Negative Elections Under a 401(k) Plan Permitted
Under IRS Revenue Ruling 98-30
Introduction

A question frequently asked by employers who sponsor 401(k) plans is “How can we increase participation in our plan?” Usually, a way to increase participation in a 401(k) plan (e.g. matching contributions) will involve additional cost to the employer, generally without any guarantee of success. However, there is one answer that can work, without requiring additional cost. It is called “negative election.”

What are Negative Elections?

Under a typical 401(k) plan, the employee must make an affirmative election to make salary reduction contributions (deferrals) to the plan, thus employees who fail to turn in their enrollment forms do not have deferrals made to the plan on their behalf. This means that employees who are undecided about whether to defer, or never get around to filling out the paperwork, etc., are deemed to have elected not to defer. Non-participation by these employees can cause the plan to fail the 401(k) discrimination test, or produce significantly lower contribution levels for highly compensated employees. Failed discrimination test refunds, or limits on the deferrals of highly compensated employees, often create a public relations nightmare for the employer.

What if an employer could automatically withhold a percentage of an employee’s wages for deposit into the plan if that employee failed to return the election forms? Under this arrangement, deferrals on behalf of an employee would begin because of their non-action rather than because of their action.

This is now possible. The Internal Revenue Service (IRS), in Revenue Ruling 98-30, determined that salary reduction contributions did not have to be made by an affirmative election, and approved a company’s proposed “negative elections” (also known as an automatic election) for deferrals made to its 401(k) plan.

Advantages

Through the use of negative elections, plan sponsors can significantly increase the participation in their 401(k) plans. Such increase has two important results:

- Increased participation will generally result in more favorable 401(k) discrimination test results. The more favorable the test results, the greater the level of contribution available to the highly compensated employees of the plan. While there are limited statistics on the use of negative elections, the available information suggests that participation in a 401(k) plan may increase by as much as 20% over pre-negative election enrollment.

- Increased participation also means that more employees are saving for retirement.
What is the level of contribution to apply to a negative election?

While Revenue Ruling 98-30 approved the negative election design using a 3% deferral rate as a model, this does not mean that 3% is the magic number. The deferral rate can be higher or lower than 3%, depending upon the make-up of the employer’s workforce. Most employers who have adopted negative election are using either a 2% or 3% deferral rate.

What are some significant issues involved in implementing negative elections?

A number of issues must be addressed before converting a 401(k) plan to negative election.

State Laws

One of the most important is whether the use of negative election needs to comply with state laws regarding withholding from employee paychecks. Many states require at least a signed written consent from the employee, and some require that the spouse agree in writing to the withholding as well.

Revenue Ruling 98-30 does not address this issue. The U. S. Department of Labor (DOL) has been asked to rule that federal law regarding employee benefits preempts state laws in the area of deferrals to qualified retirement plans. If this preemption applies, then the state laws would not be applied to the negative election provision in a 401(k) plan. Until there is a universal ruling/determination made by the IRS and/or the DOL, an employer should confirm whether his/her state laws would interfere with the implementation of the negative election provision.

One request to review a similar issue was filed and concluded by the DOL before the IRS issued Revenue Ruling 98-30. In its Advisory Opinion 94-27A, the DOL was asked to determine whether New York law was preempted. In that request, a financial institution wanted to permit 401(k) plan participants to change their deferral elections using telephonic and voice response systems rather than by using paper forms. The DOL stated that, in its opinion, the New York law, which would seem to prevent electronic deferral election changes, was preempted by federal law.
In 1999 (after the issuance of Revenue Ruling 98-30), the nationally renowned law firm of Reish & Luftman (now Reish, Luftman, McDaniel & Reicher) requested the DOL to expand its 1994 advisory opinion. In its application for review of the laws of the states of Arizona, California, and New York and the application of negative elections, the firm stated:

we request a much broader opinion, covering the whole question of whether state law must be complied with for any deferral election, whether written or electronic, whether it is the initial election or a change, whether a written signature is obtained or not, and whether the election is affirmative or negative. We are requesting that the DOL reaffirm Advisory Opinion 94-27A in this expanded context.

That request is currently pending with the DOL. If the DOL determines that the preemption is to be applied in the proposed expanded context, employers should be able to implement negative election provisions for their 401(k) plans without having to determine whether state laws interfere.

Service Providers

Another important issue is what paperwork (or lack thereof) service providers are willing to accept before they will include an employee as a participant in a plan. It is important to address the concept with the investment provider and recordkeeper for the plan to work out the mechanics of the negative election.

In determining how to implement the negative elections, the employer must decide:

- When the employee will be given notice of the negative election - when he/she is first employed, when he/she becomes eligible to participate, or both?
- How long will the employee have to make a decision before the negative election is implemented?
- What about existing employees who are already eligible and are not participating? How will the change to negative election be communicated to those employees? And who will provide the communication?
Service Providers (continued)

The employer must proceed carefully with employee communications for the following reasons:

- A change to negative election must be done in a manner that emphasizes the advantages to the employees and clearly communicates that the employee is the final decision-maker on whether to defer and in what amount.

- It should be pointed out that the default election is being adopted to facilitate participation in the plan.

- The employer should make certain that the negative election is clearly and adequately disclosed to the employees.

If these matters are addressed carefully, the employee cannot later claim that the employer did not give him/her a real opportunity to make an informed election.

Investment Direction

An important issue is the investment of the contribution from the negative election if the participant does not make any investment direction. While ERISA Section 404(c) may serve to relieve certain fiduciaries from liability when participants or beneficiaries exercise control over the assets in their individual accounts, the DOL has taken the position that a participant or beneficiary will not be considered to have exercised control when the participant or beneficiary is merely apprised of investments that will be made on his/her behalf in the absence of instructions to the contrary. Consequently, the trustees of the 401(k) plan retain full responsibility for the investment of negative election contributions in the absence of investment direction by the affected participant.

How many employers sponsor 401(k) plans that have negative elections?

Most surveyed plans do not automatically enroll an employee absent the employee’s election to participate. A survey of 491 employers conducted by Hewitt Associates found that employers that have adopted negative enrollment provisions for their plans have increased from 4% in 1997 to 7% in 1999 of the employers surveyed.

The survey also found that of the plans that provide negative elections, 70% of the plans invest the contributions made through default in a money market fund or a stable value fund. Another 22% of the plans use an asset-allocation fund (balanced) or lifestyle fund as the default investment option.

Further, according to the survey, 52% of plans that have negative election provisions use 3% as the default rate of contribution. Another 35% of plans that have negative election provisions use 2% as the default rate of contribution.