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**Re: Automatic Contribution Arrangements**

Dear Clients and Other Friends:

The 2006 Pension Protection Act includes provisions intended to make retirement saving easier by automatically enrolling employees in 401(k) and 403(b) plans and automatically investing their contributions in suitable investment funds unless and until they choose different investments. These provisions include:

- **Eligible Automatic Contribution Arrangements (“EACAs”)** enroll new participants automatically, and give the plan sponsor more time to run the ADP/ACP tests and refund excess contributions without incurring excise taxes. An EACA also may permit participants who were automatically enrolled to withdraw the amounts they contributed.<sup>1</sup>
- **Qualified Automatic Contribution Arrangements (“QACAs”)** provide a new way for highly compensated employees to contribute up to the annual limit (\$15,500 for 2008) without regard to average contributions by lower-paid employees (i.e. a new “safe harbor” from the ADP and ACP tests). QACAs are in many ways similar to the existing traditional safe harbor available under Code §401(k) and (m), but some key differences are outlined below.
- **Qualified Default Investment Alternatives (“QDIAs”)** permit a plan to invest contributions from automatically enrolled employees in more suitable investments than the money market/stable value funds which have traditionally been used for this purpose. QDIAs can also be used to invest accounts of already enrolled individuals who have not made investment elections. The QDIA rules give plan fiduciaries protection from liability if the default investment declines in value.

The purposes of this letter are to outline the steps an employer must take to use these alternatives, and the pros and cons of so doing.

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<sup>1</sup> The Pension Protection Act amends ERISA to provide that plans qualifying as EACAs (with or without the elective refund feature) are exempt from state laws restricting automatic wage withholding. It is debatable whether this PPA provision is a meaningful change; many including the writer have felt that these laws as applicable to plans subject to ERISA already were preempted. See Labor Department Advisory Opinion 2008-02A for recent confirmation of this view.

1. **Eligible Automatic Contribution Arrangements.** To establish an EACA, the following requirements must be met:

- (a) **Uniform automatic contributions.** The default contribution for individuals who have not made a contribution election is determined by the employer, but it must be a “uniform percentage of compensation” for all participants. For example, an employer may not establish a 3% automatic contribution rate for participants at one plant and a 4% rate for participants in the same plan at a different plant. However, certain automatic contribution increases based on length of participation do not violate the uniformity requirement. Also, although the proposed EACA regulations do not address this, we understand from informal comments by IRS personnel that it probably is alright for a plan to have different automatic contribution terms for bargaining unit employees than for those not in a bargaining unit.

It is unclear how the uniform contribution requirement applies to individuals who became eligible for the plan before the EACA was implemented. One possible interpretation of the proposed IRS regulations on this subject is that individuals who did not previously make affirmative elections whether or not to contribute must automatically be enrolled at the EACA default rate. If this interpretation is correct, it may be difficult for some employers to determine whether individuals are not currently contributing because they affirmatively elected to contribute zero or because they simply never got around to returning the election form.

- (b) **Notice requirement.** An initial notice must be provided when an employee first becomes eligible to participate and annual notices must be provided 30 to 90 days before the beginning of each plan year. The notice must describe the plan generally, and must explain how the default contribution provisions work, how the money will be invested and how an employee can discontinue contributing or change to a different contribution rate.
- (c) **Default investment requirement.** Automatic contributions made under an automatic contribution arrangement must be invested in a qualified default investment alternative (described in #3 below) unless and until the participant elects another investment.

An EACA may also permit participants who are automatically enrolled to withdraw their automatic contributions. Any such election must be made within 90 days after the first automatic contribution was withheld from pay. An employee who elects such a refund forfeits the match on the amounts that are refunded. This refund feature is optional, not mandatory. One factor in deciding whether to offer it is the plan recordkeeper’s ability to administer the refund feature.

If a plan qualifies as an EACA, the employer has six months after the end of the plan year to run the ADP/ACP tests and make any needed refunds without incurring any excise

taxes. This compares to the normal 2 ½ month deadline for such refunds. For many employers, this additional time to complete the tests is the major reason to offer an EACA (as opposed to the employer designed automatic contribution setups many employers have in place now).

Employers have found that traditional automatic enrollment arrangements increase average contributions by non-highly compensated employees, thereby making it easier to pass the ADP and ACP tests and permitting highly compensated employees to contribute more. EACAs should lead to the same result.

2. **Qualified Automatic Contribution Arrangements.** Under a QACA, each participant (including both current employees and new hires) who has not elected a specific contribution rate must be automatically enrolled in a contribution of at least 3% of pay. If the participant does not subsequently make a contribution election (or elect not to contribute), the automatic contribution rate automatically increases to 4% after the end of the first full plan year of participation and in one percent annual increments thereafter. It is not necessary to increase contributions above 6% of pay and the rules do not allow automatic increases that would take a participant beyond 10% of pay. For example, if a plan has a QACA feature, an individual who becomes eligible to participate during 2008 would automatically be enrolled at 3% of pay which would continue until he elects a different rate or until the end of 2009. Beginning January 1, 2010, the automatic contribution rate goes to 4%, then to 5% on January 1, 2011 and so forth. A participant who does not like the automatic contribution rate is free to cancel contributions or to change to a more congenial rate under the plan's usual contribution election terms.

A plan establishing a QACA feature must satisfy these requirements:

- (a) **Automatic enrollment.** At the time the QACA is implemented, each person who is eligible to contribute but has not previously made a contribution election must automatically be enrolled at the 3% rate. Individuals who become eligible after the QACA implementation date (e.g. new hires) must also be automatically enrolled.
- (b) **Participant notice.** The employer must provide a notice explaining basic plan terms and the automatic enrollment feature. For new participants, this generally must be given at the time the individual first becomes a participant, which is a challenge in cases where a plan has immediate eligibility upon becoming an employee. Also, the QACA notice must be provided annually within 30 to 90 days before the beginning of each plan year (similar to EACAs and existing safe harbor notices).
- (c) **Required employer match or non-elective contribution.** A QACA must provide employer contributions at least equal to one of the following levels:
- Employer match of 100% of the first 1% of pay an employee contributes and 50% of the next 5% contributed (i.e. if the employee contributes 6%

of pay, the match must be at least 3.5% of pay). This is slightly less than the match required under a traditional safe harbor arrangement.

- Employer non-elective contribution of at least 3% of pay (same as amount required for traditional safe harbor).

As under the traditional safe harbor, employer QACA contributions for a plan year must be provided regardless of the employee's hours during that year, and regardless of whether the employee terminates before year-end.

- (d) **Vesting.** Employer QACA contributions must be 100% vested after the employee completes two years of vesting service, which compares to the full and immediate vesting required in a traditional safe harbor plan and the three year cliff vesting or two to six year graded vesting required in non-safe harbor defined contribution plans.
- (e) **Other requirements.** There are a number of other requirements, which for the most part are similar to those applicable to a traditional safe harbor plan.

**Pros and Cons.** The main “pro” is relief from running the ADP and ACP tests, for a somewhat lower employer match than would be required in a traditional safe harbor plan.<sup>2</sup> The “cons” include these issues:

- The employee notice procedures and automatic enrollment requirements are cumbersome. For example, many employers have found it difficult to identify exactly which employees have not made explicit contribution elections in the past and so must be automatically enrolled now.
- If the plan offers immediate participation to new hires, the QACA notice must be furnished on or before a new employee's date of hire. Doing this on such a tight schedule might be unrealistic for some employers. (This problem can be relieved if there is a short waiting period between an employee's hire date and the date he or she first qualifies as a 401(k) participant).<sup>3</sup> Other employers may deal with the notice requirement by including the notice in new employee information supplied on or before the first day of work.
- For employers that currently have low participation rates and no automatic enrollment, adding an automatic enrollment feature can be costly – employees who never would have got around to contributing are automatically enrolled and therefore qualify for employer match.

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<sup>2</sup> However, if the plan permits traditional after tax contributions (not Roth 401(k) deferrals), they will remain subject to the ACP test.

<sup>3</sup> This same issue applies to the EACA notice requirements discussed earlier.

3. **Qualified Default Investment Arrangements.** The Pension Protection Act also changed the rules regarding how to invest participant accounts in the absence of participant investment directions. In the past, many employers concluded that the best way to avoid fiduciary liability in connection with such investments was to put the money in a stable value fund. This helped minimize potential loss of principal, but it also assured that the participant would receive a low long term investment return. The PPA investment provisions enable employers to offer default investments that should receive a more satisfactory rate of return over the long run and protect the employer from fiduciary liability if the default investment produces a loss. The QDIA rules are outlined more fully in our letters of October 26, 2007 and May 16, 2008 and we will not repeat the details here. However, these facts may be relevant in connection with the automatic contribution arrangements outlined above:

- The QDIA rules require a participant notice, which generally can be combined with and distributed at the same time as the other participant notices required in connection with a QACA or an EACA.
- In order to have an EACA, the automatic contributions must be invested in a QDIA.<sup>4</sup>
- To facilitate participant requested refunds under an EACA, a plan may use a stable value fund as the default investment for a limited period of time which generally is designed to coincide with the period while contributions are subject to refund. After that time expires, the money must be moved to an investment that meets the QDIA criteria.

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We know that many employers are considering using one or more of the features described above. The guidance available to date does not seem to permit mid-year implementation of a QACA or EACA, so the next opportunity for implementation will be the 2009 plan year. To be ready for 2009 implementation, employers should be thinking about this now, preparing to provide the required notices, and putting the other arrangements in place well before year end.

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<sup>4</sup> However, this requirement does not apply if the Plan is not subject to ERISA (e.g. a Code §457(b) Plan for government employees).

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The regulations are more flexible about mid-year implementation of a QDIA, and we see no reason to wait until year-end for that feature.

Please let us know if we can be of any help.

Sincerely,

A. David Kelly

ADK/jks/bz