to automatic contribution arrangements for plans that are subject to Title I of ERISA. For example, the DOL oversight extends to an individual account plan's default investment and to participant notifications describing the plan's default investment alternative to which deferrals will be contributed if an employee fails to provide investment direction under ERISA §404(c)(5). In this regard, the DOL on October 24, 2007, published in the *Federal Register* a **final rule** on default investment alternatives under participant-directed individual account plans. The DOL also has jurisdiction over the participant notifications required for plans that wish to take advantage of the PPA's ERISA preemption of state laws that, in effect, prohibit or restrict automatic contribution arrangements. Accordingly, plan sponsors contemplating automatic contribution arrangements should consult the DOL's regulations.

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