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TCRS 2007-08: Treasury Department Proposed Regulations On Automatic Contribution Arrangements

On November 7, the Treasury Department issued proposed regulations which provide guidance to plan sponsors who maintain qualified 401(k) plans, 403(b) arrangements and 457(b) governmental plans that contain automatic contribution arrangements under the Pension Protection Act of 2006 (PPA). Under the regulations, an Automatic Contribution Arrangement (ACA) is a cash or deferred arrangement in which a participant who fails to elect to defer (including a 0% deferral) or not to defer (declines to participate) is deemed to have made an election to contribute the automatic deferral percentage set by the plan. These proposed regulations are effective for plan years beginning on and after January 1, 2008.

The regulations provide guidance for two types of ACAs, the Qualified Automatic Contribution Arrangement (QACA) and the Eligible Automatic Contribution Arrangement (EACA). The regulations further provide that pre-PPA ACAs may continue after 2007 without having to satisfy many of the 2008 requirements. Summarized below are the characteristics of a QACA and an EACA.

Qualified Automatic Contribution Arrangement (QACA)

An ACA must meet the following basic requirements to be a QACA:

- The plan's automatic deferral must be a uniform percentage of pay and must apply to all eligible employees who failed to make an affirmative deferral election. Certain exceptions apply to this uniform percentage requirement. Eligible employees who make a 0% deferral election or who elect not to participate are deemed to have made an affirmative election.
- The plan must provide for a set schedule of minimum automatic deferral percentages.
 - The initial minimum automatic deferral percentage must be at least 3% and no more than 10% of pay. This initial minimum percentage must continue until the end of the plan year following the plan year an eligible employee's first automatic deferrals are withheld (the initial period). After the initial period, the minimum percentage increases by 1% per year until it reaches 6%. The maximum automatic deferral percentage in any year (initial plus increases) may not exceed 10% of pay. The regulations make clear that except for the 10% maximum, these percentages are minimums; a plan may choose (but is not required) to set the initial minimum percentage higher than 3%.
- The plan must provide one of two safe harbor minimum employer contributions:
 - A nonelective contribution of at least 3% of pay to all eligible non-highly compensated employees; or
 - A minimum matching contribution equal to 100% of elective contributions that do not exceed 1% of pay plus 50% of elective contributions that exceed 1% but do not exceed 6% of pay for each eligible non-highly compensated employee.
- The plan must provide for 100% vesting after 2 years of service.
- Eligible employees must be provided a written notice of their rights and obligations under the QACA. The EACA notice requirements discussed below also apply to the QACA, except that the QACA notice must also include information on the automatic increases, the plan's safe harbor employer contribution and vesting.
- The QACA must also meet all of the other requirements applicable to traditional safe harbor plans. For example, the QACA must, generally, be in effect for an entire 12-month plan year, eligible employees must be provided with an initial and an annual notice, the employer match may only be made on the first 6% of pay, and any additional discretionary match may not exceed 4% of pay.

Testing Relief Under A QACA

- A QACA is deemed to satisfy the ADP/ACP tests and, if there are no additional employer contributions or forfeitures allocated in a given year, the QACA is also deemed to satisfy the top-heavy requirements for that year.

Eligible Automatic Contribution Arrangement (EACA)

An ACA must meet three basic requirements to be an EACA:

- Like the QACA, the plan's automatic deferral percentage must be a uniform percentage of pay.
- Automatic deferral contributions must be invested in accordance with regulations prescribed by the Department of Labor (DOL). See *TCRS 2007-07* for our summary of the DOL's final regulations relating to Default Investment Alternatives under the Pension Protection Act of 2006.
- Eligible employees must be provided a notice that meets the following timing and content requirements:
 - The notice must be in writing, although providing the notice electronically is permitted.
 - The notice must be provided within a reasonable period before the beginning of each plan year. In the year an employee becomes eligible, the notice must be provided within a reasonable period before the employee's date of eligibility. If a plan provides for immediate eligibility, the notice may be provided on the employee's date of hire. The regulations remind us that the determination of whether or not a notice is provided during a reasonable period is based on all the relevant facts and circumstances. However, the timing requirement of the notice is deemed satisfied if the notice is provided no earlier than 90 days and no later than 30 days before the beginning of the plan year (or date of eligibility, if applicable).
 - The notice must specify the automatic deferral percentage under the plan and the right of eligible employees to elect not to defer or to defer a different percentage, including zero percent (0%). The notice must provide instructions on how eligible employees can change their deferral election, information on how their contributions will be invested in the absence of an affirmative investment election and, if permitted by the plan, a statement of their right to request a withdrawal during the 90-day opt-out period described below, including the process for making such a request.
 - This notice and the notice prescribed by the DOL under its final regulations relating to Default Investment Alternatives may be combined.
 - The notice must be sufficiently accurate and written in a manner calculated to be understood by the average employee.

Administrative Relief Under An EACA

- Optional 90-Day Opt-Out – If the plan allows, automatically enrolled employees may elect to have their automatic deferrals refunded to them, provided the election is made within 90 days of the first automatic deferral and the election is effective no later than the last day of the payroll period that begins after the election. Other features of the opt-out include:
 - The opt-out applies to an EACA and only to contributions made on and after January 1, 2008. It is not entirely clear if the opt-out applies to a QACA.
 - The employee's right to opt-out may not be conditioned on the employee not being able to contribute in the future. But, the plan may provide that the employee will be treated as having elected to stop deferrals by virtue of having opted out, until the employee makes an affirmative election.
 - The amount of the refund is equal to all automatic deferrals made through the effective date of the opt-out election, adjusted for gains and losses, determined under rules similar to those that apply to the refund of excess ADP contributions.
 - The amount of the refund is included in taxable income in the year distributed, except to the extent the automatic deferrals consist of Roth deferrals. No additional income tax (10%) applies to the refund amount.
 - The amount refunded is reportable on Form 1099-R.
 - Refunded amounts are not eligible to be rolled over.
 - A distribution fee may be assessed for processing refunds. The regulations provide that the distribution fee may not be different from the fee that would apply to other plan distributions.
 - Matching contributions relating to refunded amounts must be forfeited and applied in the same manner as other plan forfeitures.
 - Refunded amounts are not included in the ADP/ACP tests, provided the opt-out election is timely.

- Testing and other related relief under PPA:
 - The 2½ month period for making corrective distributions is extended to 6 months.
 - The gap period earnings requirement (earnings attributable to the period from the end of the plan year to the date of distribution) has been eliminated for the EACA and for all plans.
 - Distributions of excess ADP/ACP contributions would be taxed in the year of distribution for an EACA and for all plans.

No Retroactive Effect

These regulations are proposed to be effective for plan years beginning on and after January 1, 2008 and may be relied upon pending issuance of final regulations. To the extent final regulations are more restrictive than these proposed regulations, the final regulations will not be applied retroactively.

Issues Requiring Additional Guidance

There are a number of issues requiring clarification or additional guidance. These include:

- Whether an EACA can be added after the first day of a plan year.
- Whether the DOL's QDIA requirements apply to a QACA.
- Whether the 90-day opt-out provision applies to a QACA.
- Whether the automatic enrollment notice can be combined with the traditional safe harbor notice.
- Whether the guidelines relating to the DOL's final regulations on Default Investment Alternatives also apply to employer contributions (such as matching contributions under an EACA or a QACA) in the absence of participant investment direction.
- Which eligible employees would be subject to an EACA and, therefore, must get the required notice.
- What vesting rules apply when a plan is amended to add a QACA feature.
- If a plan adopts the opt-out provision, whether an amendment allowing such a provision is required earlier than PPA's general amendment date in 2009.
- Whether forfeitures of matching contributions related to returned automatic deferrals are to be adjusted for gains and losses.
- In a plan that imposes different distribution fees for various types of distributions, what fee should be assessed to refunded automatic deferrals and what the rule should be when the distribution fee exceeds the amount being distributed.

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