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ERISA Advisory

New Illinois Law Requires Employers to Enroll Employees in Payroll Deduction IRAs

On December 3, 2014, the Illinois legislature passed the Illinois Secure Choice Savings Program Act (the Act or the Program). 30 ILCS 105/5.855 (Dec. 3, 2014). The Program will not be effective for at least 24 months (Act §60). The Act requires private sector employers that do not already maintain a retirement plan to enroll their employees in automatic "payroll deposit retirement savings arrangements" and to remit after-tax payroll deductions to a separate trust fund (State Fund or Fund) established by a state-run board (Act §15). Illinois thus joins the ranks of the several states that have made varying attempts to require private-sector employers to make contributions to payroll deduction IRAs. (See e.g., the California Secure Retirement Savings Trust Act, signed into law by California governor Jerry Brown on September 28, 2012.)

Outgoing Democratic Governor of Illinois Patrick Quinn signed the Act on January 4, 2015, and the Act becomes effective on June 1, 2015. The Act provides, however, that implementation must occur within 24 months of the effective date (Act §60), but only after the Illinois Secure Savings Board obtains adequate "start-up" funds for implementation (Act §93) and obtains a ruling from the Department of Labor as to whether the Employee Retirement Income Security Act (ERISA) applies to the Program. Act §95. The Act further provides that the Program will not be implemented if "the IRA arrangements offered under the Program fail to qualify for the favorable federal income tax treatment ordinarily accorded to IRAs under the Internal Revenue Code [(the Code)] or if it is determined that the Program is an employee benefit plan and state or employer liability is established under [ERISA]." Act §95. An IRA for this purpose is defined under the Act as "a Roth IRA under Section 408A" of the Code. Act §5.

The concept of a "payroll deduction IRA" has been around for a long time, and both the IRS and the Department of Labor have previously expressed their views on the concept. In Announcement 99-2, the IRS noted that "employers may permit employees to contribute to traditional or Roth IRAs by direct deposit through payroll deduction" and that "the introduction of Roth IRAs in 1998 presents an additional opportunity to facilitate employee retirement savings." The DOL, in Interpretative Bulletin 99-1, discussed below, set forth conditions under which an employer-provided payroll deduction IRA might be exempt from ERISA under DOL Regulation Section 2510-3.2(d). In a recent Information Letter, the DOL also expressed the view that that an employer whose employees participate in the federal *my*RA program would not be establishing or maintaining an "employee pension benefit plan" under ERISA § 3(2) based solely on the fact that the employer allows payroll deductions, submits contributions, distributes information, facilitates employee enrollment, and otherwise encourages employees to make deposits to *my*RA accounts. See DOL Information Letter dated December 15, 2014, from Joe Canary of the DOL to Mark Iwry of Treasury (*my*RA Letter). As explained below, however, there are important differences between the federal *my*RA program and the Illinois Program, and there is an open question whether a state law requiring employers to participate in a state-run payroll deduction IRA program is preempted by Section 514(a) of ERISA, which generally overrides state laws that "relate" to employee benefit plans.

Who is Affected by the Act?

The Act applies to Illinois employers, including "any person or entity engaged in a business, industry, profession, trade, or other enterprise in Illinois, whether for profit or not for profit that (i) has at no time during the previous calendar year employed fewer than 25 in the state; (ii) has been in business at least two years; and (iii) has not offered a qualified retirement plan," including but not limited to a plan qualified under Code Section 401(a) (qualified pension or profit-sharing plan), 401(k), 403(a) (tax-qualified annuity plan), 403(b) (deferred annuity plan for certain tax-exempt employers), 408(k) (SEP plan), Section 408(p) (SIMPLE plan) or Section 457(b) ("eligible" tax-exempt deferred compensation plan) in the preceding two years (an Employer). Act §5. Under the Act, a "small employer" with fewer than 25 employees or in business in Illinois for less than two years may voluntarily participate. An "employee" under the Act is broadly defined as "any individual who is 18 years of age or older, who is employed by an employer, and who has wages that are allocable to Illinois during a calendar year" under the Illinois Income Tax Act. Act §5. The Act does not specify that an employee must be employed for any length of time or must work a specified number of hours.

Under the Act, any employer who fails to enroll an employee will be subject to a penalty of $250 per employee who was neither enrolled nor elected to opt out of participation by the applicable deadline. The penalty increases to $500 per employee still unenrolled (without having opted out) for each calendar year after the initial penalty assessment. Act §85.

What does the Act Require?

The Act requires that, unless an employee opts out of the Program or elects to change the amount of the contribution, each Employer will automatically deduct, by payroll deduction, three percent of the employee's after-tax compensation (as defined for IRA purposes under Section 219(f)(1)) and contribute it to the State Fund on the employee's behalf. Act §60(c). The State Fund will maintain an individual retirement account for each employee for whom the payroll deduction contribution was made. The Act does not require any Employer to make employer contributions to the Fund.

The Act permits employees to direct the investment of their individual accounts among investment funds approved by the Board. The Board will act as the trustee of the Fund. Act §§ 45, 60(b). Each individual retirement account will be periodically credited with earnings and losses attributable to the employee's investment elections, and the employee's benefit under the Program will be equal to the employee's account balance. Act §50. The individual accounts are expected to work like Roth individual retirement accounts under Section 408A. Thus, the contributed amounts plus earnings, when paid, will not be subject to further tax. Illinois currently does not impose any state income tax on IRA distributions, and, if the Program is determined to satisfy the requirements as a Roth IRA, federal income tax will not apply, either.

The Act specifies that an Employer can always, in lieu of compliance, establish an Employer-sponsored retirement plan, including, but not limited to, a defined benefit plan, a 401(k) plan, a Simplified Employee Pension (SEP) plan, or Savings Incentive Match Plan for Employees (SIMPLE) plan, or to offer an automatic enrollment payroll deduction IRA, instead of having a payroll deposit retirement savings arrangement under the Program. Act §60(g)-(i). In fact, the Board is required to establish a website to help employers find vendors to set up employer-sponsored plans, but only if the Board determines that there is enough employer interest in the website. In contrast to a payroll deduction IRA under the Act, a 401(k) plan, for example, allows employees to make contributions on a pre-tax basis and may provide for employer contributions.

Employees enrolled in the State Fund (called Enrollees under the Act) are permitted to designate a contribution amount expressed as either a percentage of wages or as a dollar amount, and may change their contribution level at any time. If an employee fails to opt out (i.e., fails to elect a contribution of $0) or select a different contribution level, the employee's contribution will be (and his or her wages will

automatically be reduced by) three percent, provided that such contributions do not cause the employee's total IRA contributions for the year to exceed the deductible amount for IRAs under Section 219(b)(1)(A) (currently $5,500 for individuals under age 50 and $6,500 for those who are older). Act §60(c). Although an employee can change the contribution level or opt out at any time, an Employer is permitted to establish an open enrollment period during which an employee who opted out can opt back in.
The Act does not specify any requirements as to how individual accounts are to be paid to Enrollees upon retirement.

How Will the Program be Communicated to Employees?

The Act requires the Board to design information packets and disclosure forms for Employers and for employees. The Employers will be required to disseminate the employee information packets to their employees prior to the opening of the Program. Act §55. The employee information packet will contain a disclosure form explaining the benefits and risks associated with the Program, the mechanics of making contributions, how to opt out, how to change the level of employee contributions, the Fund's withdrawal processes, and how to obtain additional information. The disclosure must also state that employees seeking financial advice should contact a financial advisor, that participating employers are not in a position to provide financial advice, that participating employers are not liable for employee decisions under the Act, that the Program is not an employer-sponsored retirement plan, and that the Program not guaranteed by the state.

Who Pays the State Fund's Administrative Costs?

The Act establishes an administrative fund to pay administrative expenses under the Plan. Act §16. It is intended that the administrative fund will hold "any grants or other moneys designated for administrative purposes from the State, or any unit of federal or local government, or any other person, firm, partnership, or corporation" that may contribute. After the initial start-up, all of the Fund's administrative costs will be paid only out of the administrative fund. Any funds borrowed for purposes of the start-up of the Program may be repaid from the administrative fund, subject to certain conditions. Act §§ 16, 45(m). In any event, annual administrative expenses must be as low as possible and cannot exceed 0.75% of the total trust balance.

How Will the State Fund be Invested?

Employees may select investment options from the permitted investment options established by the Board. The investment options will be managed by either the state treasurer's office or pursuant to a contract with the State Board of Investment or private investment managers, or both, as selected by the Board. The Act requires the Board to establish as an investment option a life-cycle fund with a target date based upon the age of the employee (Target Date Fund) that will also serve as the default investment option for enrollees who fail to elect an investment option (unless the Board designates another default investment option). Act §§45(a), 60(d).

The Act also authorizes the Board to establish any or all of four additional investment options consisting of a conservative principal protection fund; a growth fund; a secure return fund "whose primary objective is the preservation of the safety of principal and the provision of a stable and low-risk rate of return" (secure return fund); and an annuity fund. While the Act likely contemplates a money-market or bond fund as a conservative investment option, the type of "secure return fund" intended is not fully explained.

If the Board elects to establish a "secure return fund," the Act permits the Board to purchase insurance to insure the value of individuals' accounts and guarantee a rate of return, and the cost of that insurance would have to come from that fund. The Act also authorizes the Board to designate the secure return fund as the default investment election in lieu of the Target Date Fund. Act §45(c). The Board is required to review investment performance only once every four years. Act §30(e-5).

How is the Board Appointed?

The Act provides that the Board will consist of seven members. Act §20. Three of the members will be state officers (or their designees): the state treasurer as chair; the state comptroller; and the director of the governor's Office of Management and Budget. Four of the members will serve staggered terms of four years each and will be appointed by the governor (with approval by the treasurer and the advice and consent of the Senate), including two public representatives with expertise in retirement savings plan administration or investment, a participating employer representative, and an Enrollee representative. The Board will serve without compensation, except for reimbursements for travel expenses incurred in their Board duties. Recess appointees are permitted. Act §20(e). Although Section 15 of the Act states that the Board will act as trustee of the Fund, the Act (§30(b)) also contemplates that the Board will appoint a trustee for the state fund that complies with the requirements of a trustee under Section 408, meaning an approved non-bank custodian or a bank. I.R.C. §408(a)(2).

The Board, all agents appointed or engaged by the Board and the Program staff will "discharge their duties with respect to the Program solely in the interest of the Program's enrollees and beneficiaries." The Act's fiduciary rules mimic ERISA's "exclusive purpose" and "prudent person" rules and require that "any contributions paid by employees and employers in to the trust exclusively for the purpose of paying benefits to the enrollees of the Program, for the cost of administration of the Program, and for investments made for the benefit of the Program." Act §25; ERISA §404. Like any other IRAs, the IRAs established under the program will be subject to the prohibited transaction rules of Code Section 4975.

The Board's duties and responsibilities, among other things, require it to:

- Ensure the program is designed, established, and operated in a manner that accords with best practices for retirement savings vehicles (e.g., maximizes participation, savings, and sound investment practices; maximizes simplicity, including ease of administration; provides an efficient product to enrollees by pooling investment funds; ensures the portability of benefits; and provides for the de-accumulation of Enrollee assets in a manner that maximizes financial security in retirement)
- Appoint a trustee of the IRA Fund in compliance with Section 408 of the Code
- Explore and establish investment options, subject to the fiduciary provisions contained in Section 45 of the Act, that offer employees returns on contributions and the conversion of individual retirement savings account balances to secure retirement income without incurring debt or liabilities to the state
- Establish the rules for the administration of the Program
- Enter into contracts necessary for the administration of the Program and Fund, including contracts with "investment managers, private financial institutions, other financial and service providers, consultants, actuaries, counsel, auditors, third-party administrators, and other

professionals as necessary"

- Deposit into the Administrative Fund any grants, gifts, donations, fees, and earnings from investments from the Fund that are used to recover administrative costs
- Accept any grants, appropriations, or other moneys from the state or federal government or from other persons, firms, partnerships, or corporations
- Evaluate the need for insurance and indemnities for the Board as needed Act §30

Finally, the Board will engage in an open bidding process to engage an investment manager or managers to invest the Fund assets. Act §40(a). The Fund will be invested by the state treasurer's office or under contract with the State Board of Investment, private investment managers, or both, as selected by the Board, taking into consideration the manager's fees and charges to reduce administrative expenses. The investment managers will comply with all applicable law, as well as any rules promulgated by the Board and the investment of the Fund, including the investment policy. It is unclear whether the law would require the state treasurer's office and the State Board of Investment to bid against private investment managers. The investment manager will provide reports to the Board as often as the Board deems necessary to oversee the manager's performance and the performance of the Fund. Act §40.

The Act provides that the state shall have no duty or liability to any party for the payment of any retirement savings benefits accrued by any individual under the Program. Any financial liability for the payment of retirement savings benefits in excess of funds available under the Program will be borne solely by the entities with whom the Board contracts to provide insurance to protect the value of the Program. No state board, commission or agency, or any officer or employee will be liable for any loss or deficiency resulting from particular investments selected under the Act, except for any liability that arises out of a breach of fiduciary duty under the Act. Act §70.

Further, the Act says that no participating employer will "be a fiduciary, or considered to be a fiduciary, over [sic] the Program" or have any liability for an employee's decision to participate in or opt out of the Program or for any investment elections or the performance of any investment. Act §75. The Act itself, however, does not specify any penalties for failure to follow the terms of the Act (except for the non-enrollment penalties on employers) or for any fiduciary breach.

Is the Program an "Employee Pension Benefit Plan" Covered by ERISA?

There is a substantial question whether the Act on its face requires employers to establish an "employee pension benefit plan" within the meaning of ERISA, or whether the Program in operation may result in employers being deemed to have established such a plan. Section 95 of the Act requires the Board to request in writing an opinion or ruling from the DOL regarding the applicability of ERISA. The Board may not implement the Program "if it is determined that the Program is an employee benefit plan and state or employer liability is established under ERISA." Act §95.

As a threshold matter, ERISA arguably would preempt a state law that requires employers to establish an employee benefit plan administered by the state. Cf. Golden Gate Restaurant Ass'n v. City and County of San Francisco, 546 F.3d 649, 654 (9th Cir. 2008) (rejecting Secretary of Labor's argument that San Francisco's Healthcare Security Ordinance required employers to establish an employee welfare benefit plan administered by the city), rehearing en banc denied, 558 F.3d 1000 (9th Cir. 2009). Whether the Act would survive such an ERISA-preemption challenge is an open question.

Assuming that the Act would survive such a challenge, the question remains whether the Program in operation may result in an employer being deemed to have established a “pension plan” within the meaning of ERISA. The application of ERISA would, among other things, impose ERISA fiduciary duties on persons who satisfy ERISA’s definition of “fiduciary” with respect to the Program and prohibit such fiduciaries from engaging in certain categories of transactions in the absence of an exemption. ERISA §§404, 406. If applicable, these rules could subject the state or an employer to liability as an ERISA fiduciary or party in interest, thereby preventing the implementation of the Program. Further, ERISA may impose additional reporting and disclosure requirements upon employers, in addition to the state tax reporting requirements imposed by the Act. The question, then, is whether ERISA applies to the Program.

The applicability of ERISA depends on whether a payroll deduction IRA established under the Program would satisfy the definition of an “employee pension benefit plan” within the meaning of ERISA § 3(2)(A). Although governmental plans are expressly excluded from ERISA coverage, the term “governmental plan” is defined for this purpose to mean a plan established by a state or its agencies or instrumentalities for its employees. ERISA §§3(32), 4(b). Because the Program is intended to cover the employees of private employers, it would not qualify as a “governmental plan” for purposes of this exclusion.

To be an “employee pension benefit plan” under ERISA, the Program would have to be “a plan, fund, or program … established or maintained by an employer or by an employee organization, or by both.” ERISA §3(2)(A). Individual retirement accounts under Section 408 generally are not subject to ERISA, unless they are established or maintained by an employer or employee organization. In contrast, both SIMPLE plans and SEPs are subject to ERISA because, by their terms, they can exist only if established and maintained by an employer.

The Act provides that the state-run Board will establish the individual retirement accounts under the Program. Although the Act does not explicitly prohibit employer contributions to individual retirement accounts established under the Program (see Act §§15(a), 25(3)), there is certainly no requirement that employers make such contributions, nor do employers have any responsibility for selecting or entering into agreements with providers, making IRA investment decisions, or preparing employee communications with respect to the Program (see Act §75(b)). These functions are to be performed by the Board or by vendors selected by the Board. It is apparently contemplated under the Act that the employers’ only responsibilities are “enrolling” employees, figuring out either by default or from an employee election how much to deduct from the employee’s paycheck by payroll deduction, and remitting the amount to the state fund.

Under these circumstances, payroll deduction IRAs established by employers under the Program may fall under a regulatory safe harbor that applies to certain individual account plans in which an employer’s participation is minimal. These regulations provide that ERISA will not apply to an individual retirement account described in Section 408(a) or 408(b) of the Code, provided that: (i) no contributions are made by the employer; (ii) participation is completely voluntary for employees; (iii) the sole involvement of the employer or employee organization is without endorsement to permit the sponsor to publicize the program to employees, collect contributions through payroll deductions, and to remit them to the IRA sponsor; and (iv) the employer “receives no consideration in the form of cash or otherwise” although the employer may receive reasonable compensation for services actually rendered in connection with payroll deductions.

DOL Reg. §2510.3-2(d) (the "Safe Harbor")[1].

The DOL clarified the circumstances under which the Safe Harbor would apply to a payroll deduction IRA program established by an employer in Interpretive Bulletin 99-1 (IB 99-1) (64 FR 33000, June 18, 1999). IB 99-1 provides the following additional guidance regarding the application of the Safe Harbor:

- The employer must remain neutral about an IRA sponsor in the employer's communications with its employees, although the employer may:
  - Encourage employees generally to save by payroll deduction
  - Provide general information on the payroll deduction IRA program and the benefits of saving through an IRA
  - Answer employee questions about the mechanics of the payroll deduction IRA and refer other questions to the appropriate IRA sponsor
  - Provide employees with materials written by the IRA sponsor, even displaying the employer's name and logo, provided that the employer remains otherwise neutral about the IRA sponsor
  - Limit the number of IRA sponsors made available to employees, as long as the employer notifies employees in advance of any restrictions imposed by the IRA sponsor
- The employer may pay administrative fees to the IRA sponsor, provided that the employer does not negotiate special terms and conditions for its employees or influence the IRA investments
- The employer may collect reasonable compensation for the actual costs of services the employer renders in the payroll deduction program, provided that such payments do not include any profit to the employer

There is a substantial question whether employers who establish payroll deduction IRAs in compliance with the Act can also satisfy the requirements of the Safe Harbor and thereby avoid the application of ERISA. Assuming for the sake of argument that employers can both comply with the Act and satisfy the requirements of the Safe Harbor, it is difficult to see how there can be any assurance that every employer who establishes a payroll deduction IRA under the Program will satisfy the Safe Harbor requirements in practice.

The DOL's myRA Letter raises significant doubts about whether a payroll deduction IRA established in compliance with the Illinois Act would satisfy the requirements of the Safe Harbor. In concluding than an employer would not be establishing or maintaining an ERISA-covered pension plan simply by facilitating and encouraging employee participation in the myRA program, the DOL emphasized the "voluntary nature" of the program and the "absence of any employer funding." The DOL stated specifically that; (i) "Treasury does not at this stage intend for employers to implement automatic contribution arrangements (also known as automatic enrollment) whereby a contribution equal to a default percentage of the

[1] Neither a SIMPLE plan nor a SEP is covered by the Safe Harbor. First, neither a SIMPLE plan nor a SEP is defined, as required by the Safe Harbor, under Code Section 408(a) or 408(b). A SIMPLE plan is defined under Code Section 408(p), and a SEP is defined in Code Section 408(k). In SIMPLE and SEP plans, the employer's sole involvement extends beyond permitting the sponsor to publicize the program, collect contributions through payroll deductions, and remit them to the IRA sponsor. Instead, employers establish the IRAs and contribute to SIMPLE and SEP plans.

employee's pay is made to a myRA established for the employee unless the employee elects otherwise;" and (ii) "[e]mployers would not make employer contributions to myRAs and would have no investment or other funding obligations, or have any custody or control over account assets." Regarding the latter point, the DOL indicated that an employer would be treated as making contributions to a myRA if the employer "reimbursed employees for amounts they contributed to a myRA."

The DOL's myRA Letter suggests that the Illinois Program may not satisfy the Safe Harbor requirement that a payroll deduction IRA be "completely voluntary for employees." DOL Reg. §2510.3-2(d)(ii). Unlike the myRA program, the Illinois Program requires Employers to automatically enroll each of their employees and to contribute by payroll deduction three percent of each employee's after-tax compensation to the State Fund, unless an employee opts out of the Program or elects to change the contribution amount. Act §60(c). That automatic enrollment feature may cause all payroll deduction IRAs established under the Program to fall outside the scope of the Safe Harbor, and thus be treated as ERISA-covered pension plans.

In addition, as stated previously, the Illinois Act does not explicitly prohibit employer contributions to payroll deduction IRAs established under the Program. If an employer were to make employer contributions to a payroll deduction IRA established under the Program, whether by reimbursing employees for amounts they contribute or otherwise, the payroll deduction IRA established for that employer's employees would almost certainly be deemed to be an ERISA-covered pension plan.

Further Analysis

The Act contains some internal inconsistencies and ambiguities. For example, the Act applies to employers who "have not offered a qualified retirement plan," which may or may not include a tax-qualified retirement plan. It is not clear whether the Program must be offered to any employee not covered by such a plan, or whether the employer can avoid the Act by providing a retirement plan, regardless of its quality, to some but not all of its employees. This raises some of the same complicated and technical issues that many employers have been struggling with under the Affordable Care Act in dealing with part-time, temporary and seasonal employees.

The Act is unclear as to who will pay for the "start-up" of the Program. The Program cannot be implemented unless the state or federal government or private individuals contribute "start-up" money to an administrative fund. Act §90. The costs for implementing the Program could be substantial. It is unclear from the text of the Act why the drafters assumed private individuals would contribute to the administrative fund. Nonetheless, there is a hard cap on costs to the plan, and presumably implementation will not occur until the size of the administrative fund permits the Program to operate under that cap.

The Act's effective date is also unclear. Although the stated effective date is June 1, 2015, implementation must occur within 24 months or by June 1, 2017. It may be that the effective date is intended to be the date of enactment, so that implementation must occur 24 months after December 3, 2014. However, the Program cannot be implemented until there are sufficient funds in the Administrative Fund to keep administrative costs under 0.75% and rulings are obtained from the DOL and the IRS. Act §93 and 95. If the effective date is the date that there are sufficient funds in the Administrative Fund to keep administrative costs under the cap and the rulings are obtained from the DOL and the IRS, the Program may not be implemented for several years.

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One of the more surprising provisions of the Act is that the Board is required to review investment performance only once every four years. Qualified plan fiduciaries do not have such latitude under ERISA, and it is difficult to see how it is warranted in the state fund. Even if ERISA does not apply, this requirement is surprising in light of the Act's prudent person rule. Act §25(2).