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IRS Response To President Obama's New Initiative Regarding Retirement Savings

The Internal Revenue Service ("IRS") has followed up on President Obama's Saturday afternoon call for more opportunities to save for a "rainy day." In particular, the IRS guidance relates to:

- Contribution of the value of unused paid vacation, sick and other leave ("paid time off") to a defined contribution plan;
- Automatic enrollment arrangements; and
- Required notice with regard to eligible rollover distributions.

Paid Time Off Contributions

Approximately fifty percent (50%) of Americans do not take all of their vacation.[1] For those employees with generous paid time off benefits, the paid time off is lost, banked over the tenure with the employer or, in some cases, paid out at termination. The IRS guidance addresses the circumstances under which a plan may be designed to permit a participant to contribute the value of unused paid time off. The guidance (Rev. Rul. 2009-31 and Rev. Rul. 2009-32) describes two paid time off contribution arrangements. The first allows a qualified retirement plan to permit or require a participant to contribute the value of unused paid time off on an annual basis. The second allows a qualified retirement plan to permit or require a participant to contribute the value of unused paid time off at termination of employment. A qualified retirement plan may permit the contribution of unused paid time off provided that the arrangement satisfies applicable qualification requirements, such as the nondiscrimination and limitations on annual contributions requirements.

Comments: In response to the downturn in the economy, many employers have reduced or eliminated employer contributions to 401(k) plans. To the extent paid time off is already accounted for as an expense, an employer may want to consider a plan amendment permitting employees to contribute unused paid time off annually and/or at termination of employment as an additional perk. Neither of these changes are permitted unless a timely amendment is adopted. Although the

1. "Half Of U.S. Workers Don't Use Vacation Time, Study Shows", *Information Week*, April 17, 2007.

guidance also contemplates non-elective contributions of unused paid time off (*i.e.,* without employees' choice), employers should carefully analyze whether state law permits such change to previously accrued paid time off.

The guidance discusses the two contribution arrangements in the context of profit-sharing 401(k) plans and does not specifically state whether such contributions arrangements are available under 403(b) tax-sheltered annuity plans. Given the similarities among these types of programs, the IRS may later be asked to specifically extend the contribution arrangement to such plans.

The guidance does not specifically address whether paid time off contributions would be subject to FICA taxes and we currently have pending with the IRS National Office a ruling request on this issue. Currently, nonelective employer contributions to a qualified plan are exempt from FICA taxes, but cash pay in lieu of vacation pay is not. The guidance only addresses the inclusion of the value of the unused paid time off in gross taxable income at the time of distribution from the plan.

Automatic Enrollment Arrangements

The Pension Protection Act of 2006 ("PPA") amended the Internal Revenue Code ("Code") to facilitate automatic enrollment arrangements which permit employers to enroll employees who fail to make an affirmative election to contribute to a qualified retirement plan. PPA also amended the Code to permit a design-based discrimination safe harbor automatic enrollment arrangement and to permit the withdrawal of automatic contributions under certain circumstances. Although employers have adopted plans containing the designed-based discrimination safe harbor and/or permitting the withdrawal of automatic contributions, the IRS had yet to provide model language for this purpose. In addition, as employers seek to increase the amount contributed by all participants, questions remain regarding how a plan could implement an automatic increase feature.

Sample Amendments

The IRS guidance (Notice 2009-65) provides two sample amendments that can be used to adopt an automatic enrollment arrangement. A plan sponsor is not required to adopt either amendment verbatim and may revise the language to fit the desired design. The first sample amendment may be used for a simple automatic enrollment arrangement. The second sample amendment is meant to be used to comply with the rules for eligible automatic contribution arrangements ("EACA") whereby a participant may withdraw amounts automatically contributed under certain circumstances.

Comment: The EACA sample amendment specifically permits a participant to withdraw amounts automatically contributed and still contribute to the plan by affirmative election. Eligible employees can withdraw the money contributed during the first ninety days without being subject to the ten percent (10%) early distribution penalty.

Although originally required by PPA, Congress subsequently eliminated the requirement that automatic contribution amounts under an EACA be invested in a qualified default investment alternative ("QDIA"). Despite the elimination of this requirement, the second sample amendment specifically provides that amounts automatically contributed will be contributed to a QDIA. Most employers will likely design the automatic enrollment arrangement to invest automatic contributions into a QDIA in order to take advantage of the protection the QDIA affords a fiduciary with respect to losses sustained by participants who are automatically enrolled. However, the inclusion of this provision in the sample amendment emphasizes the need for an employer to seriously consider what to use as a default investment if that default investment does not currently comply with the QDIA rules.

Automatic Increases

Current law permits three types of automatic enrollment arrangements: (1) a simple automatic enrollment arrangement, (2) the designed-based discrimination safe harbor or qualified automatic contribution arrangement ("QACA") and (3) the permissive withdrawal EACA. QACAs and EACAs are subject to certain uniformity rules relating to the percentage that is contributed on behalf of each similarly situated employee while simple automatic enrollment arrangements are not. Because non-QACA and non-EACA automatic enrollment arrangements are not subject to these uniformity rules, the guidance makes clear (1) a yearly automatic increase is permissible and (2) the method for calculating the increase need not result in a uniform percentage for similarly situated participants.

The guidance also addresses the timing of the automatic increase required under a QACA. The Code requires that a QACA provide an automatic increase in the applicable percentage as of the first day of the applicable plan year. Prior to the issuance of the guidance, practitioners construed this requirement narrowly to mean that such increases could only occur on the first day of a plan year. However, the guidance makes clear that a QACA can be designed to implement the required increase at any time during a plan year provided that the plan otherwise satisfies the QACA requirements.

Comments: The clarifications made by the guidance provide additional latitude in designing an automatic enrollment arrangement. For example, an employer may wish to consider imposing a greater percentage increase on non-highly compensated employees to help with non-discrimination testing in simple automatic enrollment arrangements or to make the automatic increase in a QACA apply on a specific date that coincides with base salary increases.

Required Notice with Respect to Eligible Rollover Distributions

Over the last several years, the rules regarding eligible rollover distributions have changed. An eligible rollover distribution is a payment that may be rolled over to an eligible retirement plan such as an individual retirement account or eligible employer plan. At the time a distibutee becomes eligible to receive an eligible rollover distribution, the plan administrator of the distributing plan, such as a plan qualified under Code Section 401(a), a plan described in Code Section 403(a), an eligible Code Section 457(b) plan maintained by a governmental employer or Code Section 403(b) tax-sheltered annuity plan, is required to provide a written explanation describing certain federal tax rules that apply to the eligible rollover distribution. A plan administrator is deemed to have provided the required content if the plan administrator uses the IRS model Code Section 402(f) notice. The written explanation must be provided within a reasonable period of time (*e.g.* no less than 30 days (subject to waiver) and no more than 180 days before the date on which the distribution is made). The IRS has updated the model notice to reflect all of the changes. In doing so, the IRS now provides two separate model notices.

The first model applies to distributions that are not from a designated Roth account. The second model applies to distributions from a designated Roth account. In the IRS guidance (Notice 2009-68), the IRS recommends that the second model should only be provided if the distribution is from a designated Roth account and that both models be provided if the eligible rollover distributions are from both a designated Roth account and from an account other than a designated Roth account.

The guidance clarifies that to the extent the tax treatment of distributions or other provisions described in the model language is changed after September 28, 2009, the new models may no longer be used to satisfy the content requirement. The current IRS safe harbor model notice appropriately modified will continue to be deemed to satisfy the content requirements through December 31, 2009. The IRS says that it expects to publish a Spanish translation.

Comments: The current model notice as modified to reflect changes in the law can be confusing with respect to participants in plans that do not permit designated Roth contributions. The creation of two separate model notices will alleviate such confusion.

The guidance emphasizes the need for each plan administrator to ensure that the required written explanation reflects subsequent changes in the law.

If you have any questions regarding the IRS guidance, please contact a member of the Employee Benefits and Executive Compensation Practice Group. ■

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