July 7, 2009

Automatic Enrollment—Final Regulations Further Explain the Acronyms

Executive Summary

The Treasury Department has issued final regulations describing two new automatic enrollment alternatives for defined contribution retirement plans. The qualified automatic contribution arrangement ("QACA") provides for escalating salary deferrals coupled with an employer contribution that vests after two years. The eligible automatic contribution arrangement ("EACA") provides for salary deferrals with or without employer contributions, and permits distributions of automatic deferrals within 90 days after the first such deferral if a participant opts out within that timeframe. A QACA provides an ADP/ACP safe harbor (no testing required), while plans that use the EACA still require nondiscrimination testing unless they satisfy another safe harbor. Both the QACA and the EACA preempt state laws that may prohibit automatic enrollment and require plan sponsors to issue initial and annual notices to participants.

Automatic Enrollment Overview

A 401(k) plan is a cash or deferred arrangement that enables eligible employees to choose between cash or a tax-deferred contribution to a retirement plan. 403(b) and 457(b) plans are similar types of arrangements sponsored by tax-exempt and governmental entities. To increase plan participation and to encourage lower-paid employees to participate, in recent years 401(k) and 403(b) plan sponsors (and, to a lesser extent, 457(b) plan sponsors) have been implementing negative elections, or automatic enrollment, as part of their plan designs. Automatic enrollment is a "negative consent" arrangement; once an employee satisfies the plan's eligibility requirements, he or she is automatically enrolled in the plan with a deferral rate of a specified percentage of compensation. The employee may opt out of the enrollment or change the deferral percentage.

Before the enactment of new pension legislation in 2006, not all plan sponsors could add automatic enrollment for all employees because laws in some states precluded employers from deferring an employee's pay without his or her consent. To preempt these laws and to encourage plan sponsors to use automatic enrollment, Congress added automatic enrollment provisions under both the Tax Code and ERISA in the Pension Protection Act of 2006. By adding automatic enrollment to ERISA, Congress has allowed 401(k) plan sponsors and sponsors of 403(b) plans that are subject to ERISA to add automatic enrollment to their plans, regardless of state law prohibitions.

For more information, please contact one of the Katten Muchin Rosenman LLP attorneys listed below:

Shannon Skinner Anglin
312.902.5409 / shannon.anglin@kattenlaw.com

Gregory K. Brown
312.902.5404 / gregory.brown@kattenlaw.com

William B. Duff
212.940.8532 / william.duff@kattenlaw.com

Russell E. Greenblatt
312.902.5222 / russell.greenblatt@kattenlaw.com

Gary W. Howell
312.902.5610 / gary.howell@kattenlaw.com

Ann M. Kim
312.902.5589 / ann.kim@kattenlaw.com

Daniel B. Lange
312.902.5624 / daniel.lange@kattenlaw.com

William E. Mattingly
312.902.5266 / william.mattingly@kattenlaw.com

Edward J. Rayner
212.940.8515 / ed.rayner@kattenlaw.com

Kathleen Sheil Scheidt
312.902.5335 / kathleen.scheidt@kattenlaw.com

A. Victor Wray
704.444.2020 / victor.wray@kattenlaw.com

Andrew E. Bridgman
312.902.5509 / andrew.bridgman@kattenlaw.com

Michael R. Durnwald
312.902.5697 / michael.durnwald@kattenlaw.com

Qualified Automatic Contribution Arrangement

A plan that includes a QACA is a safe harbor plan, enabling the plan automatically to satisfy the actual deferral percentage ("ADP") test (which applies to 401(k) plans) and the actual contribution percentage ("ACP") test (which can apply to 401(k) and 403(b) plans). A QACA has the following features:

Minimum Uniform Contribution Levels: The plan must provide that the automatic deferral percentage will be applied uniformly to all plan participants who are eligible to make salary deferral contributions. The QACA contribution may differ based on the number of years the employee has participated in the QACA. To be a QACA, the plan must provide for the following minimum contribution levels:

Year	Contribution Rate
Initial period (any partial plan year and the following first full year of automatic contributions)	3%
Second full year of participation	4%
Third full year of participation	5%
Fourth full year of participation	6%

The contribution rates shown in the table above are the minimum salary deferral rates required by the QACA rules; a plan could apply an automatic deferral rate of up to 10% of compensation. The QACA deferrals are limited by the salary deferral maximums otherwise applicable to elective deferrals, such as the Code Section 402(g) limit ($16,500 for 2009). Further, QACA deferrals must be suspended for six months after a hardship withdrawal, and they must resume after such suspension, unless the participant makes an affirmative election to defer or opt out that would apply after the suspension.

The "initial period" referenced in the table above begins when an employee is first automatically enrolled in the plan, regardless of when he or she first became eligible to make salary deferrals. An employee who affirmatively elects to defer compensation under the plan or who affirmatively opts out of the plan will not have an "initial period." The regulations provide special rules for rehired employees, and an employer may not treat employees who have made no election as affirmatively electing out of the plan.

Minimum Employer Contributions: To satisfy the QACA rules, the plan sponsor must make employer contributions. Such contributions must equal at least either (1) a contribution to all nonhighly compensated employees of at least 3% of their compensation, or (2) a matching contribution equal to 100% of the first 1% and 50% of the next 5% of the salary deferrals each nonhighly compensated employee makes to the plan. Although these are the minimum requirements, to qualify for the ACP safe harbor the plan may not match salary deferrals in excess of 6%. The employer contributions must be fully vested after the participant has completed two years of service.

Eligible Automatic Contribution Arrangement

An EACA differs from a QACA in three significant ways: (1) the EACA does not require a minimum deferral rate; (2) the EACA does not require employer contributions; and (3) a plan using an EACA may permit distributions within the first 90 days after the first automatic deferral for participants who opt out and request such a distribution. Therefore, an EACA is more flexible than a QACA, but does not create an ADP or ACP safe harbor. More specifically, an EACA has the following features:

Participants Covered by the EACA: Not all participants who are eligible to make salary deferrals must be covered by the EACA and, in certain cases, separate EACAs may be applied to separate groups. The plan should state whether a participant who elects out of the plan or who elects a different deferral rate remains covered by the EACA. If he or she does not, this employee is no longer required to receive the annual notice described below. However, a plan with an EACA that covers all participants who are

eligible to make salary deferrals has an additional six months to correct ADP or ACP failures before the 10% excise tax is applied to the excess deferrals or contributions. A plan with an EACA that does not cover all eligible participants does not have this extension of time.

Uniform Contribution Levels: The final regulations require a plan with an EACA to specify the automatic deferral rate, but do not require it to be any specific percentage or impose a minimum or maximum rate of deferral. Rather, the regulations require that the deferral percentage be uniform in its application to all participants covered by the EACA. As in the QACA, the percentage may vary based on the number of years (or portions of years) since a participant's initial participation in the EACA. For example, the automatic deferral percentage may increase with each year of participation, so long as such percentage applies uniformly to all similarly situated participants. Unlike a QACA, a plan with an EACA is not required to provide for employer contributions.

Permissible Distributions: Under the final regulations, plans with EACAs may, but are not required to, permit participants who are automatically enrolled but then opt out to withdraw their automatic deferrals, as adjusted for investment returns. The automatically enrolled participant must make a withdrawal election within 90 days after the first automatic deferral otherwise would have been included in his or her income. An EACA plan may adopt a shorter withdrawal election period, as long as the election period is at least 30 days.

Withdrawals of automatic deferrals under an EACA must be processed in accordance with the plan's normal withdrawal rules, with one exception—the EACA withdrawal must be effective no later than the earlier of (1) the pay date for the second payroll after the withdrawal election and (2) the first pay date occurring at least 30 days after the withdrawal election.

Annual Notice

To satisfy the QACA and EACA requirements, the plan sponsor must provide participants with initial and annual notices of the automatic enrollment features. For a plan with an EACA, only participants covered by the EACA are required to receive the notice, while a plan with a QACA must provide the notice to all employees eligible to participate in the plan. The notice must be written in a manner calculated to be understood by the participants and should describe the participants' rights and obligations, including: (1) the percentage of salary to be contributed under the automatic deferral; (2) the employee's right to elect not to have automatic deferrals made under the QACA or EACA; (3) when and how the employee may make affirmative salary deferral elections; (4) the type and amount of compensation that may be deferred; (5) any employer contributions and the related vesting schedule; (6) the manner in which automatic deferrals will be invested in the absence of the employee's investment direction; and (7) the employee's right to withdraw EACA contributions, if applicable, and the procedures for making such withdrawal.

The notice will be deemed timely if it is made 30 to 90 days before the plan year begins. With respect to a newly eligible employee, notice will be deemed timely if it is provided at least prior to the pay date for the first payroll period in which such employee becomes eligible to participate in the plan. For a QACA, the final regulations specify that the employee's default election must be effective no earlier than the end of a reasonable period after receipt of the notice (to give the employee a reasonable amount of time to make an affirmative election) and no later than the earlier of the pay date for the second payroll period that begins after the date the notice is provided or the first pay date that occurs at least 30 days after the notice is provided.

Mid-Year Adoption Not Permitted

Because the automatic enrollment regulations require an annual notice prior to the beginning of the plan year, QACAs and EACAs may not be adopted in the middle of a plan year.

Consequences of Non-Compliance

According to the final regulations, a plan may include an automatic contribution arrangement that does not satisfy the requirements of a QACA or an EACA. Such an arrangement would not be eligible for the special treatment available for a QACA or EACA and should be designed to comply with the generally applicable Code and ERISA requirements and the more generalized agency guidance that has been issued with respect to automatic enrollment.

Key Dates

Although the final regulations became effective on February 24, 2009, the provisions relating to QACAs apply for plan years beginning on or after January 1, 2008, and the provisions relating to EACAs apply for plan years beginning on or after January 1, 2010. Plan sponsors that intend to adopt either arrangement should begin the implementation process well in advance of the desired effective date.

Published as a source of information only. The material contained herein is not to be construed as legal advice or opinion.

©2009 Katten Muchin Rosenman LLP. All rights reserved.

Circular 230 Disclosure: Pursuant to regulations governing practice before the Internal Revenue Service, any tax advice contained herein is not intended or written to be used and cannot be used by a taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. Katten Muchin Rosenman LLP is an Illinois limited liability partnership including professional corporations that has elected to be governed by the Illinois Uniform Partnership Act (1997). London affiliate: Katten Muchin Rosenman Cornish LLP.