

IRS Issues Proposed Regulations For Automatic Contribution Arrangements Under 401(k) And Similar Plans

The Pension Protection Act of 2006 (PPA) included two significant provisions that accommodate - and even encourage - automatic contribution arrangements for elective pre-tax deferrals under 401(k), 403(b) and governmental 457(b) plans. Under an automatic contribution arrangement, if a participant fails to make any election to contribute or not to contribute pre-tax salary deferrals, pre-tax deferrals are automatically deducted at a specified, uniform percentage of pay, and continue to be deducted unless and until the participant affirmatively elects not to contribute or to contribute at a different percentage of pay.

The first PPA provision for automatic contribution arrangements applies only to 401(k) plans and provides a discrimination testing safe harbor (i.e., no discrimination tests need to be performed) for plans that adopt a "qualified automatic contribution arrangement" (QACA). A QACA requires automatic pre-tax deferrals at an increasing minimum percentage of pay, subject to a 10% cap; minimum employer non-elective or matching contributions; two-year vesting for employer contributions; 401(k) restrictions on withdrawals; and the provision of an initial written notice and annual written notices thereafter.

The second PPA provision for automatic contribution arrangements is available to 401(k), 403(b) and governmental 457(b) plans that adopt an "eligible automatic contribution arrangement" (EACA). If a plan with an EACA permits it, a participant for whom automatic pre-tax salary deferrals have been made may elect within the first 90 days of eligibility under the EACA to withdraw all such deferrals. In addition, a 401(k) plan with an EACA, that fails 401(k) or 401(m) discrimination tests (an EACA that is not a QACA has no discrimination testing safe harbor), may make corrective distributions without penalty within six months (rather than 2 ½ months) after the end of the plan year. An EACA requires automatic pre-tax deferrals at a uniform percentage of pay; investment of those deferrals in a qualified default investment alternative (QDIA) sanctioned by DOL regulations; and provision of initial and annual written notices similar to those required for a QACA.

The IRS has now issued proposed regulations for QACAs and EACAs. Plan sponsors and administrators may rely on the proposed regulations until final regulations are issued. Here are some of the highlights.

- The default deferral election under a QACA does not apply to employees who are eligible for the 401(k) plan immediately before the effective date of the QACA and who have made an affirmative election to participate or not to participate that remains in effect. A QACA may not be limited to new hires but must also apply to existing employees who have made no affirmative 401(k) election (including an election not to participate).

- Exceptions to the requirement that the deferral percentage under a QACA be uniform for all employees include (1) variations based on years of participation in the QACA (in fact, the minimum deferral percentage is required to increase with years of participation); (2) no requirement to reduce a higher deferral percentage that has been elected and is in effect when the QACA default percentage becomes effective; (3) restrictions required to comply with statutory limits on compensation, elective deferrals or total aggregate allocations; and (4) suspension of pre-tax salary deferrals following a hardship withdrawal. In the case of a suspension following a hardship withdrawal, the plan must provide for resumption of automatic pre-tax salary deferrals when the suspension period ends, at the deferral percentage that would have applied absent the suspension.
- The initial and annual notice requirements for QACAs and EACAs correspond to the notice requirements for QDIAs under final regulations recently issued by the DOL. The preamble to the proposed regulations explains that none of the notice requirements can be satisfied with a summary plan description, but a single document can be used to satisfy the notice requirements for all three kinds of arrangements.
- The IRS has posted a sample notice on its website that satisfies the requirements for all three arrangements included in a hypothetical 401(k) plan. Plan administrators may customize the sample notice to accommodate their own plans.
- Initial notices for QACAs and EACAs must be provided no later than the date an employee becomes eligible for the arrangement. Hence, if a plan provides for immediate eligibility when an employee is hired, the required notice may be provided on the first day of employment. Unlike the QDIA notice rules, however, this timing requirement for newly eligible employees is not conditional on the right to withdraw automatic contributions within the first 90 days.
- Ninety-day withdrawals under an EACA must be adjusted for gains and losses, and may be reduced by any generally applicable fees.
- Any matching contributions related to 90-day withdrawals of pre-tax salary deferrals must be forfeited, and can neither be returned to the employer nor distributed to the employee.
- Ninety-day withdrawals need not be made available to all employees who are eligible under the EACA.
- Ninety-day withdrawals may not be conditioned on an employee's ineligibility to make future pre-tax salary deferrals for a period of time. Such a restriction would violate the contingent benefit rule for 401(k) plans and the universal availability requirement for 403 (b) plans. The withdrawal election form, however, could provide a default election under which pre-tax salary deferrals would cease unless the employee affirmatively elected to make future deferrals.
- Pre-tax salary deferrals under an EACA, but not under a QACA, must be invested in a QDIA. The proposed regulations clarify that this requirement applies only to a plan that is otherwise subject to ERISA.

If you have questions or would like additional information about automatic contribution arrangements, please feel free to contact Brian J. Dougherty at 215-587-5919 or bdougherty@postschell.com.

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