

IRS and Department Of Labor Issue Automatic Enrollment and Investment Guidance

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Recent guidance from the U.S. Department of Labor (“Labor Department”) and Internal Revenue Service (“IRS”) is helping to chart a pathway for plan sponsors and fiduciaries of 401(k), 403(b) and 457 defined contribution plans to add and use automatic enrollment and investment features automatically to enroll and invest contributions of participants that fail to return plan enrollment and investment elections. Using automatic or default enrollment and investment features can help employers increase participation in their 401(k) or other defined contribution plans. Until recently, however, concern about tax disqualification and fiduciary liability risks deterred most employers and plan fiduciaries from using these processes to promote plan participation.

As part of the Pension Protection Act (PPA,ⁱ however, Congress sought to facilitate the adoption by employers of automatic enrollment features in 401(k), 403(b), and 457 plans by enacting a series of amendments to the Employee Retirement Income Security Act (“ERISA”) and the Internal Revenue Code (the “Code”). Under the PPA, Congress amended the Code to make it easier for employers to sponsor 401(k), 403(b) and 457(b) defined-contribution plans containing default enrollment and contribution features without disqualifying the plan. The PPA amendments to the Code establish rules under which these plans can provide that an employee will be automatically enrolled in the plan unless he affirmatively elects not to participate, and permit these plans to avoid some of the

Code's nondiscrimination testing requirements by qualifying for a "safe harbor" by adopting specific plan design features. In addition, the PPA also amended ERISA to provide a safe harbor within which accounts of participants in ERISA-covered 401(k) and other individual account retirement plans who fail to make investment elections can be default invested under the plan and still qualify as "self-directed" investments for purposes of ERISA § 404(c).

On November 8, 2007, the IRS published proposed rules (the "QACA Rule") construing the PPA auto-enrollment amendments to the Code for post December 31, 2007 plan years. The preamble to the proposed QACA Rule provides that employers and plans may rely upon the QACA Rule for purposes of designing and administering default enrollment processes until the IRS adopts final rules. Additionally, on October 24, 2007, the Labor Department published final regulations (the "QDIA Rule") interpreting the statutory relief for plan fiduciaries of 401(k) and other individual account plans covered by ERISA who invest the assets of participants who do not provide investment direction (such as automatically enrolled workers) in "qualified default investment alternatives" or "QDIAs."

Code Requirements For Automatic Enrollment Features

The PPA amends the Code to facilitate employer adoption of automatic enrollment in 401(k) plans, and similar features in 403(b) tax-sheltered annuities and 457(b) governmental deferred compensation plans. If the requirements of the QACA Rule are met 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. In addition, the PPA allows “eligible automatic contribution arrangements” (“EACAs”) to adopt a permissible withdrawal provision to allow plans to return default elective deferrals to participants under certain circumstances without the distributions being subject to the 10% early withdrawal tax that normally would apply.

To qualify as an EACA, the PPA generally requires that the default enrollment arrangement must:

- Allow the participant to elect to have the employer make contributions to the plan on his behalf when a participant fails to return 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.

To fall within the new safe harbor for EACAs established by the QACA Rule, a 401(k), 403(b) or 457(b) plan must satisfy several conditions including requirements that:

- The Plan uniformly must apply a minimum and escalating percentage of automatic elective deferrals for each eligible employee who fails to elect otherwise;

- The Plan must give each participant the opportunity to elect out of the plan or to make elective deferrals at a different level;
- The Plan must provide minimum employer matching or nonelective contributions on behalf of each eligible nonhighly compensated employee;
- The Plan must comply with applicable vesting requirements for employer matching or nonelective contributions;
- The Plan must comply with applicable Code requirements that it restrict distributions; and
- The Plan must comply with the Code's requirements for providing notification to participants about its default enrollment provisions.

The QACA Rule, as proposed, provides clarification about the application of these rules in several respects. The following paragraphs highlight some of the key components of this guidance.

Regarding the application of the uniformity requirement, the QACA Rule clarifies that to qualify as 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 QACA rule clarifies that the qualified percentages are minimums and that a QACA can provide for higher percentages not in excess of 10%. Additionally, the QACA Rules states that a 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;
- Limits the amount of elective deferrals so as not to exceed the limits on compensation, elective deferrals, or benefits and compensation (under Code §§401(a)(17), 402(g), and 415, respectively); or
- Suspends employees from making elective deferrals for six months after they take a hardship distribution.

The QACA Rule also specifies that the a plan can 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.

The QACA Rule construes the PPA's requirement that the plan provide notices "within a reasonable period before each plan year" as met where the plan furnishes a notice to participants at least 30 days and no more than 90 days before the beginning of each plan year that explains the QACA and informs participants of the opportunity to elect out of the program or to change their deferral percentages from the QACA's qualified percentages. In keeping with its announced intention under the QACA Rule, the IRS posted on its website a sample notice for use in providing this notice on November 14, 2007.ⁱⁱ

With respect to the permissible withdrawals of automatic contributions, the QACA Rule sets forth guidance on returning default elective deferrals to participants. It

clarifies that this PPA provision gives all 401(k), 403(b), and governmental 457(b) plans with EACAs to return under the conditions specified in the QACA Rule 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. These distributions are treated as taxable income in the year distributed but are not subject to the early withdrawal tax. If elective deferrals are withdrawn, employees also forfeit any applicable employer matching contributions associated with the withdrawn amounts.

The QACA Rule also reflects 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.

The QACA Rule also clarifies that:

- 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 other than designated Roth contributions are includible in the employee's gross income and must be reported on Form 1099-R in the year of distribution but are not subject to the 10% additional early withdrawal tax under §72(t).

Fiduciary Relief For Default Investments Under ERISA

The QDIA Rule defines the conditions under which fiduciaries of defined contributions plans providing for participant self-direction of investments can continue to enjoy the protection of the self-directed investment relief provided by ERISA 404(c) when accounts of participants failing to provide direction to the plan are invested automatically in default investment alternatives established

under the plan. The QDIA Rule protection requires that the default investment meet all of the technical requirements of the QDIA Rule and applicable IRS regulations, and those fiduciaries otherwise comply with applicable ERISA fiduciary standards when selecting and overseeing the QDIA options.

To meet the requirements of the QDIA Rule, the QDIA Rule specifically requires that default investments meet the following conditions in order for the default investment to be treated as a self-directed investment for purposes of ERISA § 404(c):

- The Plan must offer a “broad range of investment alternatives” as defined in the ERISA § 404(c) regulations;
- The Plan can only make default investments in “qualified default investment alternatives” or “QDIA as defined in the QDIA Rule;
- Default investments are allowed only for participants and beneficiaries given an opportunity to provide investment direction who failed to make an investment choice;
- The Plan must furnish a notice to participants and beneficiaries in advance of the first investment in the QDIA and annually thereafter that provides the information dictated by the QDIA Rule;
- The Plan must furnish material, such as investment prospectuses, for the QDIA to participants and beneficiaries;
- The Plan must give participants and beneficiaries the opportunity to direct investments out of a QDIA as frequently as from other plan investments, and not less frequently than quarterly;

- The Plan must limit fees for participants opting out of participation in the plan or electing to self-direct their investments;
- Fiduciaries remain responsible for appropriate selection and monitoring of the QDIA investments in accordance with ERISA's fiduciary responsibility standards; and
- Each QDIA must be managed either by an investment manager, plan trustee, or plan sponsor who is a named fiduciary, or by an investment company registered under the Investment Company Act of 1940.

The QDIA Rule describes four types of mechanisms that can qualify for treatment as a QDIA:

- A product with a mix of investments that takes into account the individual's age or retirement date such as a life-cycle or targeted-retirement-date fund;
- An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date such as a professionally-managed account;
- A product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual such as a balanced fund; and
- A capital preservation product for only the first 120 days of participation offered as an option for plan sponsors wishing to simplify administration if workers opt-out of participation before incurring an additional tax.

The QDIA Rule does not provide any relief for any default investment of participant contributions in employer securities. Furthermore, in recognition that

certain plan sponsors adopted stable value products as their default investment prior to passage of the PPA, the QDIA Rule provides a transition rule that “grandfathers” these arrangements by providing relief for contributions invested in stable value products prior to the effective date of the final QDIA Rule. Otherwise, however, the transition rule does not provide safe harbor relief for future contributions to stable value products. The QDIA Rule also clarifies that a QDIA may be offered through variable annuity contracts or other pooled investment funds.

Other DOL Enforcement & Regulatory Activity

In addition to its publication of the QDIA Rule, the EBSA also published other notable guidance and engaged in aggressive enforcement of ERISA during the first quarter of 2007. During the first three quarters of 2007, for instance, the EBSA:

- Amended Interpretive Bulletin 95-1 to limit its application to the selection of annuity providers for defined benefit plans;
- Revised its rules for imposing civil penalties under ERISA § 502(c)(7);
- Published new rules on the timing and order of issuance of domestic relations orders;
- Released new Mental Health Parity Regulations applicable to health plans;
- Amended safe harbor rules for distributions from terminated individual account plans and termination of abandoned individual account plans to require inherited individual retirement plans for missing nonspouse beneficiaries; and

- Issued a statutory prohibited transaction exemption for cross-trading of securities.

It also has proposed, but not yet adopted in final form, rules concerning when multi-employer pension plan information must be made available on request; guidance concerning the selection of annuity providers for individual account plans; additional amendments affecting the assessment and collection of civil penalties under ERISA § 502(c)(7); and guidance about fee and expense disclosures to participants in individual account plans. Meanwhile, EBSA also has maintained an active enforcement agenda.

The Labor Department enforcement activities this year also reflect its longstanding and ongoing policy of aggressive investigation and enforcement of alleged misconduct by companies, company officials, and service providers in connection with the maintenance, administration and funding of ERISA-regulated employee benefit plans.

The EBSA continues to investigate embezzlement, kickbacks, and false statements, or other criminal violations involving ERISA-covered employee benefit plans and to refer its findings for prosecution by the Justice Department.

The EBSA and Justice Department have announced a number of criminal prosecutions and settlements as a result of these efforts this year.

With business failures on the rise, the EBSA also continues to devote substantial resources to the enforcement of ERISA's fiduciary responsibility rules against bankrupt and financially distressed plan sponsors and the employees, officers and service providers. Labor Department officials report that these aggressive

enforcement activities resulted in the recovery by the Labor Department of more than \$1.4 billion related to pension, 401(k), health and other benefits from companies, company executives and others for alleged violations of ERISA in fiscal year 2006 alone. In addition to prosecutions brought by the Labor Department, companies and individuals that exercise discretion and control of the administration or funding of employee benefit plans regulated by ERISA also may be sued personally by participants and beneficiaries for breach of fiduciary under ERISA. A review of the Labor Department's enforcement record makes clear that where the Labor Department perceives that a plan sponsor or its management fails to take appropriate steps to protect plan participants, the Labor Department continues to aggressively pursue ERISA enforcement regardless of the size of the plan sponsor or its plan, or the business hardships that the plan sponsor may be facing.ⁱⁱⁱ For this reason, businesses providing employee benefits to employees or dependents, as well as members of management participating in, or having responsibility to oversee or influence decisions concerning the establishment, maintenance, funding, and administration of their organization's employee benefit programs need a clear understanding of their responsibilities with respect to such programs, the steps that they should take to demonstrate their fulfillment of these responsibilities, and their other options for preventing or mitigating their otherwise applicable fiduciary risks.

Earlier this year, the EBSA also initiated a nationwide investigation project that examines and seeks to uncover ERISA violations arising from the use by the adviser/consultant of its position with a benefit plan to generate additional fees

for itself or its affiliates, failures to adhere to investment guidelines, improper selection or monitoring of the consultant or adviser, potential criminal violations, such as kickbacks or fraud and other potential improprieties under ERISA. The scrutiny of the consultant and advisor activities follows Congressional hearings examining these relationships earlier this year.^{iv}

In addition, EBSA also has ongoing national projects targeting health care fraud involving multiple employer welfare arrangements or “MEWAs,” violations of ERISA’s rules for the timely investment, administration and use of employee contributions; enforcement of ERISA’s requirements with respect to various ESOP rules and transactions; investigation of participant and beneficiary complaints; and Form 5500 audit and return enforcement.

Along side these special areas of enforcement, the EBSA also continues aggressively to pursue collection of ERISA civil against plan administrators and others for other violations of ERISA, including:

- Failing to operate the plan prudently and for the exclusive benefit of participants;
- Using plan assets to benefit certain related parties to the plan, including the plan administrator, the plan sponsor, and parties related to these individuals;
- Failing to properly value plan assets at their current fair market value, or to hold plan assets in trust;
- Failing to follow the terms of the plan (unless inconsistent with ERISA);
- Failing to properly select and monitor service providers; and

- Taking any adverse action against an individual for exercising his or her rights under the plan (e.g., being fired, fined, or otherwise being discriminated against).

These evolving and ongoing EBSA regulatory and enforcement activities emphasize the continuing and growing need for employee benefit plan fiduciaries, the employers sponsoring these plans, and the internal staff and external consultants involved in the design and administration to act diligently to ensure that their programs are properly designed and administered to comply with ERISA and existing enforcement policy.

ⁱPublic Law 109-280.

ⁱⁱSee *Sample Automatic Enrollment and Default Investment Notice* posted at http://www.irs.gov/pub/irs-tege/sample_notice.pdf.

ⁱⁱⁱSee, "Enron Litigation Has Implications For Plan Sponsors And Management," *401K Advisor* (December 1, 2006).

^{iv}See, "Congress Scrutinizing Relationships Between Companies & Executive Compensation Consultants & Other Executive Compensation Practices," *H.R. Employee Benefits & Internal Controls E-Update* (May 25, 2007).