# Benefit Insights



HEMBREE TPA

www.hembreetpa.com

HEMBREE TPA, INC.
13660 N. 94TH DRIVE, SUITE F-3
PEORIA, ARIZONA 85381
(623) 594-9542 • (888) 486-401K • (623) 594-9592 FAX



**A non-technical review of qualified retirement plan legislative and administrative issues** **December 2007**


## Default Investment Rules Facilitate Auto Enrollment

The increasing popularity of salary deferral plans has led to a rise in the number of retirement accounts that allow participants to self-direct their investments. Participants like it because it gives them control over their accounts which are at least partially funded by their own contributions. Employers like it because it reduces the investment responsibilities of plan fiduciaries.

Sometimes a participant may fail to give investment direction although the opportunity exists. A fiduciary must then invest the assets on behalf of the participant. This is more prevalent in plans using an automatic enrollment feature, which signs up an eligible employee at a specified deferral rate unless the employee elects otherwise. If election forms are not returned, the account is established and contributions are placed in a default investment.

In non-safe harbor plans, automatic enrollment can help passage of the average deferral percentage (ADP) and average contribution percentage (ACP) tests by increasing plan participation. This can result in higher contributions being allowed for highly compensated employees (generally owners and those earning over $100,000 in 2007). It also results in more money being saved for retirement which is beneficial in light of concerns about the social security system.

The Pension Protection Act of 2006 (PPA) created an “eligible automatic contribution arrangement” effective in 2008. Among other things, it requires default investments to meet certain guidelines. The Department of Labor (DOL) recently issued final regulations for a “qualified default investment alternative” (QDIA). This article will take a close-up look at the QDIA provisions and how they apply to automatic enrollment arrangements.

### Automatic Enrollment

The most common use of QDIAs will be under automatic enrollment provisions when employees fail to return participation election forms. But they can also be used any time a participant fails to exercise the right to direct investments.

PPA established criteria for eligible automatic contribution arrangements under which salary deferrals to a 401(k), 403(b) or 457(b) plan could

be automatically deducted at a specified rate unless the employee elects not to have the deduction or elects a different rate. Employees must receive a notice within a reasonable time before their eligibility and prior to each plan year explaining their right to elect not to participate or a different deferral rate from the default election. It must also explain how contributions will be invested in the absence of their election. Participants may be given a 90-day period during which they can request a return of their deferrals deducted without their election pursuant to an automatic enrollment program.

Plans that meet the eligible automatic contribution arrangement requirements are subject to relaxed rules for correcting a failed ADP or ACP test. This includes the extension of the 2½-month period for penalty-free corrective distributions to six months. In addition, fiduciaries are granted liability protection by using the default investments provided under the QDIA rules.

PPA also provided for a "qualified automatic contribution arrangement" which, like safe harbor 401(k) plans, automatically satisfies the ADP and ACP tests, as well as the top heavy requirements. The default election must be at least 3% the first year, 4% the second, 5% the third and 6% thereafter, not to exceed 10%. In addition, the employer must make either a 3% non-elective contribution for all non-highly compensated employees (generally non-owners and those earning less than $100,000 in 2007) or a match contribution of 100% of the first 1% deferred and 50% of the next 5% deferred. Employer contributions must be fully vested after two years of service.

The final regulations reiterate that any state law that directly or indirectly prohibits or restricts the inclusion in any plan of an automatic contribution arrangement is pre-empted by ERISA as amended by PPA.

## Qualified Default Investment Alternative (QDIA)

Employers who want to implement automatic enrollment can now do so without concern over fiduciary liability. Adherence to the guidelines of the final regulations will protect plan fiduciaries from exposure resulting from investment losses.

The new regulations were designed to meet the long-term retirement savings needs of each employee. A plan must meet the following requirements to satisfy the QDIA provisions:

- Assets must be invested in one of the allowable QDIA categories (see below);
- Participants must first be given an opportunity to provide investment direction;
- A notice must be provided to participants containing information about the QDIA and how to obtain information about the other investment options under the plan (see below);
- Materials concerning the QDIA investment, such as mutual fund prospectuses and proxy voting rights, which would normally be provided to participants allowed to self-direct, must be furnished to participants;
- Participants must be given the opportunity to transfer their QDIA investment to any other investment option allowed under the plan as often as the plan allows transfers by those who exercise investment control, but not less frequently than once within any three-month period;
- No fees or expenses can be charged for transfers or permissible withdrawals out of a QDIA during the first 90 days; and
- The plan must offer a broad range of investment alternatives in accordance with ERISA section 404(c) which governs participant-directed accounts.

## Allowable Investment Alternatives

In order to be considered a QDIA, the investment must be in one of the following categories:

- A mix of investments that takes into consideration a participant's age, projected retirement date or life expectancy (such as a life-cycle or target-retirement-date fund);
- A mix of investments which bases its investment risk on the participants of the plan as a whole (such as a balanced fund); or
- A professionally managed account that is diversified and considers the participant's age, projected retirement date or life expectancy.

With certain exceptions, employer securities cannot be part of a QDIA.

In addition, a capital preservation investment, such as a money market account, may be utilized during the first 120 days after which time it must be transferred into one of the three alternatives described above. This will preserve the principal in the event the participant requests a refund during the 90-day revocation period provided by some auto enrollment programs.

Investments that meet these guidelines will provide fiduciary protection under ERISA section 404(c) as if participants had exercised control over such assets. However, as is the case with all 404(c) participant-directed accounts, fiduciaries must still prudently select and monitor any qualified default investment alternative under the plan.

## QDIA Notice

The notice to participants must be written in a manner expected to be understood by the average participant and contain the following information:

- A description of the circumstances under which a participant's account may be invested in a QDIA and, if applicable, the circumstances under which deferrals will be deducted and contributed to the plan under an automatic enrollment program, including the deferral percentage and the participant's right to elect a different percentage or to decline participation;
- An explanation of the right of participants to direct the investment of the assets in their individual accounts;
- A description of the QDIA, including investment objectives, risk and return characteristics (if applicable) and any fees and expenses;
- A description of the right of participants whose accounts are invested in a QDIA to direct the investment of those assets to any other investment alternative available under the plan, including any restrictions, fees or expenses applicable to such transfer; and
- An explanation of where participants can obtain information about other investment alternatives under the plan.

The notice must be distributed at least 30 days prior to a participant's eligibility; 30 days before the first QDIA investment; or anytime up to the eligibility date if the participant can exercise the 90-day permissible withdrawal option in an automatic enrollment program. In addition, the notice must be given out at least 30 days prior to each subsequent plan year.

## Effective Date

The QDIA rules take effect on December 24, 2007. Default investments made prior to that date will be "grandfathered" if they meet certain requirements of guaranteed principal, rate of return and withdrawal without fees or surrender charges.

## Conclusion

The DOL's final regulations on QDIAs provide welcome guidance for employers utilizing automatic enrollment provisions in their salary deferral plans. Fiduciaries will now be protected when they establish default investments that meet the new guidelines. Now that these rules are in place, it is expected that automatic enrollment will significantly increase participation in salary deferral plans in the coming years.

## IRS and Social Security Annual Limitations

Each year the U.S. government adjusts the limits for qualified plans and social security to reflect cost of living adjustments and changes in the law. Many of these limits are based on the "plan year." The elective deferral and catch-up limits are always based on the calendar year. Here are the 2008 limits as well as the three prior years for comparative purposes:

| Limit | 2008 | 2007 | 2006 | 2005 |
|---|---|---|---|---|
| Maximum compensation limit | $230,000 | $225,000 | $220,000 | $210,000 |
| Defined contribution plan maximum contribution | $46,000 | $45,000 | $44,000 | $42,000 |
| Defined benefit plan maximum benefit | $185,000 | $180,000 | $175,000 | $170,000 |
| 401(k), 403(b) and 457 plan maximum elective deferrals | $15,500 | $15,500 | $15,000 | $14,000 |
| Catch-up contributions* | $5,000 | $5,000 | $5,000 | $4,000 |
| SIMPLE plan maximum elective deferrals | $10,500 | $10,500 | $10,000 | $10,000 |
| Catch-up contributions* | $2,500 | $2,500 | $2,500 | $2,000 |
| IRA maximum contributions | $5,000 | $4,000 | $4,000 | $4,000 |
| Catch-up contributions* | $1,000 | $1,000 | $1,000 | $500 |
| Highly compensated employee threshold | $105,000 | $100,000 | $100,000 | $95,000 |
| Key employee (officer) threshold | $150,000 | $145,000 | $140,000 | $135,000 |
| Social security taxable wage base | $102,000 | $97,500 | $94,200 | $90,000 |

*Available to participants who are or will be age 50 or older by the end of the calendar year.

This newsletter is intended to provide general information on matters of interest in the area of qualified retirement plans and is distributed with the understanding that the publisher and distributor are not rendering legal, tax or other professional advice. You should not act or rely on any information in this newsletter without first seeking the advice of a qualified tax advisor such as an attorney or CPA.

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13660 N. 94TH DRIVE
SUITE F-3
PEORIA, ARIZONA 85381