

AUTOMATIC ENROLLMENT ARRANGEMENTS FOR DEFINED CONTRIBUTION PLANS

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INTRODUCTION

Automatic contribution arrangements under defined contribution plans have become an increasingly popular device used by employers to encourage participants to save for retirement and increase participation in retirement plans. Generally stated, automatic enrollment arrangements provide for the automatic deferral of a specified percentage of an eligible employee's compensation, unless such employee affirmatively "opts out" of the arrangement within a specified time period.

Below we have outlined the requirements for an eligible automatic contribution arrangement, which is a form of an automatic contribution arrangement that was added by the Pension Protection Act of 2006. One of the distinguishing features of an eligible automatic contribution arrangement is the ability of the employee to make in-service "permissible withdrawals" in limited circumstances, as described below.

Also, it is important to keep in mind any State law provisions with regard to necessary authorizations for deductions from employee's wages.

OVERVIEW OF ELIGIBLE AUTOMATIC CONTRIBUTION ARRANGEMENTS ("EACA") UNDER IRC § 414(w) AND FINAL REGULATIONS § 1.414(w)-1.

Definitions.

2. "EACA" means an arrangement under which:
 - a. the participant is treated as having elected to have the employer make contributions in an amount equal to a uniform percentage of compensation or uniform percentage of compensation up to a capped dollar amount (until the participant specifically elects not to have contributions made or elects a different percentage),
 - The default contribution must be a uniform percentage of compensation, such that the same rate applies for all classifications under the plan. However, the percentage can vary based on the number of years the employee has participated in the EACA, permitting an automatic increase in deferral rates at specified intervals.
 - b. the employer provides notice of the employee's rights and obligations under the arrangement, and

c. the employer designates how the contribution will be invested in absence of an investment election by the employee.

3. "Covered Employee" means an employee who is covered under the automatic contribution arrangement, determined under the terms of the plan.

Notice Content Requirement.

Under an EACA, each Covered Employee must receive an annual notice outlining the:

1. level of default elective contributions which will be made on the Covered Employee's behalf,
2. Covered Employee's right to elect not to have default elective contributions,
3. manner the contribution will be invested absent an investment election by the Covered Employee, and
4. Covered Employee's rights to make a permissible withdrawal.

Notice Timing Requirement.

A written EACA notice must be provided within a reasonable period before the beginning of each plan year or during the plan year if the Covered Employee is first eligible to make a cash or deferred election (or first becomes a Covered Employee under the EACA as a result of a change in employment). The notice will be deemed to be have been timely provided it is given at least 30 days (and no more than 90 days before the first day of each plan year) and to each Covered Employee.

For Covered Employees becoming participants after the notice period, the timing requirement is satisfied if the notice is provided no more than 90 days before the Covered Employee becomes eligible to make a cash or deferred election and no later than the date that affords the Covered Employee a reasonable period of time after receipt of the notice to make a permissible withdrawal election.

Permissible Withdrawal Elections.

If a plan allows a participant to withdraw EACA default contributions, certain withdrawal timing requirements must be met. A participant electing to withdraw default elective contributions must make the election no less than 30 days and not later than 90 days after the date of the *first* default elective contribution. (Note: the plan could establish any period within the aforementioned time period.) The participant's election must be *effective* no later than the earlier of:

1. the pay date for the second payroll period that begins after the date the election is made; and
2. the first pay date that occurs at least 30 days after the election is made.

Permissible Withdrawal Distributions.

Plans permitting participants to withdraw EACA default contributions must withdraw an amount of the default contribution through the effective date of the election of such withdrawal, adjusted for allocable gains and losses to the date of the distribution. The following distribution rules also apply:

1. if the default contribution was separately accounted for in the participant account, the total amount will be distributed (*See* IRC § 1.401(k)-2(b)(2)(iv) if amounts are not separately accounted for);
2. the amount distributed may be reduced by generally applicable fees;
3. the date of the distribution must be made in accordance with the plan's normal timing procedures for distributions;
4. the amount withdrawn must be included in the eligible employee's gross income for the taxable year in which the distribution was made and reported on Form 1099-R, but is not subject to the additional 10% early withdrawal tax under IRC § 72(t); and
5. the amount withdrawn is ignored for purposes of determining the limit on elective deferrals under IRC § 402(g).

Forfeiture of Matching Contributions.

If a plan permits a participant to withdraw the EACA default contribution, any employer matching contributions with respect to the amount withdrawn that have been allocated to the participant's account (adjusted for gains and losses) must be forfeited.

Rehired Employees.

For purposes of determining the date of the *first* default elective contribution under an EACA, a plan is permitted to treat an employee who for an entire plan year did not have default elective contributions made under the EACA as if the employee had not had such contributions for any prior year as well.

EACAs Require Default Investment Option.

EACAs require a default investment option; however, the option does not have to satisfy the DOL rules for a qualified default investment option.

ERISA DEFAULT INVESTMENT RULES – MODEL FOR GOVERNMENTAL PLANS?

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ISSUE

How does a plan fiduciary satisfy its fiduciary duties under a participant-directed defined contribution plan where a participant fails to make an affirmative investment election?

ERISA MODEL

One model is the Department of Labor ("DOL") Regulations on qualified default investment alternatives ("QDIA"). Below are the key features of these Regulations. However, it is important to note that these Regulations are only directly applicable to ERISA plans, not governmental plans, and thus they do not provide explicit fiduciary relief. Nonetheless, they do provide a useful framework for governmental plans to follow in meeting their fiduciary duties where a QDIA product is used.

- ERISA provides that a fiduciary will not be liable for losses resulting from an individual's exercise of control over assets in his or her account. ERISA § 404(c)(1). For purposes of a default investment, an individual will be treated as "exercising control over the assets" in his account where the assets, in the absence of an investment election by the individual, are invested by the plan, if (1) the default investment satisfies DOL regulatory requirements, and (2) certain notice requirements are met.

Below is an abbreviated summary of these requirements.

QUALIFIED DEFAULT INVESTMENT REQUIREMENTS

Investment. A QDIA must be one of the following:

- A product which takes into account specified factors related to the individual, like age or normal retirement date (ex: life cycle or targeted retirement date fund);
- A product with a range of investments which accounts for the characteristics of the group of employees as a unit, rather than individually (ex: "balanced fund" based on the demographics of the plan as a whole);
- An investment management service, like a "managed account," that allocates the individual's assets among existing options under the plan based on the individual's age, normal retirement date or life expectancy; or

- A capital preservation product which is offered during the first 120 days of participation (this may be used only if the plan has an eligible automatic contribution arrangement).

Opportunity to invest. The participant or beneficiary must have had the opportunity to direct the investment direction, but did not do so.

Provide investment materials. Certain required materials explaining the QDIA investment must be provided to the participant or beneficiary (the same materials that would be provided to individuals who actively direct their own investment).

Transfer rights. The participant or beneficiary must have the right to transfer all or a portion of the assets invested in the QDIA to any other investment option under the plan:

- With the same frequency as participants and beneficiaries who actively elected to invest in the QDIA (but no less frequently than once within any three month period), and
- Without restrictions for the first 90 days (after which the restrictions applicable to a transfer may only be those otherwise applicable to a participant or beneficiary who actively elected to invest in the QDIA).

Investment alternatives. The plan must offer a "broad range of investment alternatives" within the meaning of 29 CFR 2550.404c-1(b)(3). The plan must offer at least three investment alternatives which are (1) diversified, (2) have materially different risk and return characteristics, (3) enable the participant or beneficiary to choose among them to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary, and (4) when combined tend to minimize, through diversification, the overall risk of a participant's or beneficiary's portfolio when combined with investments in the other alternatives.

Continuing fiduciary obligations. Continuing obligation to prudently select and monitor a QDIA always remains.

NOTICE REQUIREMENTS

Content. An initial and annual notice must be provided to participants and beneficiaries which contains the following:

- A description of the circumstances in which assets will be invested on behalf of the participant and, if applicable, a description of when elective contributions will be made on behalf of the participant, the automatic deferral percentage, and the right of the participant to change that percentage;
- An explanation of the right of participants and beneficiaries to direct the investment of their accounts;

- A description of the QDIA, including investment objectives, risk/return characteristics, and fees and expenses;
- A description of the participant's or beneficiary's right to direct the investment of the assets in the QDIA to any investment under the plan, and any applicable restrictions or fees associated with any transfer; and
- An explanation of where to obtain information on other plan investment alternatives.

Initial Notice. Must be provided at least 30 days in advance of the date of plan eligibility, or at least 30 days in advance of the first QDIA investment on behalf of the participant or beneficiary.

Annual Notice. Must provide within a reasonable period (at least 30 days) before each plan year, and have a reasonable period thereafter to direct investment.