

# retirement

## plan news

JANUARY/FEBRUARY 2007

### Current Automatic Enrollment Rules

Much has been written about the automatic enrollment plan enhancements included in the Pension Protection Act (PPA). As a result, there is a growing interest in these arrangements. There is also a great deal of confusion about which automatic enrollment plan provisions are available — and when.

Automatic enrollment plans have existed since 1998. The automatic enrollment rules that apply today will continue to be available in future years. The PPA rules that have been receiving so much attention, however, are not effective until the 2008 plan year. (See page three article.)

Why is there so much interest? The cost of funding traditional defined benefit plans that provide lifetime retirement benefits to former employees has increased dramatically. Automatic enrollment 401(k) plans are portrayed as the retirement plan of the future because they present solutions to a number of challenges.

**The CODA Advantage.** Defined contribution plans allow employers to better budget their costs and avoid financial and competitive disadvantages. The switch not only to defined contribution plans, but specifically to cash or deferred arrangements, addresses an additional issue — employee participation. Unlike the more traditional defined benefit and defined contribution plans where participants automatically shared in all employer contributions, typical cash or deferred arrangements require employees to *elect* to make contributions if they wish to receive an allocation of employer matching contributions.

#### “Cruise Control” for Plan Sponsors.

Automatic enrollment plans introduce a new twist. Employees are automatically enrolled and must take specific action to *opt out* of their employer’s plan. Generally speaking, automatic enrollment increases participation, which usually helps plans pass nondiscrimination testing.

From an employee standpoint, automatic enrollment encourages greater retirement savings. Further, expanded portability rules allow employees to more easily move their retirement savings from one employer’s plan to another, or roll over their accounts to individual retirement accounts (IRAs), so their savings can continue to grow until retirement.

#### Automatic Enrollment in the

**Beginning.** Automatic enrollment was approved by the IRS in 1998. Under automatic enrollment, a new plan participant is deemed to have consented to defer a stated percentage of compensation (as specified in the plan



document). The participant must be permitted to either elect to defer a different amount or to opt out of deferring altogether.

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## Current Automatic Enrollment Rules (Continued from page 1)

A follow-up ruling released in 2000 permitted a plan to apply the automatic enrollment rules to current plan participants who make elective deferrals that fall under a minimum annual threshold (as stated in the plan document).

**Expanded Rules.** In 2004, the IRS issued a General Information Letter that expanded and clarified the application of the automatic enrollment rules, and they were reiterated in the final 401(k) and 401(m) regulations. Under the expanded rules:

1. The deferral percentage selected in the plan document may be any amount that is otherwise permitted under the terms of the plan. It is not limited to 3%, which had been the limit (based on the example in the 1998 IRS authorization) until this guidance.
2. The plan may provide a schedule of automatic deferral amounts that change over time. For example, the deferral amount may be 3% for the first five years of participation and 5% thereafter.
3. The deferral percentage normally applies to increases in compensation (including raises and bonuses).

The plan document (including the Summary Plan Description) must clearly state *and* explain the automatic enrollment rules, including the option to elect out of deferring altogether.



**Notice Requirements.** Employers that sponsor plans with the automatic enrollment feature must provide notices to employees explaining the feature and giving them a chance to vary their contribution amount or elect not to participate. This notice must be provided when employees are hired, when they become eligible to participate in the plan, and prior to the start of every plan year.

**Two New Provisions.** Although most PPA provisions are effective beginning with the 2008 plan year, two automatic enrollment provisions are effective immediately.

**Override of State Withholding Laws.** PPA eliminates conflicts between automatic enrollment rules and state wage and hour laws. However, preemption is only available if employees are provided with an annual notice before the start of each year.

**Default Investments.** PPA amends ERISA Section 404(c), which provides rules for investment liability relief for plan fiduciaries. Under the new provision, as long as a participant receives a notice explaining the right to designate how his or her contributions and earnings are invested and describing the plan's default investment (i.e., the investment to which contributions and earnings are directed should no designation be made), and as long as the investment meets the applicable rules, then the participant will be considered to have exercised control over a default investment, and the fiduciary will be "safe harbored" from liability for the participant's investment choices. (See the DOL's proposed default investment rules on page four.) ❖

## IRS and Social Security Cost-of-Living Adjustments

IRS LIMITS	2007	2006
Defined Contribution Plan Limit on Annual Additions	\$45,000	\$44,000
Defined Benefit Plan Limit on Annual Benefits	\$180,000	\$175,000
Maximum Compensation for Allocation and Accrual Purposes	\$225,000	\$220,000
401(k), SARSEP, 403(b), and 457 Plan Deferrals/Catch-up	\$15,500/\$5,000	\$15,000/\$5,000
SIMPLE Deferrals/Catch-up	\$10,500/\$2,500	\$10,000/\$2,500
IRA Contributions/Catch-up	\$4,000/\$1,000	\$4,000/\$1,000
Compensation Defining Highly Compensated Employee (2007 amount for use in 2008 plan year tests)	\$100,000	\$100,000
Compensation Defining Key Employee/Officer	\$145,000	\$140,000
Social Security Taxable Wage Base (SSTWB)	\$97,500	\$94,200

# New Automatic Enrollment Rules Starting in 2008

The Pension Protection Act (PPA) provides new incentives for adopting automatic enrollment in 401(k) plans beginning on or after January 1, 2008. Perhaps the most interesting provision is a new safe harbor program known as a “qualified automatic contribution arrangement” or QACA, which is exempt from nondiscrimination testing, provided employers follow the rules. These provisions apply to plan years beginning on or after January 1, 2008.

**Safe Harbor Rules.** Following are the automatic enrollment safe harbor rules. Note that one of the key incentives is that the required matching contribution for a QACA is less than the matching contribution for a safe harbor 401(k) plan.

- **Minimum Deferral Percentages.** A QACA will have a minimum specified automatic contribution percentage. The percentage will escalate in the second, third, and fourth plan years of an employee’s participation. The minimum deferral for the first year of participation is at least 3% (but no more than 10%) of compensation. The minimum increases to 4% the second year, 5% the third year, and 6% the fourth year.
- **Eligibility Exceptions.** The automatic enrollment rules apply to all employees eligible to defer — with two exceptions. The first exception is for employees who are already deferring. The second exception is for those who have filed an election not to defer. The employer may choose to include in the program eligible employees who defer less than the plan’s minimum amount.
- **Minimum Contribution Requirements.** The plan sponsor is required to make *either* a matching contribution of 100% of the first 1% of compensation deferred plus 50% of the next 5% deferred (for a maximum match of 3.5% of compensation on the first 6% deferred) *or* a nonelective contribution of at least 3% of compensation to *all* eligible nonhighly compensated employees (regardless of whether they make deferrals).
- **Distributions.** Restrictions apply to distributions before age 59½.
- **Vesting.** Employer contributions must be 100% vested



after an employee has completed no more than two years of service. Note that regular 401(k) safe harbor arrangements (i.e., those that are not QACAs) will continue to require immediate full vesting of safe harbor contributions.

- **Notice Requirements.** Within a reasonable time (at least 30 days) before the beginning of each plan year, employees eligible to participate in the QACA must receive written notice of their rights and obligations regarding automatic enrollment. (This notice is not a new concept.) The notice must also be provided when an employee is hired and just before eligibility requirements are satisfied. The notice must explain the employee’s right to decline automatic enrollment or to change his or her election amount, including the right to stop deferrals.

**Provisions Affecting All Automatic Enrollment Plans in 2008.** Two provisions apply to QACAs *and* non-safe-harbor automatic enrollment arrangements starting January 1, 2008.

**90-day Revocation.** PPA created this rule to cover situations where employees fail to return their enrollment forms and then complain when their pay is deferred. Employees may withdraw automatic deferrals and related earnings penalty free *if* requested within 90 days after the first payroll period during which the first automatic deferral was withheld.

**Testing Changes.** Non-safe-harbor automatic enrollment arrangements will have six months (rather than 2½ months) after the end of the plan year to perform the ADP/ACP testing and make refunds. Corrective distributions and the earnings thereon will be taxed in the year distributed. Distribution of “GAP period” earnings has been eliminated *for all plans* and for all corrective distributions as of the testing for the 2008 plan year. ❖

# recent developments

## ■ DOL Proposes Default

**Investment Rules.** As part of the Pension Protection Act of 2006 (PPA), the Department of Labor was instructed to create safe harbor criteria for default plan investments made on behalf of participants who fail to make investment selections. If the default investment criteria are met and notice requirements satisfied, plan fiduciaries will not be liable for investment selections because participants will be deemed to have “exercised control” over their investments. Here are the DOL’s proposed rules for a qualified default investment alternative (QDIA).

- Participants or beneficiaries may not be restricted from transferring funds from a QDIA to any other investment alternative available under the plan.

- Transfers must be permitted with the same frequency as other plan investment transfers, but not less than on a quarterly basis.
- No financial penalties may be charged for transferring the funds from a QDIA to other plan investments.
- The QDIA must be managed by an investment manager *or* an investment company registered under the Investment Company Act of 1940.
- The QDIA must be diversified to minimize possible investment losses.
- The QDIA may not be invested in employer securities.
- The QDIA may be a life cycle fund, a target retirement date fund, a balanced fund, or a professionally managed account.

Participants and beneficiaries must be notified of the QDIA rules 30 days in advance of their first investment and at least 30 days before the start of every plan year thereafter. The QDIA rules, which apply to the 2007 plan year, will become effective as specified in the final regulation when it is published in the Federal Register.

## ■ Qualified Charitable

**Distributions from IRAs.** Under PPA, an individual age 70½ or older may make a tax-free donation of up to \$100,000 a year directly from his or her IRA, payable to a qualified charitable organization — but only for tax years 2006 and 2007. Such distributions satisfy the IRA’s minimum distribution requirements. This option does *not* apply to distributions from qualified retirement plans. Anyone interested in making such a donation should seek the advice of a tax advisor. ❖

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

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