

2007 Fifty Most Influential Persons

The 401kWire recently determined the 401(k) Industry's 2007 Fifty Most Influential Persons. At the top of that list was Fred Reish, as the #1 influencer, for 2007.

Also, included in the top five were Shlomo Benartzi of UCLA, David Wray of the Profit Sharing/401(k) Council of America and Don Trone of the Foundation for Fiduciary Studies.

The law firm is delighted to see one of its partners recognized in this way. It is gratifying to know that active participants in the 401(k) community hold Fred in such high regard.

We are particularly encouraged that the recognition has come from Fred's positive message that plan sponsors, providers and advisers should work together to assist employees in their pursuit of benefits that will support a reasonable standard of living in retirement. We believe that this award is a recognition of how powerful that message is. It is also a recognition that, while the law is detailed and complex, it often has an important purpose or policy. There are times when the trees (or the details) seem to overwhelm the forest (or the policy), but in the final analysis, we will be measured by our adherence to the policy of the law and to high principles.

Reish Luftman Reicher & Cohen

New Developments for Automatically Enrolled Plans

By Debra Davis, Fred Reish & Bruce Ashton

Numerous studies have shown that not enough workers are saving for retirement—and of those that do, they often do not save enough. To combat employee inertia, the Pension Protection Act of 2006 (PPA) made significant changes to both the Internal Revenue Code and Title I of ERISA to facilitate and enhance automatically enrolled plans. These changes give more options to employers to help employees save for retirement. This bulletin highlights—and comments on—the key features of the new automatic enrollment provisions of the PPA.

Preemption of State Law

An important change is that ERISA is amended to “preempt” (or, in a manner of speaking, overrule) state laws which restrict a plan’s ability to use automatic enrollment. This preemption helps both 401(k) plans and private sector 403(b) plans that are subject to ERISA.

The following requirements must be satisfied for preemption to apply:

- Deferrals and employer contributions must be placed in qualifying default investment alternatives (QDIAs) under new ERISA § 404(c)(5), for participants who do not direct the investment of their accounts; and
- Notices must be given to participants that explain that they

have the right to opt out or change their deferral percentage and that the participants’ accounts will be invested in the QDIA if they do not give investment directions. Participants must have a reasonable time to opt out or to elect a different amount of deferrals after the notice is given and before the automatic enrollment begins.

The preemption is necessary in states, such as California, where there are state or local laws that require an employee’s written consent to deductions from the employee’s paycheck. These laws effectively prohibit withholding of automatic deferrals from employee paychecks. Some employers in these states were reluctant to use automatic enrollment because of a concern about liability for violating state labor laws. However, the PPA preemption eliminates any concern employers may have about that issue.

Plans that fail to satisfy the QDIA and notice requirements will still be entitled to preemption of state law. However, a substantial per day penalty may apply to the failure to timely provide the notice.

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The law refers to these plans as automatic contribution arrangements. The provisions became effective on the date the PPA was enacted, *i.e.*, August 17, 2006.

Additionally, automatically enrolled plans can return deferrals to an employee who requests that the deferrals be refunded within 90 days of his being automatically enrolled—when that part of the PPA becomes effective in 2008. (*See*, “Revocation of Enrollment” below.)

Safe Harbor

The PPA also amends the Internal Revenue Code to add a design-based safe harbor for automatically enrolled plans (referred to in the PPA as “qualified automatic contribution arrangements”) for plan years beginning after December 31, 2007. Note that the safe harbor rules are optional. In other words, the employer has a choice of being a safe harbor automatically enrolled plan or a traditional automatically enrolled plan—employers are not required to have safe harbor plans in order to take advantage of automatic enrollment.

Like regular 401(k) safe harbor plans, these safe harbor automatically enrolled plans are exempt from the ADP, ACP and top heavy tests. In order for plans to satisfy the safe harbor:

- The safe harbor automatic enrollment provisions must apply to all employees who satisfy the plan’s eligibility requirements. This includes both: (i) employees who become eligible to participate after the automatic provisions are adopted; and (ii) employees who were already eligible to participate before the adoption of those provisions, unless they previously made an affirmative election to defer or affirmatively opted out. (In our experience, most 401(k) plans have not required that eligible employees turn in forms if they don’t want to participate. As a result—and as a practical matter, this means that most of these plans will need to automatically enroll all eligible employees in the first safe harbor year, including those employees who became eligible in earlier years.)

RLRC Comment: Most employers who have automatically enrolled employees before this change in the law have not automatically enrolled their employees who became eligible in previous years. Instead, they just automatically enrolled newly eligible employees. As a result, we are concerned that the requirement that all eligible employees, including those who became

eligible in previous years, must be automatically enrolled could be a deterrent to some plan sponsors that are considering adopting the safe harbor automatically enrolled plan design.

RLRC Comment: However, traditional automatically enrolled plans (as opposed to safe harbor automatically enrolled plans) are not required to automatically enroll previously eligible employees. But, of course, in that case they will have to do the ADP, ACP and top-heavy testing and compliance.

- At a minimum, the following percentages of compensation must be deferred for automatically enrolled participants in a safe harbor plan: 3% for the participant’s first plan year; 4% for the second plan year; 5% for the third plan year and 6% per year thereafter. However, the automatic deferral amount may not exceed 10%. Of course, an employee can always opt out of the default increase.
- The plan sponsor must make either matching or profit sharing contributions for all non-highly compensated employees. The matching contribution must equal 100% of the first percent deferred, plus 50% of the next five percent deferred. For example, a participant who deferred 6% of compensation would be entitled to a matching contribution of 3.5% (100% of the first 1% and 50% of the next 5%). Alternatively, the plan sponsor can make a profit sharing contribution equal to three percent of the compensation of each eligible employee. These contributions must be 100% vested after the employee has completed two years of service (that is, 0% after the first year and 100% after the second year).

RLRC Comment: By comparison, plans that use the current 401(k) safe harbor (referred to in this bulletin as “regular safe harbor 401(k) plans”) must provide for a matching contribution of 100% of the first 3% deferred, plus 50% of the next 2% deferred. For example, a participant who deferred 6% of compensation would be entitled to a matching contribution of 4% (100% of the first 3% and 50% of the next 2%). Alternatively, the plan sponsor can make a

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profit sharing contribution equal to three percent of the compensation of each eligible employee. By way of contrast, the contributions for regular safe harbor 401(k) plans must be 100% vested immediately.

- Notices must be provided to participants before the beginning of each plan year that explain (i) the participant's right to opt out or change the deferral percentage and (ii) how the participant's account will be invested if he does not give investment direction. Also, participants must have a reasonable period of time to specify the percentage of their deferrals after receiving the notice and before the automatic enrollment begins.

RLRC Comment: Both automatic enrollment notices and notices required under the QDIA provisions will need to be provided.

Unfortunately, the PPA does not address whether plans that are established or add a 401(k) feature during a year will be able to use the safe harbor for the first year. Additionally, the PPA does not state when the notice must be provided to employees who are hired during the year or when the automatic deferrals must begin for new employees. The IRS will hopefully issue guidance before 2008. We assume that IRS guidance will address these questions in a practical way.

The escalator provisions (that is, automatic increases in the deferral percentage) are likely to become a popular feature for automatically enrolled plans, regardless of whether they intend to comply with the safe harbor. Additionally, 401(k) plans that do not automatically enroll may provide escalator provisions as an option to participants who elect to defer—for example, participants may be able to elect an automatic increase of 1% per year up to a maximum percentage as an option on their election forms.

While the PPA introduces the concept of automatic enrollment deferral “escalators” into the law, the Internal Revenue Service (IRS) had previously stated that escalator provisions are permissible as long as participants are given notices. (*See*, Information Letter to J. Mark Iwry on March 17, 2004. *See also*, Rev. Rul. 2000-35, Rev. Rul. 2000-8, Ann. 2000-60; Treas. Reg. § 1.401(k)-1(a)(3)(ii).) The Information Letter provides that the notices must explain the automatic enrollment feature and the employee's right to opt out or change the amount of the election.

Some companies that want to use the safe harbor may have difficulty implementing escalator provisions due to payroll issues. That is, it may be an administrative burden to track the required levels of automatic deferrals (if their payroll service or provider will not do it for them). For example, employees automatically enrolled in the first year the feature is added to the plan will be on a different deferral schedule than employees who commence participation in later years. As a result, those plans may decide to satisfy the requirement by using a fixed deferral rate of 6% for all automatically enrolled participants.

RLRC Comment: In the early days of automatic enrollment, the most common deferral percentage was 2%. Now, 3% is the most common and 4% is becoming increasingly more popular. A long-term ancillary effect of the new safe harbor automatic enrollment may be to increase the average initial automatic deferral to 6%. And a higher initial deferral rate should be beneficial to participants in the long run by increasing their retirement savings.

Revocation of Enrollment

Eligible automatic plans will be able to return automatic deferrals to participants. The law refers to these deferrals as “erroneous automatic contributions.” An employee must request the return of the deferrals within 90 days after the date the first automatic deferral is withheld from his paycheck. The deferrals must be adjusted for earnings or losses, that is, the account balance (as opposed to the deferrals) must be paid to the participant.

This provision applies for plan years beginning after December 31, 2007. Thus, plans that implement automatic enrollment will not be able to return automatic deferrals of employees until then.

Allowing employees to have their deferrals returned is intended to provide comfort to plan sponsors that are concerned about disgruntled employees who failed to opt out.

Default Accounts

In order for state law to be preempted and for participants to be able to have their “erroneous” deferrals returned, deferrals and employer contributions contributed to the participant's account must be invested in a new ERISA § 404(c)(5) default investment—the QDIA—if they do not direct the investment of their accounts.

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The default investment must include a “mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both.” The proposed regulations issued by the DOL indicate that the QDIA must be: (1) a mutual fund or model portfolio that is based on the participant’s age, target retirement date or life expectancy (for example, age-based lifecycle or target maturity funds); (2) a mutual fund or model portfolio, that is risk based (for example, lifestyle or balanced funds); or (3) an investment management service where a fiduciary or investment manager allocates the participant’s account based on the participant’s age, target retirement date or life expectancy (for example, a managed account).

Further, the default investment must either be a mutual fund or be managed by a fiduciary that is an investment manager under section 3(38) of ERISA.

Fiduciaries who invest defaulting participant accounts in QDIAs receive 404(c) fiduciary protection if certain notice requirements are met. (See prior Bulletin at www.reish.com/publications/pdf/newreliefbulletin.pdf.)

In mid-February, the DOL will be issuing a final regulation defining which investments qualify for QDIA status and related issues, such as participant notice requirements.

Conclusion

The automatic enrollment provisions added by the PPA are likely to receive a warm welcome from plan sponsors. We anticipate that large and mid-sized plan sponsors will embrace the concept the most quickly. (In fact, approximately 20% of the largest 401(k) plans already automatically enroll.) Among smaller plans, we believe that automatic enrollment will be embraced by the more paternalistic plan sponsors and that the safe harbor automatic enrollment will be popular with that group.

These provisions benefit both employers and employees by increasing participation in retirement plans. Additionally, the 404(c) protections for default investments should benefit plan sponsors because of fiduciary protections, and participants because their accounts will be invested in professionally designed portfolios. ❖

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