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IRS Guidance on Automatic Contribution Arrangements

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▲ Background

On November 7, 2007, the Department of the Treasury released proposed regulations providing guidance on the implementation, operational, and notice requirements applicable to retirement plans containing Automatic Contribution Arrangements (ACAs) under IRC §§401(k)(13), 401(m)(12) and 414(w) (**http://www.treasury.gov/press/releases/reports/reg13330007(checked)(checked)%20(2).pdf**). These regulations are applicable to qualified plans under §401(a), §403(b) arrangements, and §457(b) governmental plans.

▲ Basic Types of Automatic Contribution Arrangements (ACAs)

The proposed regulations define two specific types of ACAs: Eligible Automatic Contribution Arrangements (EACAs) and Qualified Automatic Contribution Arrangements (QACAs). Plans that include a default deferral election and satisfy several basic requirements are defined as EACAs. In addition, the QACA is a new ADP/ACP test safe-harbor option for ACA plans that satisfy similar requirements to the EACA as well as additional minimum contribution, vesting, and notice requirements.

An ACA plan may satisfy the requirements of an EACA, a QACA, neither, or both; although it appears that most QACAs will also be EACAs. A plan that qualifies as an EACA or a QACA will be entitled to a number of administrative benefits; however, the specific benefits depend on whether the plan is an EACA, a QACA, or both.

The following is a summary of the new guidelines applicable to EACAs and QACAs:

Uniformity—The default elective deferral percentage must be applied on a uniform basis to *all employees eligible to make a cash or deferred election*. There are several exceptions to this uniformity rule, including plans that automatically escalate the default percentage and plans that do not apply the default percentage to participants who already have an affirmative deferral election in place. An additional exception applies for participants who are suspended from making salary deferrals due to having taken a hardship distribution, as long as they are re-enrolled at the applicable percentage at the end of the suspension period.

Default Investment—The plan must comply with the Department of Labor's regulations under ERISA §404(c)(5) (which include the regulations on Qualified Default Investment Alternatives, see ASPPA *asap* 2007-27). In most instances, compliance requires selection of the appropriate default investment option and compliance with the QDIA notice requirements. The regulations appear to apply this requirement only to EACAs and not to QACAs.

Notice Requirement—An EACA must provide each eligible employee with a notice of the employee's rights and obligations under ERISA. The notice must specify (1) the amount that will be withheld from the participants' compensation absent an affirmative election; (2) the right of the participant to defer at a level different from the default percentage (including 0%) and instruct the participant on how to change their deferral election; (3) how the default contributions will be invested in the absence of an affirmative election (unless such notice is provided in a separate QDIA notice); and, (4) the right of the employee to make a withdrawal within the 90-day period and the process for making such a request, if applicable.

The notice must be provided to all eligible employees annually within a reasonable time before the beginning of each year. The time period is deemed reasonable if it is no more than 90 days and no fewer than 30 days prior to the initial withholding of default deferrals. For participants who are new to the ACA, the notice may be provided anywhere from 90 days prior to their entry date up to their date of eligibility. Immediate entry plans will satisfy this requirement as long as the notice is provided on an employee's date of hire.

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▲ QACA—The New Design-Based Safe Harbor

Most requirements associated with current safe harbor plans also apply to the QACA. Listed below are the main characteristics that distinguish QACAs from other safe-harbor designs.

Employee contribution requirements—The initial default contribution percentage ("Qualified Percentage") must be at least 3% for those who do not affirmatively elect a deferral percentage. At the end of the year following year in which a participant first has default deferrals withheld, the minimum percentage increases by 1%. At the end of each subsequent year, the minimum percentage will again increase by 1% until it reaches at least 6%. While a plan can elect to set its initial percentage above 3% (to shorten or eliminate the escalation period), the default percentage cannot exceed 10% of pay in any year. The default election and increases must be applied to all eligible participants who do not have an affirmative deferral election in effect.

Employer Contribution Requirements—Employers have two contribution options to satisfy the QACA requirements. First is a 3% non-elective contribution to all eligible employees. The second is an employer matching contribution of 100% on the first 1% of compensation deferred, then 50% on the next 5% (a participant deferring 6% will receive the maximum 3½ % match). Unlike the immediate vesting requirement for existing safe-harbor contributions, both of these types of contributions must be fully vested after no more than two years. The proposed regulations do not address vesting transition issues for existing safe-harbor plans electing to implement a QACA.

Other Requirements—All of the requirements applicable to existing safe-harbor 401(k) plans also apply to QACAs. This includes the annual notice requirement (QACAs can combine the EACA, QDIA and safe-harbor communications into a single notice), distribution restrictions, as well as the requirement that the QACA be place for a full 12-month plan year.

▲ Do-Over Distributions

To address concerns about plans accumulating many small balances due to participants not making timely elections to opt out of the default deferral arrangement, EACA plans have the option of allowing do-over distributions (referred to in the regulations as permissible withdrawals). Participants must request such distributions within 90 days of the date of the first contribution by the participant under the ACA provisions, subject to the following requirements:

- The full amount of the default deferrals (including gains or losses) must be distributed.
- The distribution is taxable in the year paid; however, the 10% early withdrawal penalty under IRC §72(t) is waived.
- The distribution must be reported on Form 1099-R.
- A distribution processing fee can be charged to the participant, as long as it is the same fee charged for other types of plan distributions. This may pose administrative difficulties if the normal distribution processing fee exceeds the amount being distributed (ASPPA is requesting clarification from the DOL).
- Any related matching contributions must be forfeited and not returned to the employer.
- Do-over distributions and forfeited matching contributions are not included in the ADP/ACP tests. Retirement plan professionals performing testing will need to be cautious to ensure they use proper testing data with regard to do-over distributions processed early in a subsequent plan year.
- Do-over distributions are only allowed for contributions made after the plan became an EACA. Therefore, no deferrals contributed prior to January 1, 2008, are eligible for distribution under this provision.

▲ ACA, EACA, and QACA Attributes

- ACAs, EACAs, and QACAs are all afforded ERISA preemption of state laws regarding the deduction of amounts from employee pay without written consent.
- ADP/ACP Testing Period Extension—An EACA is granted relief from the excise tax in §4979 for corrective distributions issued up to six months after the end of the plan year. Section 902 of PPA amended §4979(f)(2) to provide that any distribution of excess contributions or excess aggregate contributions is taxable in the year distributed. Gap period income requirements have also been eliminated. While gap period income calculations have been eliminated for Excess Contributions and Excess Aggregate Contributions for all plans (not only ACAs), they still apply to Excess Deferrals.
- The proposed regulations remind us that Excess Contributions and Excess Aggregate Contributions will be taxed in the year distributed for all CODA plans.

▲ Effective Date and Reliance

The proposed regulations are effective for plan years beginning on or after January 1, 2008.

The ASPPA Government Affairs Committee will be thoroughly reviewing the proposed regulations and offering comments to Treasury and IRS on items that require clarification.

An existing qualified CODA must adopt the QACA safe harbor and provide notice before the plan year starts and remain in effect for an entire 12-month period.