

# CLIENT ACTION Bulletin

Employee Benefits

## IRS Issues Final Rule on Automatic Contribution Arrangements

### SUMMARY

The IRS has published its final rule governing automatic contribution arrangements in 401(k) and similar defined contribution retirement plans, generally adopting the agency's 2007 proposed regulations (see *Client Action Bulletin 07-14*) with several modifications. The final rule, which also applies to automatic contribution arrangements in 403(b) plans and 457(b) governmental plans, provides guidance on "qualified automatic contribution arrangements" (QACAs) and "eligible automatic contribution arrangements" (EACAs) as a way to automatically enroll participants in a plan.

One helpful item – which extends to traditional 401(k) safe harbor plans that permit participation upon an employee's date of hire – allows an employer to furnish the required notice about the plan "as soon as practicable" after the initial eligibility date.

In general, the final rule applies to QACAs in plan years beginning on or after Jan. 1, 2008 (operating with good-faith compliance on the proposed rule until the Feb. 24, 2009, publication date of the final rule), and to EACAs in plan years from Jan. 1, 2010.

### DISCUSSION

#### EACAs and QACAs in General

The Pension Protection Act facilitated the adoption of automatic enrollment in 401(k), 403(b) and 457(b) governmental plans by allowing an employer to set up an automatic contribution arrangement (also known as an "automatic enrollment" or "negative election" arrangement). Under such an arrangement, an employee who is eligible to participate in the plan is enrolled automatically and begins to contribute to the plan at its default contribution percentage unless he or she affirmatively elects a different rate (including zero). Since 2008, two types of automatic contribution arrangements have been available:

Under an EACA, participants are treated as having elected to defer the plan's set percentage of compensation until they affirmatively change the election or opt out. An EACA may allow participants an election to make a "permissible withdrawal" within 90 days of the initial automatic deferrals, and a sponsor has six months (rather than two-and-one-half months) to make corrective distributions for failures of the nondiscrimination tests without incurring a 10% excise tax.

A QACA's automatic enrollment feature entails a 3% minimum initial deferral percentage through the end of the following plan year. Subsequently, the deferral rate must increase by at least 1 percentage point for each of the succeeding three plan years to a fourth-year minimum requirement of 6%. The deferral rate percentage in any given year may not exceed 10%. By satisfying other design elements and regulatory requirements, QACAs are exempt from the actual deferral percentage (ADP) nondiscrimination test and the "top heavy" rules, and may also automatically pass the actual contribution percentage (ACP) nondiscrimination test applicable to employer matching contributions.

#### QACAs under the Final Rule

For QACAs, the final rule provides that:

- QACAs must generally be established for an entire plan year, with few exceptions (e.g., mid-year startup of a new plan).
- Mid-year increases in the default contribution percentage – such as to coincide with pay increases – are permitted if the change is based on the number of years since the employee first made deferrals under the QACA, provided the default percentage satisfies at least the minimum percentage requirement throughout the plan year.

- Only employees who had an affirmative election in effect immediately before the QACA is effective may be excluded from the QACA's automatic enrollment provisions.
- A QACA may provide for an expiration of an affirmative election, thereby requiring an employee to make a new affirmative election for a prior rate of elective contributions to continue. Without such an election, the plan's default percentage would apply.
- A plan must automatically enroll an employee if the QACA does not reinstate affirmative elections following a six-month suspension for hardship withdrawals.
- Employees who first become eligible under the QACA mid-year must be notified about the plan "as soon as practicable" and permitted an election to make deferrals beginning on that date. Thus, the employer must furnish the required QACA notice prior to the pay date for the payroll period that includes the initial eligibility date.
- Besides being subject to the same withdrawal restrictions as employee elective deferrals, QACA safe harbor employer nonelective and matching contributions are not eligible for hardship withdrawals.

### EACAs under the Final Rule

The final rule provides the following guidance on EACAs:

- The definition of "eligible employee" has been clarified to cover only the EACA-specified eligible employees. By so doing, an employer need not furnish an annual notice about the EACA to employees who affirmatively elected to make contributions, but rather, only to employees hired on or after the effective date of the EACA.
- EACAs must be established for an entire plan year (i.e., no mid-year implementation is allowed). In addition, only EACAs covering all eligible employees for an entire plan year may have six months after the plan year ends to make corrective distributions for failures of the ADP and ACP tests without the sponsor incurring a 10% excise tax (i.e., EACAs covering fewer than all eligible employees will not have the extended six-month period).
- If participants in an ERISA-covered plan fail to provide investment instructions, the default deferred amounts need not be invested in accordance with the Labor Department's rule on qualified default investment alternatives.
- Multiemployer and multiple employer plans are permitted to establish separate EACAs (with different uniform percentage deferral rates, if desired) for different groups of employees (e.g., those covered by separate collective bargaining agreements or different employers).
- A plan that includes both collectively bargained and noncollectively bargained employees may provide for separate EACAs for the different groups, with different default percentages for each EACA.
- An EACA may set a deadline sooner than 90 days of the first default deferrals for an employee to make a permissible withdrawal election, but the period to do so must be at least 30 days. The actual distribution must be made according to the plan's ordinary timing procedures for processing and making distributions.
- An EACA need not make matching contributions to the accounts of participants who take permissible withdrawals prior to the date the plan allocates matching amounts. However, any matching amounts (adjusted for gains and losses) allocated prior to the permissible withdrawal must be forfeited.
- The employee notification requirements applicable to QACAs (above) are the same for EACAs.

### ACTION

Notwithstanding the current economic conditions, encouraging employees to save through an employer-sponsored plan can be a significant step toward helping them achieve retirement income security. The IRS's final rule generally provides much-needed clarifications that should help in the adoption or expansion of EACA or QACA offerings under 401(k), 403(b), and 457(b) governmental plans. Although mid-year establishment of EACAs are prohibited, employers considering an EACA adoption will have ample time to do so before Jan. 1, 2010. Employers should review their plans to ensure compliance with the final rule by the effective dates, operating the automatic contribution arrangements in good-faith as appropriate. Plan amendments may be required to adopt some of the optional features. In addition, administrative systems and employee communications materials may have to be revised.

For additional assistance with automatic contribution arrangements or the IRS's final rule, please contact your Milliman consultant.

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