The IRS recently released final automatic contribution regulations to reflect changes made by PPA. In this article, we explore the key differences in the final regulations and discuss their effect on 401(k) plans.

On February 23, 2009, the IRS released final automatic contribution regulations. The regulations cover two major changes to 401(k) rules made by the Pension Protection Act of 2006 (PPA) – the PPA automatic contribution safe harbor and rules allowing the distribution of "automatic" contributions where a participant elects out (within 90 days) of an automatic contribution program.

Not all sponsors of automatic contribution programs will be interested in the safe harbor. Often, automatic contributions alone -- that is, without safe harbor matching contributions, vesting, etc. -- are sufficient to solve a sponsor's 401(k) nondiscrimination testing issues. But the new 90-day distribution rules are likely to be of interest to most sponsors of automatic contribution arrangements, particularly those with immediate eligibility.

In this article we review the new automatic contribution safe harbor and 90-day distribution rules.

**Automatic contribution safe harbor**

PPA added a new safe harbor for automatic contribution plans that meet certain minimum requirements. If those requirements are met, the plan is generally exempt from 401(k) nondiscrimination testing. Under the regulations, these plans are called "qualified automatic contribution arrangements" (QACAs). To be a QACA, a plan must provide for automatic contributions and either nonelective or matching contributions at least at specified rates, and meet certain other requirements.

**Automatic contribution requirement**

Under a QACA, each eligible employee must be automatically enrolled (unless the participant affirmatively opts out) in the plan at a minimum contribution rate of 3%. That contribution rate continues for the plan year of the initial contribution and for the subsequent plan year (the "initial period"). Thereafter, it is increased 1% per year until a 6% rate is reached, after which no further increases are required.
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The following table summarizes these rules.

<table>
<thead>
<tr>
<th>Year</th>
<th>Contribution rate</th>
</tr>
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<tbody>
<tr>
<td>Initial period (plan year of initial contribution and next plan year)</td>
<td>3%</td>
</tr>
<tr>
<td>2\textsuperscript{nd} year</td>
<td>4%</td>
</tr>
<tr>
<td>3\textsuperscript{rd} year</td>
<td>5%</td>
</tr>
<tr>
<td>4\textsuperscript{th} year</td>
<td>6%</td>
</tr>
</tbody>
</table>

For plan years beginning on or after January 1, 2010, the compensation used for a QACA must be 401(k) safe harbor compensation.

Uniformity requirement

The automatic contribution schedule described above provides only minimums. The initial automatic contribution rate could be, for instance, 4%. Automatic contributions may not, however, exceed 10%.

In any case, the default percentage must generally be applied uniformly. Certain exceptions to uniformity are permitted, including variations based on:

- the number of years (or portions of years) since the beginning of the employee's initial contribution period
- a higher pre-QACA rate of contribution
- Internal Revenue Code required limits (e.g., the compensation limit under Code section 401(a)(17))
- a period of contribution suspension related to a hardship withdrawal

Nonelective/matching contribution requirement

To qualify for the safe harbor, the plan must provide for either minimum nonelective or matching contributions for non-highly compensated employees. "Nonelective contributions" are employer contributions that are not contingent on the participant contributing anything. The minimum nonelective contributions for a QACA are the same as those for the "regular" 401(k) safe harbor (generally, 3% of pay).

The minimum matching contributions are lower (that is, they require a smaller match) than those under a "regular" 401(k) safe harbor matching requirement. Generally, minimum matching contributions under a QACA must equal 100% of employee contributions up to 1% of pay and 50% of employee contributions above 1% and up to 6% of pay. In English: dollar-
for-dollar on the first 1%, 50 cents-per-dollar on the next 5%; thus the maximum required match would be 3.5% of pay.

Nonelective/matching contributions must vest 100% after no more than two years of service.

Pre-QACA affirmative elections

Under a QACA, automatic contribution rules do not have to be applied to employees who were eligible to participate in the plan immediately before the effective date of the QACA and who have an election – either to make or not make contributions to the 401(k) plan – in effect on that effective date. For this exception to apply, generally the employee must have completed an election form (paper or electronic) and chosen an amount or percentage (including zero) of his or her compensation to be deferred.

Calculation of the eligibility period

As discussed above, QACA automatic contributions generally increase with service. In this regard, the final regulations provide guidance as to the treatment of rehired employees. Generally, under the final rules, the period of eligibility is calculated without regard to whether an employee has continued to be eligible to make contributions under the plan. A plan is permitted, however, to treat an employee for whom no contributions are made for an entire plan year as, in effect, a new employee.

Notice – content

Employees subject to a QACA must be provided with a notice that includes information required to be in the “regular” 401(k) safe harbor notice (e.g., information concerning matching and other contributions and the type and amount of compensation that may be deferred). In addition, the notice must include an explanation of:

- the level of elective contributions which will be made on the employee’s behalf if the employee does not make an affirmative election otherwise

- the employee's right to elect not to have default elective contributions made or to contribute a different percentage

- how contributions under the arrangement will be invested

Notice – timing

Because, in some plans, an employee may be hired and immediately enrolled, rules as to when the QACA notice must be delivered were a focus of comments on the proposed regulations. As a general matter, the QACA notice must be provided so that, within a reasonable period of time after receipt and before the first default contribution is made, the
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employee has the opportunity to make an affirmative election not to contribute (or to contribute a different amount). Generally, the final regulations provide that this rule is satisfied if the notice is provided to each eligible employee at least 30 days (and no more than 90 days) before the beginning of each plan year, or for newly eligible employees, within a reasonable period before the employee’s eligibility date.

The final rules provide an additional accommodation: if it is not practicable for the notice to be provided on or before the date specified in the plan that an employee becomes eligible, the notice will nonetheless be treated as timely provided "if it is provided as soon as practicable after that date and the employee is permitted to elect to defer from all types of compensation that may be deferred under the plan earned beginning on the date the employee becomes eligible." The preamble explains this requirement as follows: "Thus, an employer is required to provide the notice to the employee prior to the pay date for the payroll period that includes the date the employee becomes eligible." Generally, this seems to go as far as possible in accommodating immediate enrollment while still allowing the employee the ability to elect out before pay is reduced.

The final regulations provide that the default election must (1) be effective no earlier than a reasonable period of time after the receipt of the notice, and (2) 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.

90-day distributions

PPA also added a provision permitting (but not requiring) a plan to allow any employee who has default contributions made under an "eligible automatic contribution arrangement" (EACA) to withdraw those contributions. Recall, not all sponsors interested in default contribution arrangements will be interested in the QACA safe harbor, and a 401(k) does not have to be a QACA to take advantage of these EACA rules.

Generally, the election to withdraw must be made no later than 90 days after the date of the first default contribution under the EACA. The final regulations permit sponsors the use of a less-than-90 day period, but the period for withdrawals cannot be less than 30 days.

The latest effective date of the permissible withdrawal election cannot be after the earlier of: (1) the pay date for the second payroll period beginning after the election is made, or (2) the first pay date that occurs at least 30 days after the election is made. Distributions must be made in accordance with the plan’s ordinary timing procedures, i.e., they should be processed and distributed no differently than any other distribution permitted under the plan.

The amount withdrawn is includible in the employee's income for the taxable year in which it is distributed and is not subject to the 10% early withdrawal penalty. Any employer matching contributions are forfeited.
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Coverage

Under proposed rules an EACA had to apply to each employee who is eligible to make a cash or deferred election under the plan. The final regulations allow sponsors considerably more flexibility, providing that “(A)n eligible automatic contribution arrangement need not cover all employees who are eligible to elect to have contributions made on their behalf under the applicable employer plan.”

The final regulations provide that the plan document must specify the employees who are covered under the EACA and must state whether an employee who makes an affirmative election remains covered under the EACA. EACA notice requirements need only be provided to those employees covered by the EACA. Connecting the dots – if a plan provides that an employee who makes an affirmative election is no longer covered, no post-election EACA notice is required. Effective with 2010 plan years, if the EACA does not cover all employees who are eligible under the plan, it cannot take advantage of the extended six-month period for providing refunds.

Generally, and subject to Code section 410(b) mandatory disaggregation rules (applicable, for instance, to certain collectively bargained employees), multiple EACAs must be aggregated for purposes of the EACA rules.

Uniformity requirement

Generally, the default elective contribution under an EACA must be a uniform percentage of pay (e.g., 2% of pay). Uniformity rules similar to those applicable to QACAs apply here.

Notice – content and timing

Each eligible employee under an EACA must be provided with a notice that includes information required to be in the "regular" 401(k) safe harbor notice. In addition, the notice must include an explanation of:

- the level of elective contributions which will be made on the employee’s behalf if the employee does not make an affirmative election

- the employee’s right to elect not to have default elective contributions made or to contribute a different percentage

- how contributions made under the arrangement will be invested in the absence of any investment election (in accordance with the "Worker, Retiree, and Employer Recovery Act of 2008" (WRERA), the requirement that, to qualify for the EACA 90-day distribution treatment, default elective contributions had to be invested in accordance with the Department of Labor’s qualified default investment alternative (QDIA) regulations has been eliminated)
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the employee’s right to make a permissible withdrawal, if applicable, and the procedures to elect such a withdrawal

Timing for this notice generally parallels timing requirements for QACAs discussed above.

Effective date

Generally, the QACA rules apply to plan years beginning on or after January 1, 2008. Regulations relating to EACAs apply for plan years beginning on or after January 1, 2010.

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Some sponsors may find the new QACA safe harbor useful. As discussed at the beginning, sponsors considering a QACA will want to also consider whether a non-safe harbor automatic contribution program (an EACA) will address nondiscrimination testing issues. The 90-day distribution rule is also likely to be useful, especially for sponsors that provide for immediate enrollment.

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