DrinkerBiddle

Employee Benefits &
Executive Compensation Client Alert
September 2009

Automatic Enrollment — Paid Time Off Contributions — 404(c) and Mutual Fund Prospectus

Recent Defined Contribution Plan Guidance

This Alert highlights recent guidance regarding (1) automatic enrollment features in 401(k) plans, (2) the contribution of unused paid time off to tax-qualified defined contribution plans as either employer contributions or employee salary deferral contributions, and (3) the permissibility of distributing a mutual fund's "Summary Prospectus" to participants to satisfy one of the requirements for limited fiduciary protection under section 404(c) of the Employee Retirement Income Security Act of 1974 (ERISA).

Automatic Enrollment

Under automatic enrollment, a percentage of an employee's compensation is automatically deferred into a 401(k) plan without the employee's affirmative election, unless and until the employee elects that a different percentage (or no percentage) be deferred. The IRS guidance clarifies the rules for escalating the automatic deferral percentage under an automatic enrollment arrangement. The guidance also includes sample amendments that may be used to add an automatic enrollment feature. The sample amendments are not required, but shed light on previously unclear issues:

- It was previously unclear, in the case of certain types of automatic enrollment arrangements, when employees should be notified. The sample amendments suggest time periods for providing required notices to eligible employees regarding the automatic enrollment feature under all such arrangements. Specifically, an annual notice should be provided 30 to 90 days before the start of each plan year. If an employee does not receive the annual notice because he or she becomes eligible after it was provided, the employee should be given the notice no later than the date he or she becomes eligible (but no more than 90 days in advance).

- An amendment adding an automatic enrollment arrangement to an existing nongovernmental 401(k) plan may be adopted as late as the last day of the plan year in which the arrangement is first effective – as long as the plan is not a "safe harbor" plan. Under a safe harbor plan, certain nondiscrimination tests (the ADP and/or ACP test) do not have to be conducted. Generally, in safe harbor plans, the amendment must be adopted before the beginning of the plan year (with certain exceptions for plans that are using the "contingent" safe harbor rule and plans that adopt a Pension Protection Act (PPA) safe harbor by the PPA amendment deadline).

Paid Time Off Contributions

The IRS has provided guidance regarding contribution of the cash-equivalent of unused time under a sick and vacation leave plan (PTO) to a qualified defined contribution plan. The guidance discusses contributions made where the employee does not have the option of receiving cash (nonelective employer contributions) and contributions where the employee has the option to receive cash or make the contribution (elective contributions). To provide an idea of the permissible arrangements from the IRS's standpoint, we list below in very general terms several arrangements approved by the IRS, where the PTO program is available to all employees on substantially the same basis, based on years of service.

- Under the PTO program, employees may not carry over unused PTO from year 1 to year 2. The cash equivalent of any unused PTO for year 1 is contributed to the qualified defined contribution plan for year 1, subject to Internal Revenue Code limits (this is a nonelective contribution). To the extent the contribution cannot be made to the qualified plan, the cash equivalent is paid to the employee in year 2.

- Under the PTO program, a limited amount of unused PTO may be carried over from year 1 to year 2. Unused PTO in excess of the carryover limit will be (a) paid to the employee in cash in year 2, or (b) if the employee makes a timely election, contributed to the 401(k) plan – as an elective contribution – for year 2 (subject to Internal Revenue Code limits).

- Under the PTO program, a limited amount of unused PTO may be carried over from year 1 to year 2. Unused PTO in excess of the carryover limit is forfeited. If an employee terminates, the unused PTO is forfeited under the PTO program, and the cash equivalent of the unused PTO (up to the carryover limit) is contributed to the qualified defined contribution plan within one month after termination, subject to Internal Revenue Code limits (this is a nonelective contribution). To the extent the contribution cannot be made to the qualified plan, the cash equivalent is paid to the employee within 60 days after termination.

> Under the PTO program, a limited amount of unused PTO may be carried over from year 1 to year 2. Unused PTO in excess of the carryover limit is forfeited. If an employee terminates, the cash equivalent of the unused PTO up to the carryover limit is (a) paid to the employee in cash within one month after termination, or (b) if the employee makes a timely election, contributed to the 401(k) plan – as an elective contribution – on the same date cash would have been paid to the employee absent a deferral election (subject to Internal Revenue Code limits).

Please contact us for assistance in designing such a program, applying state law to determine if the PTO program is permissible and applying the qualified plan contribution limits and nondiscrimination tests to the contributions. For nonelective contributions, it may be difficult to predict whether the nondiscrimination test will be satisfied, unless the contribution is limited to nonhighly compensated employees. For terminations close to the end of the year in a program with nonelective contributions, the plan design may need to limit contributions to less than 100 percent of the cash equivalent of the unused PTO to comply with the limits of section 415 of the Internal Revenue Code.

Mutual Fund Prospectuses

Under ERISA section 404(c), a qualified plan fiduciary may be relieved of liability for any losses that are the direct and necessary result of investment instructions given by a participant – if certain requirements are met. One of the requirements is to provide participants a copy of the most recent mutual fund prospectus provided to the plan, upon request and when they first make their investment in the mutual fund. The regulations do not define the term "prospectus." In January 2009, the Securities and Exchange Commission issued new rules allowing mutual funds to provide only a "Summary Prospectus" to investors, as long as both the Summary Prospectus and the more exhaustive "regular" prospectus are available on-line at a specified website address, and in paper or by e-mail upon request. The Department of Labor has concluded, in Field Assistance Bulletin 2009-03, that qualified plan fiduciaries can satisfy their obligations to provide a mutual fund prospectus under ERISA section 404(c) by providing the Summary Prospectus, if that is the most recent prospectus provided to the plan.

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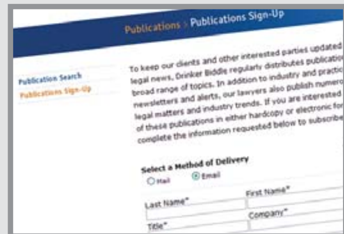

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