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Electronic Notices and Consents: The IRS Issues Final Regulations

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The Internal Revenue Service has issued final regulations interpreting how the Electronic Signatures in Global and National Commerce Act (E-SIGN) applies to the requirements that certain plan documents be "in writing." The regulations may not change current practices significantly, but they offer plan sponsors an opportunity to review and, if necessary, enhance their procedures.

Despite its much publicized national campaign to promote electronic filing of tax returns, the Internal Revenue Service (IRS) has taken a cautious approach when considering the use of electronic notices and consents for employee benefits purposes. The widespread use of third party administrators that rely on electronic communications put pressure on the Service to provide a more flexible definition of what constituted "written consent" or "notice." This pressure increased with the passage of the Electronic Signatures in Global and National Commerce Act (E-SIGN) in 2000, which essentially mandated acceptance of electronic "writings" and signatures in lieu of traditional writing if certain conditions are met.

The IRS had issued regulations permitting use of electronic or "paperless" communications prior to E-SIGN. These regulations allowed certain notices and consents to be provided electronically in prescribed circumstances.[1] Participant consents to distributions and notices to interested parties of a filing of a determination letter request are examples. Spousal consents could not be provided electronically.

The IRS' response to E-SIGN was to reconsider the use of electronic media with respect to its various "writing" requirements and to consolidate in one place its rules for electronic "writings." Those rules, which only apply to requirements under the Internal Revenue Code, are in new Section 1.401(a)-21 of the IRS regulations.

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Scope of the Regulations

The so-called E-SIGN regulations apply when IRS rules require that employee benefit plan communications to or from a plan participant be in writing. Examples provided in the preamble to the regulations (Preamble) are the "402(f) notices" describing taxation of distributions, the 204(h) notices of reductions in accrued benefits, and the joint and survivor benefit explanations required under Section 417 of the Code.[2]

The new regulations apply to most statutory employee benefit plans, including:

- Retirement plans such as 401(k) and pension plans, Section 403(a) and 403(b) plans, simplified employee plans (SEPs), Savings Incentive Match Plans (SIMPLEs) and 457(b) plans;
- Cafeteria plans, medical plans, insurance plans, educational assistance plans, qualified transportation plans, medical savings accounts and health savings accounts; and
- IRAs.

The regulations can also be used as a "safe harbor" for benefit plan notices or consents that are not required to be in writing, such as beneficiary designations. They only apply to employee benefit plan notices, consents and communications; they do not apply to Internal Revenue Code requirements relating to tax reporting, substantiation of expenses, or recordkeeping.[3]

Under E-SIGN, the agency responsible for any requirement that a document be "in writing" must apply the rules of E-SIGN to its "writing requirements." That is why the IRS has interpreted the application of E-SIGN to participant consents and notices required under the Code or IRS regulations. But that is also why the regulations do not apply to notices, election or consent requirements that are required under Titles I or IV of ERISA; that is, those requirements subject to the jurisdiction of the Labor Department or the PBGC. Therefore, the regulations do not deal with electronic distribution of SPDs or summary annual reports. Similarly, the regulations do not apply to COBRA notices or suspension of benefits communications because the IRS shares authority with the Labor Department in these areas.

Electronic Media Basic Requirements

The regulations make clear that any electronic notices and consents must meet all other applicable requirements for the content and timing of the notice. For example, an electronic 204(h) notice must meet the timing and content requirements for those notices. The regulations also set forth two basic rules that must be followed when electronic media is used. These requirements are in addition to any other specific rules involving notice and consents.

First, the electronic system used must be reasonably designed to provide the information to the recipient in a manner no less understandable to him than if provided on a written paper document.

Second, the electronic system must be designed to alert the recipient of the significance of the information being provided and set forth any instructions needed to access the notice in a reasonably understandable manner.

Note that in addition, records that must be kept can be electronic if they are in a form that can be retained and reproduced for future reference.

Specific Methods of Providing Electronic Notice

The regulations set forth two ways to provide electronic notices. The first is the "consumer consent" method, which is the method generally required for electronic notices provided to "consumers" under E-SIGN. The second method is a method established by the IRS and permitted as an alternative to the consumer consent notice under E-SIGN.

Under the "consumer consent" method, the participant must affirmatively consent to receive the applicable notice in an electronic form, in a manner that demonstrates that the participant can access the notice (*e.g.*, electronic confirmation of information set forth in the notice). The participant must be provided with a right to receive a paper copy of the information and the right to withdraw consent to receive electronic notices. These rules are likely to be too difficult for most plans to administer and in fact are generally stricter than the rules the IRS initially permitted for "paperless" notices prior to E-SIGN. The IRS resisted any changes to its proposed regulations interpreting the "consumer consent" rules, arguing that most plan administrators will use the alternative method described below.

Under the alternative method, notices may be provided electronically if (1) the participant can "effectively" access the notice electronically and (2) if the participant is told that he or she may receive a paper version of the notice at no charge.[4] It is anticipated that most plans will use this alternative method rather than the "consumer consent" method.

The regulations stress that participants must be "effectively able to access" the electronic media through which notices are sent or an election is made. Many have interpreted this to mean that either the participant regularly use a computer at work or have access to a kiosk or workstation where the materials can be accessed easily and privately. In many cases, for example, plans often provide employees electronic notices, but mail paper notices to vested terminated former employees.

Requirements for Elections

For elections to be made electronically, a system that is "reasonably designed to preclude any person other than the appropriate individual from making the election" must be used. The regulations note that the reasonableness of any security method depends in part on whether the potential for conflicts of interest exist, such as spousal consents. This requirement probably would be satisfied by use of a PIN number in most cases. The system must give the participant a "reasonable" opportunity to review, confirm, modify or rescind the election before it is effective. It is not clear how "reasonable" is to be interpreted here; for example, most plans do not require a "cooling off" or "waiting period" for elections to be effective unless required by law (such as the joint and survivor election). Finally, the participant must receive confirmation of his or her election, either through a written paper document or using an electronic medium that satisfies these regulations.

As discussed above, a precondition to a valid electronic election is the participant's ability to access the electronic media. If participants cannot effectively access the electronic media, the notice or election would not be valid. Furthermore, the Preamble to the final regulations hints that the plan might be disqualified in this case because there may be a violation of the requirement of nondiscriminatory "benefits, rights and features" under Section 401(a)(4) or failure to follow plan terms (*i.e.*, if no election is effectively available, then the plan has not followed its own election procedures).

Special Rules for Consents Requiring Witnesses

The IRS' earlier regulations governing paperless transactions did not allow "non-paper" spousal consent. But the new regulations do allow this. However, some elections, such as waivers of a joint and survivor annuity by a participant's spouse, must be witnessed by a plan representative or notary public. This is specifically required by Section 417(a)(2) of the Internal Revenue Code.

Such witnessing can be done electronically pursuant to E-SIGN and these regulations, if the signature of the individual is witnessed in the physical presence of the plan representative or notary public and if applicable state law recognizes the electronic notarization. The Preamble to the final regulations indicates that the IRS specifically rejected the idea that the use of special PINs for spouses would provide sufficient protection in this case. Given these constraints, it is not clear how popular electronic "witnessing" will be.

Application of the Rules

An example in the regulations illustrates how the IRS thinks they should be applied and contrasts the "consumer consent" and alternative method of electronic communication.

> *Facts involving using the consumer consent requirements to deliver a section 402(f) notice via e-mail.* Plan A, a qualified plan, permits participants to request benefit distributions from the plan on Plan A's Internet Web site. Under Plan A's system for such transactions, a participant must enter his or her account number, personal identification

number (PIN), and his or her e-mail address to which the notice is to be sent. The participant's PIN and account number must match the information in Plan A's records in order for the transaction to proceed. Participant H requests a distribution from Plan A on Plan A's Web site, and, at the time of the request for distribution, a disclosure statement appears on the computer screen that explains that Participant H can consent to receive the section 402(f) notice electronically. The disclosure statement provides information relating to the consent, including how to receive a paper copy of the notice, how to withdraw consent, the hardware and software requirements, and the procedures for accessing the section 402(f) notice, which is in a file format from a specific spreadsheet program. After reviewing the disclosure statement . . . , Participant H consents to receive the section 402(f) notice via e-mail by selecting the consent button at the end of the disclosure statement. As a part of the consent procedure, an e-mail is sent to Participant H's e-mail address in order to demonstrate that Participant H can access the spreadsheet program. In the e-mail, Participant H is prompted to answer a question from the spreadsheet program, which is an attachment to the e-mail. Once Participant H correctly answers the question, the section 402(f) notice is then delivered to Participant H via e-mail.

Facts involving using the alternative method to deliver a section 411(a)(11) notice via e-mail. Plan B, a qualified plan, permits participants to request benefit distributions from the plan on Plan B's Internet Web site. Under Plan B's system for such transactions, a participant must enter his or her account number and personal identification number (PIN), and his or her e-mail address to which the notice is to be sent. The participant's PIN and account number must match the information in Plan B's records in order for the transaction to proceed. After Participant K, a single employee, requests a distribution from Plan B on Plan B's Internet Web site, the plan administrator provides Participant K with a section 411(a)(11) notice in an attachment to an e-mail. Plan B sends the e-mail with a request for a computer generated notification that the message was received and opened. The e-mail instructs Participant K to read the attachment for important information regarding the request for a distribution. In addition, the e-mail also states that Participant K may request the section 411(a)(11) notice on a written paper document and that, if Participant K requests the notice on a written paper document, it will be provided at no charge. Plan B receives notification indicating that the e-mail was received and opened by Participant K.

Facts involving making a participant's consent to a distribution. In order to consent to a distribution, Plan B requires a participant to enter the participant's account number and PIN in order to preclude any person other than the participant from making the election. After

> the authentication process, Participant K completes a distribution request form on the Web site. After completing the request form, the Web site provides a summary of the information entered on the form and gives Participant K an opportunity to review or modify the distribution request form before the transaction is completed. Within a reasonable period of time after Participant K consents to the distribution, the plan administrator, by e-mail, sends confirmation of the terms (including the form) of the distribution to Participant K and advises Participant K that, upon request, the confirmation may be provided to Participant K on a written paper document at no charge. Plan B retains an electronic copy of the consent to the distribution in a form that is capable of being retained and accurately reproduced for later reference by Participant K.[5]

Conclusion

These regulations are effective January 1, 2007. Many administrators have been following the procedures set forth in the proposed regulations (which were not changed significantly) so should be able to adapt to the final regulations. Finally, the IRS recognizes that electronic systems change and anticipate that new procedures (particularly with respect to witnessed consents) may be able to be used in the future.

NOTES

1. *See, e.g.*, Treas. Reg. § 1.7476-2(c)(2) (notice to interested parties); Notice 2000-3, 2000-1 C.B. 413 (use of electronic media for 401(k) safe harbor notices).

2. *See* T.D. 9294, 71 Fed. Reg. 61877 (Oct. 20, 2006).

3. Treas. Reg. § 1.401(a)-21(a)(3).

4. Treas. Reg. § 1.401(a)-21(c) and (d).

5. Treas. Reg. § 1.401(a)-21(f) (Examples 1 and 2).