

# State-Facilitated Retirement Savings Programs

*A Policymaker's Guide to ERISA and the Tax Code for IRAs and 401(k)s*



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The findings and conclusions in this report are the responsibility of the authors and do not necessarily reflect positions or policies of the Georgetown Center for Retirement Initiatives, K&L Gates, or any other organization. This report should not be construed as legal advice.

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# I. INTRODUCTION

For more than a decade, federal and state policymakers have been developing solutions for providing all private sector workers with simple, low-cost, easily accessible ways to save for retirement. Today, millions of American private sector workers are not offered a way to save for retirement by their employers, and employers are not required to offer their workers a retirement savings plan. As a result, some estimated 57.3 million private sector workers (46%)<sup>1</sup> lack access to an employer-sponsored retirement savings plan and even more are projected to suffer financial hardship in retirement.<sup>2</sup> This gap is distributed inequitably, affecting mostly employees of small businesses, “gig” and part-time workers, lower-income workers, younger workers, minorities, and women.

Workers are much more likely to save for retirement if they have access to a retirement savings plan through their employers. This access gap is one of the reasons that retirement readiness continues to deteriorate. Although workers can open individual retirement accounts (IRAs) and save on their own, they rarely do.<sup>3</sup> The good news is that when offered a workplace savings solution, particularly one in which they are enrolled automatically, most people choose to consistently save a portion of their paychecks.<sup>4</sup>

The two types of retirement savings vehicles that have shown the greatest potential for states<sup>5</sup> to close the savings access gap are auto-IRAs and 401(k)s. State auto-IRAs are state-facilitated payroll withholding IRA saving programs that certain employers<sup>6</sup> are required to make available to their employees.<sup>7</sup> For a state-facilitated 401(k) defined contribution (DC) savings plan model, the state would establish a turnkey 401(k) “plan-in-a-box.” While the 401(k) could take the form of a “single employer plan,” with each employer technically sponsoring its own plan, it is more likely to be a multiple employer plan (MEP) or pooled employer plan (PEP) — an aggregated plan in which more than one employer participates and potentially benefits from scaling and cost efficiencies.

In both the state-facilitated auto-IRA and 401(k) models, covered employees would automatically contribute a specified default percentage of each paycheck, the contribution rate could gradually escalate over time, and savings would be invested in a default investment fund. Employees would have the freedom to choose a different contribution level or other investments from the program’s pre-selected menu, or to opt out of contributing and not participate. The choice whether to save would always be voluntary for the employee. To implement either savings model, the state would contract with external providers, including recordkeepers, institutional trustees, and investment managers, to create a turnkey program.

Auto-IRAs and 401(k)s each have strengths and drawbacks, mainly because of differences in federal laws — the Employee Retirement Income Security Act of 1974 (ERISA) and Internal Revenue Code of 1986 (Tax Code) — and the regulations governing their operations.<sup>8</sup> The most-significant distinction is that states can require employers to facilitate their workers’ participation in an auto-IRA but not a 401(k), and employers may contribute to a 401(k) but not an auto-IRA. IRAs generally are exempt from ERISA’s federal preemption rules if employers do not endorse or

<sup>1</sup> Antonelli (2020). “What are the Potential Benefits of Universal Access to Retirement Savings?,” Georgetown University Center for Retirement Initiatives in conjunction with Econsult Solutions, Inc.

<sup>2</sup> Munnell, Chen, & Siliciano (2021). “The National Retirement Risk Index.” *Issue in Brief* 21-2;

<sup>3</sup> Chen & Munnell (2017). “Who Contributes to Individual Retirement Accounts?,” *Issue in Brief* 17-8.

<sup>4</sup> See “What Are the Potential Benefits of Universal Access to Retirement Savings?” and Vanguard, “How America Saves.”

<sup>5</sup> While New York City, Seattle, and other cities and counties also are exploring solutions to the coverage and savings gap, this paper refers to simply to “states” for convenience.

<sup>6</sup> Typically, state law would mandate coverage by for-profit and not-for-profit employers that do not offer any retirement plan with, perhaps, an exception for employers with under a specified number of employees and/or time in business (e.g., two or three years). The employer mandate would cover workers in the state.

<sup>7</sup> Several states, such as New York and New Mexico, have enacted or are considering auto-IRA legislation that do not require employer participation. To date, no such voluntary programs are in operation. There is little, if any, statistical evidence about whether employers would voluntarily join an auto-IRA rather than a 401(k) plan or simply continue to offer no retirement plan to their workers. This paper does not address state auto-IRA programs that do not require employers who do not have a plan of their own to facilitate employee participation in the state program.

<sup>8</sup> This paper follows the common usage that the term “ERISA” only refers to the fiduciary, participant safeguards, reporting and disclosure, and enforcement rules found in Title I of ERISA. Technically, the Internal Revenue Code (Tax Code) rules that govern the favorable income tax treatment afforded to qualified retirement plans also are found in ERISA, in Title II. With a few exceptions, the Department of Labor (DOL) regulates Title I and the Internal Revenue Service (IRS) regulates Title II.

contribute to the program and certain other requirements are satisfied.<sup>9</sup> ERISA probably would prohibit a state-mandated 401(k) requirement on employers. Table A compares the basic features of state-facilitated IRAs and 401(k)s.

The objective of this paper is to provide policymakers with a primer about ERISA and the Tax Code, how these federal laws and their regulations pertain to IRAs and 401(k)s, and what this means for state-facilitated retirement savings programs. After reviewing the question of ERISA applicability to state auto-IRAs and an overview of the federal Tax Code and IRA rules, this paper then explores how ERISA and the Tax Code rules apply to 401(k)s, including the new rules allowing states (and others) to possibly lower 401(k) costs by sponsoring group 401(k) MEPs and PEPs.

**TABLE A**  
**A Comparison of the Basic Features of a State-Facilitated IRA vs. a 401(k)**

Program/Feature	IRA	401(k)/DC
ERISA Regulation	Non-ERISA	ERISA
Administrative Simplicity	Yes	Somewhat (single plans vs. MEP affects burden on employers)
Contributions Allowed	Employee pre-tax/Roth	Employee pre-tax/Roth; and Employer
Investments	Employee chooses from plan “menu,” including a state-pooled and professionally managed option and/or private sector (third-party) options	Employee chooses from plan “menu,” including a state-pooled and professionally managed option and/or private sector (third-party) options
Employers Required to Adopt	Yes, can be under current law	Unlikely
Auto-enrollment With Employee Opt-Out	Yes	Yes
Pros	<ul style="list-style-type: none"> <li>• Employer mandate allowed</li> <li>• Simple</li> <li>• Low-cost</li> <li>• Easier to establish</li> </ul>	<ul style="list-style-type: none"> <li>• Some complexity but flexible design</li> <li>• Employees may contribute \$19,500 (\$26,000 ≥ age 50);</li> <li>• Allows employer contributions</li> </ul>
Cons	<ul style="list-style-type: none"> <li>• Relatively low contribution levels of \$6,000 (\$7,000 ≥ age 50)</li> <li>• No employer contribution</li> <li>• Investment risk on participant</li> <li>• Participant leakage</li> </ul>	<ul style="list-style-type: none"> <li>• Some participant leakage<sup>†</sup>, depending on plan design</li> <li>• Investment risk on participant</li> </ul>

<sup>†</sup> Leakage is a term that refers to plan fund withdrawals made by participants from IRAs or 401(k)/defined contribution plans. Data from HelloWallet, for example, suggest that 75 percent of 401(k) plan participants breached their savings because of basic money management problems, and 26 percent of 401(k) participants used their 401(k) savings for non-retirement needs. [http://www.hellowallet.com/wp-content/files\\_mf/hellowallet\\_retirementbreach2.pdf](http://www.hellowallet.com/wp-content/files_mf/hellowallet_retirementbreach2.pdf).

<sup>9</sup> Of course, there are numerous other considerations that policymakers may wish to consider beyond the employer mandate. For example, IRAs are simple, easily portable, and essentially cost-free to employers while 401(k)s are more-robust savings vehicles but can add to employer costs. See Antonelli (2020), “What Are the Potential Benefits of Universal Access to Retirement Savings?,” p. 32.

## II. ERISA and Auto-IRAs

**What is ERISA?** ERISA was enacted to protect participants in private sector employee benefit plans from improper administration, inadequate or misleading communications, and dishonest handling of plan benefits and assets.<sup>10</sup> Encompassing 401(k) and other DC arrangements and traditional pension (defined benefit) plans, the key elements of an ERISA-regulated retirement plan are the payment of post-employment income and employer involvement as sponsor, overseer, and/or administrator.<sup>11</sup>

In addition to protecting workers, ERISA established a national administrative scheme by preempting “any and all state laws [that] relate to any employee benefit plan.”<sup>12</sup> The Supreme Court has limited ERISA preemption to state laws regulating “a central aspect of plan administration,” such as ERISA’s reporting and disclosure regime, determining eligibility to participate, or the amount of benefits.<sup>13</sup> Thus, a state law requiring that certain employers facilitate employee paycheck savings through a state auto-IRA program would not be preempted if: (1) the state auto-IRA program was itself not an ERISA retirement plan and (2) the state enabling law establishing a new state savings program did not affect a central aspect of an employer’s operation of its own retirement plan.

**IRAs Are (Generally) Not ERISA Plans.** IRAs, which predate the passage of ERISA, typically would not be ERISA plans even though they are retirement savings vehicles, because they are personal savings accounts established and controlled by individuals and not employers. By way of contrast, a 401(k) plan is an ERISA plan because of the high degree of employer involvement and control, including the employer’s selecting the investments and service providers, setting plan terms, and making benefit determinations, as well as the ability of employers to contribute.

**Employer-Offered IRAs Meeting Certain Criteria Are Not ERISA Plans.** What if an employer wanted to help workers save by setting up a payroll withholding program with one or more IRA providers? Would the employer’s involvement turn the IRA into an ERISA-regulated plan? The Department of Labor (DOL), which enforces ERISA, has issued “safe harbor” guidance to address this question and, in general, the answer is that employer involvement does not turn an IRA into an ERISA-regulated retirement savings plan if the employer’s activities are kept to a ministerial (mostly nondiscretionary) level. Indeed, one of the DOL’s first actions when ERISA took effect was to issue a four-part safe harbor from ERISA regulation for employer-offered IRAs. Under this safe harbor, an IRA program would be exempt from ERISA if: 1) the employer did not contribute on behalf of employees; 2) the employer did not endorse the program; 3) the employer did not receive any financial advantage (kickback); and 4) each employee’s contributions to the IRA were completely voluntary.<sup>14</sup>

Over the years, the DOL expanded that safe harbor to allow additional degrees of employer involvement. These DOL safe harbors are discussed in more detail in Appendices A and B.

**State Auto-IRAs Not Interpreted as Subject to ERISA.** When states began adopting auto-IRAs, it was clear that they satisfied the existing DOL IRA safe harbor because the employers had no discretion, decision-making, or control; employers simply had to facilitate worker participation by cooperating with the program administrator and processing payroll withholding.<sup>15</sup> In addition, because employers lack control and are legally only required to facilitate their employees’ participation, employers do not sponsor or maintain the programs. Even without the DOL safe harbor, most legal experts concluded that, because the state or state-appointed board is in control of the program, and there is a lack of employer sponsorship, responsibility, or ongoing maintenance, a state-facilitated auto-IRA is not an ERISA plan.

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<sup>10</sup> ERISA does not apply to federal, state, or local governmental plans; that is, retirement plans for a government entity’s own employees; however, a plan created and/or operated by a government entity for private sector employees would not be considered a governmental plan. A state could not escape ERISA regulation simply by bringing private sector workers into its own government retirement plan.

<sup>11</sup> A union or other labor organization also may sponsor an ERISA plan; see Sec. 3(2)(A) of ERISA.

<sup>12</sup> ERISA Sec. 514(a); *Egelhoff v. Egelhoff*, 532 U.S. 141, 148 (2001) (quoting *Fort Halifax Packing Co. v. Coyne*, 482 U.S. 1, 9 (1987)).

<sup>13</sup> *Gobeille v. Liberty Mutual Ins. Co.* 136 S. Ct. 936 (2016).

<sup>14</sup> DOL Reg. § 2510.3-2(d).

<sup>15</sup> Iwry (Autumn 2020). *Observations on Coverage, CalSavers, and ERISA Preemption*, 33 *Benefits Law Journal*, No. 3).

In 2016, in the waning days of the Obama Administration, states received some additional support when the DOL finalized additional safe harbor guidance specific to state auto-IRAs outlining the conditions that a program could satisfy to automatically be exempt from ERISA.<sup>16</sup> Although this guidance was subsequently nullified by Congress in 2017 at the request of the Trump Administration, states continued to move forward with the adoption of the programs based on both the original DOL IRA safe harbor that remains in place and judicial limitations on ERISA preemption.<sup>17</sup> For a more-detailed discussion of the 2016 DOL IRA safe harbor guidance for state-facilitated programs, see Appendix B.

## Current Legal Consideration: Courts, Preemption, and State Auto-IRAs

In the only judicial decision involving auto-IRAs and ERISA to date, the U.S. District Court for the Eastern District of California held that the California program, known as CalSavers, is not an ERISA-regulated retirement plan and the California statute was not preempted by ERISA.<sup>18</sup> Specifically, the court, in *Howard Jarvis Taxpayers Assn v. The California Secure Choice Retirement Savings Program*, found that the degree of employer involvement in facilitating CalSavers was minimal and the program was not established or maintained by an employer. The District Court stated that to be an ERISA-regulated plan, “an employer’s administrative duties must involve the application of more than a modicum of discretion” and that “an employer who makes no promises to its employees regarding an employee benefit plan or its coverage” has not established or maintained a plan. Simply remitting payroll deductions to an auto-IRA without discretion regarding the money does not turn an employer into a plan sponsor. Because CalSavers is not an ERISA plan and does not affect any employer’s operation of an ERISA plan, the state law — including the requirement that employers without a plan of their own facilitate (allow their employees to participate in) CalSavers — is not preempted. The decision has been appealed to the Ninth Circuit and oral arguments were heard on February 8, 2021.<sup>19</sup>

Although there are three operating state-facilitated auto-IRAs and a number of others in the planning stage, there have been no challenges seeking ERISA preemption of an auto-IRA statute or state program other than *Jarvis*. For further analysis of related federal case law, see Appendix C.

**States Should Follow Federal Guidance and Legal Interpretations to Avoid ERISA Preemption.** The bottom line for policymakers is that existing law gives states room to establish auto-IRA programs and to require that employers facilitate their employees’ participation in auto-IRA programs. Nevertheless, states embarking on this approach should take care to limit covered employers’ responsibilities to ministerial tasks, such as registering with the program administrator, providing certain employee census information, properly withholding eligible employees’ contributions from their wages, and timely and accurately transmitting those amounts to the program. Employers should not have administrative decision-making or fiduciary authority. Policymakers should consider both the existing DOL safe harbor and the disapproved auto-IRA safe harbor (See Appendices A and B) in designing a program. Policymakers and their counsel also should continue following developments in this still-emerging area of law, including the *Jarvis* appeal to the Ninth Circuit.

<sup>16</sup> DOL Reg. § 2510.3-2(h).

<sup>17</sup> H.J. Res 66, 115th Cong. (2017).

<sup>18</sup> *Howard Jarvis Taxpayers Assoc. v. Cal. Secure Choice Retirement Savings Program*, E.D. Cal., No. 2:18-cv-01584-MCE-KJN.

<sup>19</sup> After years of non-involvement, the Trump administration filed a statement of interest in the *Jarvis* district court proceeding and the DOL filed an amicus brief in the *Jarvis* Ninth Circuit appeal, both arguing in favor of preemption. The DOL’s participation in the case was withdrawn in a February 5, 2021, filing with the Ninth Circuit, stating that the DOL “does not support either side.”



### III. The Tax Code and Auto-IRAs

States establishing auto-IRA programs can choose between offering a Roth IRA and traditional IRA as the default vehicle while allowing participants to choose the other type. In designing state auto-IRA programs, policymakers have to be aware of the differences between these two options. However, Roth and traditional IRAs are similar in many ways, including:

- *Eligibility & Vesting.* An individual must have “earned income” at least equal to their IRA contribution. Earned income includes salary, wages, bonuses, tips, and self-employed earnings. Of course, the individual is always 100% vested in the IRA.<sup>20</sup>
- *Investments.* The typical IRA investment is a mutual fund, including target date or lifecycle funds. The state may limit the program’s investment options to a pre-selected “menu” of funds.<sup>21</sup> Although too speculative an investment and expensive for recordkeeping to be suitable for an auto-IRA, investments in individual stocks and bonds are allowed, but an IRA may not invest in “collectibles” such as art, coins and jewelry or buy life insurance.<sup>22</sup>
- *Contribution Limits.* For 2021, the annual contribution limit is \$6,000, or \$7,000 if the individual will be at least 50 years old by the end of the year. These amounts are adjusted annually for inflation. IRA contributions exceeding the dollar limit (or made by someone not eligible to contribute) must be withdrawn by the date federal income taxes are due for the year. Otherwise, the individual must pay a 6% excise tax on excess contributions each year until corrected.
- *Saver’s Credit.* The federal Saver’s Tax Credit (Saver’s Credit) is available for traditional and Roth IRA contributions (and 401(k) contributions) of up to \$2,000 for individuals and \$4,000 for couples. The credit is between 10% and 50% of the amount contributed and is phased out for taxpayers earning above \$33,000 for individuals, \$49,500 for heads of households, and \$66,000 for married couples in 2021. The Saver’s Credit is in addition to the tax deduction for a traditional IRA or 401(k) contribution. The tax credit can serve as an incentive to boost retirement savings, and if Congress would make it refundable, the boost to long-term retirement savings could be significant.<sup>23</sup>
- *Withdrawals and Distributions.* IRA withdrawals taken before age 59 1/2 are hit with a 10% added excise tax. (For a Roth IRA, the excise tax only applies to the portion of the withdrawal attributable to investment income.) There are exceptions for disability, death, certain types of hardship, and first-time homebuyers, among others. A participant may not borrow from their IRA or use it as loan collateral.
- *Beneficiaries.* IRA owners may designate one or more beneficiaries. A married individual may name a non-spouse without spousal consent. Auto-IRAs should consider using a default beneficiary hierarchy for individuals who do not name a beneficiary.
- *IRA Document.* An IRA must be in writing. Fortunately, the IRS provides Form 5305, 5305A, or 5305RA — short and user-friendly documents that states may use to create Roth and traditional IRAs. The forms lay out the basic Tax Code rules and state that the IRA owner and provider agree to cooperate with one another.
- *Exclusive Benefit.* An IRA must be held by a bank, an IRS-approved non-bank institution, or an insurance company in an account maintained for the exclusive benefit of the owner. Also, an IRA may not engage in certain related party “prohibited transactions,” such as using the IRA as collateral for a loan.<sup>24</sup>

<sup>20</sup> Tax Code Sec. 219(c)(1) allows certain non-working spouses to contribute to an IRA.

<sup>21</sup> Due to an unfortunate interaction between the Tax Code and federal securities law, an IRA cannot invest in certain stable value funds, but it appears that they may invest in group annuity contracts offering similar book value guarantees. Stable value-type investments typically have higher interest rates than money market funds, an important consideration because money market rates, after deducting program fees, can be negative. Similarly, an IRA cannot invest in a separate account or commingled fund — a lower fee alternative to mutual funds that many larger 401(k)s use to reduce participant costs.

<sup>22</sup> Tax Code Sec. 408(m).

<sup>23</sup> For example, a young worker with a modest income who simply follows default IRA savings choices for 40 years could generate as much as \$14,320 and, if Congress would enact a refundable Saver’s Tax credit, as much as \$21,300, per year in additional income at retirement. For more about the potential benefits of the Saver’s Credit, see Antonelli (2020), “What are the Potential Benefits of Universal Access to Retirement Savings?,” Georgetown University Center for Retirement Initiatives in conjunction with Econsult Solutions, Inc.

<sup>24</sup> Tax Code Sec. 408(a).

- *ERISA as Benchmark.* For more than 40 years, ERISA has provided a workable system of fiduciary standards and best practices for running a retirement program, protecting participants, and resolving disputes over benefit claims. Policymakers may wish to consider this ERISA “infrastructure” in creating state rules and consumer protections for any state-facilitated auto-IRA program.

**How Are Roth IRAs and Traditional IRAs Different?** There are three key distinctions between Roth and traditional IRAs that policymakers should keep in mind: 1) A Roth IRA has an income-based eligibility restriction (discussed below); 2) Roth IRA contributions are not tax-deductible but, if certain holding and timing conditions are met, distributions at the time of retirement are 100% tax-free; and 3) Roth IRAs are not covered by the age 72 minimum distribution requirement.<sup>25</sup> Table B highlights the differences between Roth and traditional IRAs.

**State-Facilitated Auto-IRA Programs: Choosing a Roth IRA as the Default Option.** The first three active auto-IRA programs — OregonSaves, Illinois Secure Choice, and CalSavers — all have chosen the Roth IRA as the default while also making the traditional IRA available.

Generally, someone expecting to be in a higher tax bracket at the time of retirement is financially better off by contributing to a Roth IRA than a traditional IRA, because distributions at the time of retirement will not be taxed. Beyond potential tax benefits, Roth IRAs have the advantage of not requiring minimum distributions at age 72. From an administrative perspective, a Roth IRA also makes it easier to process a participant’s “do-over” request to dis-enroll after participating for only a few pay periods, because the return of contributions is non-taxable and penalty-free. (Return of any investment income — likely to be small — would be taxable, and probably subject to the 10% early withdrawal penalty.)

States using a Roth IRA as the default will have no way of knowing whether a participant will exceed the Roth IRA income limit for the year. Contributions that exceed the income limit are hit with a 6% excise tax unless withdrawn by the individual’s income tax filing deadline. (The 6% tax is imposed annually until corrected.) Thus, state program communications should clearly inform participants of the earnings limit and correction rules for Roth IRAs and/or traditional IRAs.

Although there are strong reasons for using a Roth as the default, states should consider allowing participants to elect a traditional IRA, either because they earn too much for a Roth IRA or the traditional version meets personal retirement or tax planning objectives.

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<sup>25</sup> Tax Code Sec. 408A.

**TABLE B**  
**A Comparison of the Tax Treatment of Traditional IRAs vs. Roth IRAs**

	Traditional IRAs	Roth IRAs
Eligibility	<p>Individual must have a salary, self-employment earnings, or other taxable compensation.</p> <p>There is no age maximum.</p>	<p>Same as traditional, and individual (plus spouse if married, filing a joint return) must have modified adjusted gross income (MAGI) below specified limits. For 2021, the limits are as follows:</p> <p><b>Single filer</b> with MAGI of:</p> <ul style="list-style-type: none"> <li>• Up to \$125,000 — full contribution</li> <li>• \$125,000–\$140,000 — partial contribution</li> <li>• \$140,000 or more — not eligible</li> </ul> <p><b>Joint filers</b> with MAGI of:</p> <ul style="list-style-type: none"> <li>• Up to \$198,000 — full contribution</li> <li>• \$198,000–\$208,000 — partial contribution</li> <li>• \$208,000 or more — not eligible</li> </ul>
Deductible Contributions	<p><b>For 2021:</b></p> <p>Contributions are tax-deductible if individual (and spouse) are not covered by a 401(k) or other retirement plan. This means that contributions come out of employee paychecks pre-tax and are instead taxed upon distribution at retirement. If covered by a retirement plan, contributions are deductible only if income is below certain limits.</p> <p><b>Single filer, covered by a retirement plan at work, with MAGI of:</b></p> <p>\$65,000 or less — fully deductible, phased out for income between \$65,000–\$75,000 and \$75,000 or more — nondeductible</p> <p><b>Joint filer, covered by a retirement plan at work, with MAGI of:</b></p> <p>\$104,000 or less — fully deductible \$104,001–\$124,000 — partially deductible \$124,000 or more — nondeductible</p>	<p>Roth contributions are not tax-deductible.</p>
Federal Income Tax Treatment on Contributions and Earnings	<p>Earnings grow tax-deferred until distributions begin. Distributions are taxed as ordinary income. Withdrawals of nondeductible contributions are not taxed.</p>	<p>Withdrawals of contributions are not taxed. Qualified distributions are tax-free.</p> <p>Earnings on nonqualified distributions earnings are taxed as ordinary income and may be subject to a penalty.</p>
Penalties on “Early” and “Late” Distributions	<p>Distributions from contributions and earnings can be taken after age 59½ without a federal tax penalty.</p> <p>Minimum (based on life expectancy) withdrawals (RMDs) must begin by age 72. Late distributions subject to 50% excise tax.</p> <p>Distributions before age 59½ are subject to a 10% penalty tax unless certain exceptions are met, including:</p> <ul style="list-style-type: none"> <li>• disability</li> <li>• periodic installment payments</li> <li>• the distribution is used to cover certain medical bills</li> <li>• the distribution is used to pay health insurance premiums during unemployment lasting at least 12 weeks</li> <li>• the distribution is used for post-secondary education expenses</li> <li>• the distribution is used to purchase a first home (\$10,000 maximum)</li> <li>• certain distributions up to \$5,000 related to the birth or adoption of a child.</li> </ul> <p>Distributions to beneficiaries on an owner’s death are also exempt from the 10% penalty.</p>	<p>Distributions from earnings are tax-free if the initial contribution to the IRA was made at least five years ago and the individual is:</p> <ul style="list-style-type: none"> <li>• age 59½</li> <li>• disabled</li> <li>• using the funds for a first home purchase (up to \$10,000)</li> </ul> <p>Payments made to beneficiaries after the five-year period are also tax- and penalty-free. Payments made before the end of the five-year period are penalty-free.</p> <p>Distributions from earnings are not subject to the 10% penalty if they qualify for an exception — same as exceptions for traditional IRAs.</p>

## IV. ERISA AND 401(k)s, MEPs, and PEPs

A 401(k) can be viewed as an IRA on steroids. Both employees *and* employers may contribute, at combined limits more than triple that of IRAs, with a broader range of available investments and more-flexible program design. Of course, these 401(k) advantages are achievable only if the employer chooses to establish a plan. As previously noted, however, ERISA would preempt a state requirement that an employer offer its workers a 401(k).

An employer can create its own single employer plan, or become part of a multiple employer plan (MEP) or pooled provider plan (PEP). In a single employer plan, each company sponsors, controls, and is responsible for its own plan. MEPs and PEPs are comingled plans that several employers can join.

Employers have many reasons for not offering a retirement plan, such as cost, complexity, and potential fiduciary liability.<sup>26</sup> A state-facilitated 401(k) would seek to encourage employers to offer a retirement savings plan by minimizing these concerns and doing much of the legwork. The state, or a state-selected board, would screen and hire a team of providers — recordkeeper, administrator, investment managers, trustees, lawyers, and advisors — to establish the necessary plan documents and administrative infrastructure. In addition to doing much of the heavy lifting for employers, this “401(k) in a box” may have significantly lower administrative and investment costs and added services than employers, especially small to mid-size employers, could negotiate on their own. In that regard, a MEP- or PEP-aggregated structure may give the state greater bargaining power in negotiations with providers over fees and services.

What follows is an overview of the special MEP or PEP considerations affecting the entities that may join or sponsor the program; the general ERISA and Tax Code rules applicable to all 401(k)s; and some program design considerations for policymakers, including which format may be most appropriate. The same ERISA and Tax Code rules apply regardless of whether it would be a state-facilitated plan or a private sector employer-sponsored plan.

**Differences Between 401(k) MEPs and PEPs.** MEPs predate ERISA, while PEPs are brand-new, created by the Setting Every Community Up for Retirement Enhancement Act of 2019 (the SECURE Act) (Pub. Law 116-94). The first PEPs are expected to launch in 2021. The differences between MEPs and PEPs are subtle — employers and certainly employees are unlikely to notice — but are important for states to consider.

The DOL requires that employers joining a MEP share a commonality of interests, such as an association of businesses in the same field (e.g., lawyers, realtors, plumbers) or in the same locality (e.g., a particular state).<sup>27</sup> Under these rules, a state could establish a MEP for employers located in their state but probably would have to keep out-of-state employers from joining. The DOL’s rationale for the commonality rule is that a “bona fide” association of employers will be best to monitor service providers and stymie fraud or abuse.

PEPs are not covered by the commonality requirement that applies to MEPs. While any employer may join, the PEP must be operated by a “pooled plan provider:” an entity agreeing to be the plan’s named fiduciary, responsible for the plan’s overall operations and registered with the DOL. The PEP itself must have a system for the smooth running of the program and collecting contributions, and enable employers and participants to withdraw from the plan without unreasonable restrictions or fees. While it may be possible for a state board to qualify as a pooled plan provider, most (probably all) states would want to hire a third-party financial, recordkeeping, or consulting firm for that role to shift the pooled provider’s ERISA fiduciary duties from the state to a qualified private sector professional.

**ERISA Requirements.** ERISA establishes standards for establishing and running a 401(k) or other DC plan, including the fiduciary duties of prudence and acting in the best interest of participants and beneficiaries, and imposes participant disclosure and government reporting requirements. A plan is established by a “plan sponsor” through a written plan document.<sup>28</sup> All employee and employer contributions and investment earnings must be held in a “bullet-proof” trust or an insurance company annuity, and only used to pay benefits or cover legitimate plan expenses.<sup>29</sup>

<sup>26</sup> GAO (2013). “Retirement Security: Challenges and Prospects for Employees of Small Businesses (GAO 13-748T),” <http://www.gao.gov/assets/660/655889.pdf> for *Research on Labor and Employment*, p. 4.

<sup>27</sup> DOL Advisory Opinion 2012-04A, May 25, 2012. In 2019, the DOL regulations also allowed a bona fide professional employer organization (PEO) and certain other employee leasing organizations to establish a MEP for the leased employees. DOL Reg. Sec. 2510.3-55.

<sup>28</sup> ERISA Sec. 402.

<sup>29</sup> ERISA Sec. 412(a).

1. *ERISA Fiduciaries and Their Duties.* The plan sponsor and anyone with control over plan assets — such as a trustee or money manager — is an ERISA fiduciary. Anyone with authority to appoint or fire a fiduciary is themselves a fiduciary.<sup>30</sup> Thus, fiduciary responsibility can never be fully “outsourced” to a third party because hiring that third party is a fiduciary act.

Fiduciaries are expected to be experts (or hire expert advisors) and to act prudently for the exclusive benefit of participants.<sup>31</sup> However, perfection is not required; just prudent and well-thought-out, reasonable decision-making. Fiduciaries are obligated to avoid self-dealing or taking actions that are adverse to the plan. Finally, ERISA (and the Tax Code) penalize certain “prohibited transactions” between a plan and a related party, including the direct or indirect sale, exchange, or leasing of any property, lending of money, or supplying goods and services between the plan and a party in interest.

2. *Special Investment Consideration.* A large portion of fiduciary efforts concerns plan investments. ERISA 404(c) allows fiduciaries to offload much of their fiduciary responsibilities by making participants responsible for investing their own plan accounts.<sup>32</sup> For this to happen, participants must be given a choice of at least three diversified investment funds: an S&P 500 fund, an international fund, or a fixed-income fund; the opportunity to switch investments at least quarterly; and, of course, proper disclosure to participants. Participants not making an investment election, perhaps because they were auto-enrolled, are defaulted into a diversified “target date,” “lifecycle,” or similar all-in-one diversified investment fund.<sup>33</sup> Even under this ERISA 404(c) exception, though, the plan fiduciaries are responsible for selecting and monitoring the investments offered on the fund lineup, including the default fund.<sup>34</sup>
3. *Reporting and Disclosure Requirements.* The ERISA disclosure obligations include giving participants a “plain English” summary plan description (SPD), a notice of plan amendments, and information about plan fees and investment options.<sup>35</sup> Participants must receive quarterly benefit statements and, starting in 2021, an estimate of the monthly lifetime retirement income a participant and their spouse might reasonably expect from their current plan savings.<sup>36</sup> Each plan generally must file an annual report with the Internal Revenue Service (IRS), including an audited financial statement and other investment information.
4. *Paying for Plan Startup & Operations.* Most, if not all, states will want their plans to be self-sustaining and cover all their costs, such as recordkeeping and investment fees, as well as expenses for lawyers, consultants, auditors, and employee education and communication. Each employer could pay for its share of these expenses, but DC plans typically pass on most costs to participants through embedded investment fees or a separate fee deducted from each employee’s account. ERISA requires that all fees paid by the plan or participants be reasonable.<sup>37</sup>

An additional fee consideration for states is who pays for the state’s own startup and ongoing costs. States could insist that the plan administrator or pooled plan provider cover these costs. Alternatively, certain expenses possibly could be paid by the plan itself, such as through a small, extra asset-based charge. However, ERISA forbids charging participants for “settlor expenses:” activities that benefit the employer and not the plan or its participants. Logically, state costs should not be settlor charges, since the state does not have any employees covered by the plan and is acting to promote retirement savings by workers. States should seek legal guidance about this point.

<sup>30</sup> ERISA Sec. 3(21)(A).

<sup>31</sup> ERISA Sec. 404. The ERISA fiduciary duties have been famously described as the “highest known to law.” *Donovan v. Bierwirth*, 680 F.2d 263, 272 fn.8 (2d Cir. 1982).

<sup>32</sup> ERISA Sec. 404(c); DOL Reg. Sec. 2550.404c-1.

<sup>33</sup> ERISA Sec. 404(c)(5); DOL Reg. Sec. 2550.404c-5.

<sup>34</sup> Lately, ESG-type funds that consider a company’s environmental, social, and governance policies and practices in making stock selections are being added to plan investment lineups. The Obama DOL viewed ESG screens as prudent if the fund manager did not sacrifice the ERISA goals of return and diversification. The Trump DOL went in the other direction, requiring that the plan investment fiduciary take extra steps and focus solely on investment potential before offering participants an ESG option. The Biden DOL is expected to return to a more-accommodative or at least neutral position; states should still consult their attorneys and financial consultants before adding an ESG fund.

<sup>35</sup> ERISA Sec. 105.

<sup>36</sup> Morse (Autumn 2020). “Annuity Illustrated,” 33 *Benefits Law Journal*, No. 3.

<sup>37</sup> There have been dozens of class action suits against sponsors and vendors, seeking return of too-high fees.



## V. The Tax Code and 401(k)s

While ERISA focuses on fiduciary behavior, the Tax Code seeks to encourage participation by lower-paid workers and prevent “unfair” advantages for owners, senior executives, and other key employees. 401(k) and other retirement plans must be “tax qualified” by meeting a series of mathematical “discrimination” tests, operating rules, and limits intended to keep the plan from benefiting highly compensated employees (HCEs) too much. In 2021, an HCE is generally anyone owning 5% or more of the employer or who earned at least \$130,000 (indexed) in 2020.

There also are rules for employee and employer contributions, vesting, restrictions on withdrawals, and what terms need to be in the official plan document. For example:

1. *Eligibility to Participate.* A plan may cover all employees, but the Tax Code permits exclusion of certain employees, such as new hires, part-timers, individuals under age 21, or workers in certain specified categories (such as those at a particular location), as long as the plan passes “coverage” tests by including sufficient numbers of non-HCEs.<sup>38</sup>
2. *Employee and Employer Contributions.* Employee 401(k) contributions are tax-deferred up to the Tax Code’s limits — for 2021, \$19,500 for those under age 50 and \$26,000 for those who will be at least 50 by year-end.<sup>39</sup> (Dollar limits are indexed annually for inflation.) Alternatively, a plan may allow employees to make Roth 401(k) contributions up to these same limits. Unlike with IRAs, any participant may make a Roth 401(k) contribution regardless of income. Many plans allow employees to choose between traditional and Roth 401(k) contributions.

Employers may match employees’ contributions (e.g., 50% of the first 6% contributed) and/or make non-matching contributions (e.g., 3% of each worker’s pay). Plans typically give employers flexibility to reduce future contributions or to wait until the end of the year before deciding how much, if any amount, to contribute.

3. *Vesting.* Employees are always 100 percent vested in their own contributions and, depending on the plan’s terms, employer contributions can vest anywhere from immediately to over three to six years.<sup>40</sup> Forfeitures of nonvested contributions when a participant leaves may be used by the employer to reduce future contributions or pay plan expenses, or as an additional contribution for the remaining participants.
4. *Spousal Rights.* A married DC plan participant must designate their spouse as beneficiary unless the spouse consents in a notarized writing to waive this right. Upon divorce or legal separation, a court may issue a domestic relations order, called a QDRO, requiring that the plan transfer part (or even all) of the participant’s benefit to a plan account set up for the ex-spouse.<sup>41</sup>
5. *Loans and Withdrawals.* The Tax Code permits a plan to allow participants to borrow from their account. Generally, loans may not exceed \$50,000 and must be repaid, with interest, over five years.<sup>42</sup> Plans also may allow employees to withdraw their savings for “hardship,” such as to prevent eviction or pay funeral costs, home purchase, and college tuition. Loan defaults and withdrawals are taxable and may be hit with a 10% excise tax if the participant is under age 59½, unless certain exceptions apply.<sup>43</sup>

The availability of loans and withdrawals may encourage employee contributions by allowing access to funds in financial emergencies. However, “leakage” — spending retirement savings before retirement — is a concern, and many 401(k) programs offer free financial education and budgeting assistance to encourage savings. Some plans restrict loans and hardship beyond the Tax Code requirements to reduce leakage.

<sup>38</sup> Tax Code Sec. 410(b).

<sup>39</sup> Tax Code Sec. 402(g).

<sup>40</sup> Tax Code Sec. 411(a).

<sup>41</sup> Tax Code Secs. 401(a)(11) and 414(p).

<sup>42</sup> Tax Code Sec. 4975.

<sup>43</sup> Tax Code Secs. 401(k)(2) and 72(t).

6. *Distributions.* Plan distributions must begin by the later of age 72 or retirement (5% owners must withdraw by 72 even if still employed).<sup>44</sup> Retirees may choose to receive their benefits in any form allowed by the plan document. Typically, these include lump sums and installments. There is increasing interest in encouraging participants to use all or a portion of their account to buy a lifetime annuity from an insurance company to help manage their assets to last in retirement. While many experts agree that providing a lifetime income option would be beneficial, there is a need to develop more-attractive and cost-effective options that both employers and employees demand. New types of lifetime income solutions are being developed to meet this emerging need for DC plans to generate a reliable stream of income in retirement as with a traditional DB plan.
7. *Tax Code Violations.* Plan administrators should have procedures (including regular testing) to prevent over-contributions and discrimination. Even with the best practices in place, mistakes will occur, and violation of any of the Tax Code requirements could theoretically cause a plan to be “disqualified.” Disqualification causes the retroactive loss of all favorable tax benefits: Participants are immediately taxed on vested benefits, even if not paid out; the plan must pay income tax on its investment earnings; the employer can lose its tax deduction; and participants and the employer may have interest and tax penalties.

Fortunately, because of these draconian consequences, the IRS is loath to disqualify a plan. Instead, it has created a series of procedures by which an employer can correct a qualification defect.<sup>45</sup> Depending on the relative size and nature of the error, and how it was caught (by the employer and self-corrected or by the IRS in an audit), almost all errors may be fixed by undoing the mistake, making all participants whole, and — for certain egregious violations — the employer paying an IRS user fee or penalty.

8. *Bad Apples, MEPs, and PEPs.* Generally, the Tax Code nondiscrimination qualification rules apply separately to each employer participating in a MEP or PEP.<sup>46</sup> Although the IRS asserts that one employer’s violation infects the entire plan,<sup>47</sup> the “bad apple” will not affect the other (good apple) employers, as long as the plan administrator has policies to avoid, find, and fix mistakes; instructs the bad apple employer to fix the error; and notifies participants of how the problem is being addressed. Finally, if the offending employer does not act, the slice of the plan attributable to the bad apple employer must be spun off into a separate plan. Such correction protocols will protect the state, MEP or PEP, employers, and participants from punishment for the sins of another.<sup>48</sup>

**State-Facilitated 401(k) Plan Considerations: Plan Type, Design, and Fiduciary Responsibilities.** While a single employer, MEP, or PEP approach can all be appropriate for a state-facilitated 401(k), a state should consider the following key considerations with respect to the selection of plan design and the extent to which that selection affects the degree of fiduciary responsibility assumed by the state:

1. **Single Employer 401(k) Plan.** A state-facilitated single employer 401(k) would entail the state selecting the administrator/recordkeeper, trustee, and investment lineup, and then developing the program’s terms. To join, employers (in or out of state) would complete a fill-in-the-blank “prototype” plan adoption agreement. Legally, each employer would sponsor its own plan (hence the term “single employer”), with authority to amend the plan, alter investments, etc. By selecting the providers and program features, the state would curate the choices available to adopting employers, thus simplifying administration and (ideally) enabling the state to negotiate favorable fees.
2. **A MEP or PEP Plan Has Advantages Over a Single Plan.** While the single employer, MEP, or PEP approach can all be appropriate for a state-facilitated 401(k), policymakers may favor group plans in general and PEPs in particular for two reasons. First, a PEP could be offered to both in-state employers and outsiders. While a state would be primarily concerned with expanding coverage for its own residents, out-of-state employers would add to the asset base, potentially lowering per-participant plan costs. Indeed, this is the

<sup>44</sup> Tax Code Sec. 401(a)(9).

<sup>45</sup> IRS Rev. Proc. 2019-19.

<sup>46</sup> IRC Secs. 413(c)(6) & 410(b).

<sup>47</sup> Treas. Reg. Sec. 1.413-2(a)(3)(iv). Both Democrats and Republicans want to encourage 401(k) coverage, and recent legislation and Congressional pressure have softened the bad apple rule. Many experts have encouraged Congress to remove the rule entirely.

<sup>48</sup> The danger may be mostly illusory: We are not aware of any instance where the IRS penalized all employers or the plan itself due to one employer’s violation.

model used by many state 529 college tuition reimbursement programs. Second, the state can outsource most (but probably not all) of its ERISA fiduciary responsibility to the pooled plan provider.

3. **ERISA Fiduciary Responsibility.** The choice of single employer, MEP, or PEP approach could affect the degree, if any, of fiduciary responsibility assumed by the state or state-appointed board tasked with selecting, monitoring, and (if necessary) running the program. As previously discussed, someone with authority to appoint or remove an ERISA fiduciary is themselves a fiduciary. However, states are well-situated to act as fiduciaries and should be able to manage any fiduciary status comfortably, first by following careful processes to select providers (and states already have detailed procurement rules in place) and then by obtaining robust indemnification protections from all providers. States are likely to already have fiduciary exposure (albeit, under state law, not ERISA) for their 529 accounts and other programs geared for the private sector.<sup>49</sup>
4. **Tools and Flexibility to Encourage Plan Participation.** Experience with private sector 401(k)s and active auto-IRA programs shows, beyond doubt, that automatic participation (with opt-outs) dramatically increases savings levels.<sup>50</sup> Thus, policymakers should insist that plan documents require that covered employees be automatically enrolled at a set contribution rate and escalate their contributions increase annually until reaching a specified level. Policymakers should be careful not to set the contribution default rate too low, because that would slow the progress of savers. For example, the Massachusetts CORE program sets a 6% default contribution rate for plan participants. Research has shown that employees readily accept higher default contribution rates than the traditional 3%, which is becoming increasingly less common in private sector employer-sponsored plans.<sup>51</sup>

To encourage employers to join the plan, policymakers should allow employers some flexibility to choose eligibility rules, contribution rates, and other plan features from a menu of terms established by the state. However, employer flexibility must be balanced with state efforts to keep administrative costs low and worker savings high. In addition, plan design could minimize the possibility of a qualification violation by taking advantage of various Tax Code safe harbor provisions. For example, the Tax Code gives a 401(k) plan with auto-enrollment and a minimum level of fully vested matching or other employer contributions a free pass on many of the non-discrimination rules.<sup>52</sup>

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<sup>49</sup> The argument that the state is not a fiduciary might be strongest with single employer plans and PEPs. For single employer plans, states could claim that they merely curate the program, while each adopting employer has control over adoption and the ability to switch service providers. With PEPs, the state could assert that the pooled provider is completely in charge.

<sup>50</sup> Ellis, Munnell, & Eschtruth (2014). *Falling Short: The Coming Retirement Crisis and What to Do About It*, Oxford University Press.

<sup>51</sup> John & Shiflett (April 2017). Higher Initial Contribution Levels in Automatic Enrollment Plans May Result in Greater Retirement Savings: A Review of the Evidence, AARP Public Policy Institute.

<sup>52</sup> Tax Code Sec. 401(k)(12) & (13).

## VI. CONCLUSION

State-facilitated auto-IRAs and 401(k)s are two options for policymakers to consider as ways to make significant progress in closing the retirement access gap and offer millions of private sector workers the opportunity to save for retirement. While it is also possible that the new PEPs authorized by the SECURE Act can provide another option for employers, including those that do not currently offer a plan, it is unlikely that PEPs will cover the majority of the 57 million private sector workers who currently lack access. Therefore, these state programs and private sector options should be viewed as complementary rather than competitive.

The key distinctions between the two options for state-facilitated retirement savings programs are 1) an auto-IRA is not preempted by ERISA; 2) a 401(k) is an ERISA-regulated plan that offers higher contribution limits for participants and employers, but 3) this means that a state can require that employers allow employees to save through an auto-IRA, while employers must adopt a 401(k) voluntarily. Policymakers will have to weigh the pros and cons of each before choosing a solution. However, if the objective is to close the access gap, far more workers are going to begin to save if most, if not all, employers are required to offer their workers access to a way to save. State programs, in particular state auto-IRA programs that require employer participation, already have begun to demonstrate their ability to make significant progress in closing the access gap for private sector workers.

# Appendix A

## The U.S. Department of Labor's (DOL) Existing IRA Safe Harbor Guidance

One of the DOL's first actions when ERISA went into effect was to issue a safe harbor for payroll deduction IRAs. The regulation states that an IRA program is not an ERISA pension plan if: (1) no contributions are made by the employer; (2) employee participation is completely voluntary; (3) the sole employer involvement is to collect contributions through payroll deductions and remit them to the IRA sponsor and to permit, without employer endorsement, the sponsor to publicize the program to employees; and (4) the employer receives no compensation (other than for certain permitted services actually performed).<sup>53</sup>

In 1999, the DOL issued *Interpretive Bulletin* 99-1 as part of its efforts to encourage retirement savings through payroll deduction IRAs. The *Bulletin* noted that "over half of the private wage and salary workforce does not have employment-based retirement coverage" and that this lack of coverage was most-prevalent among employers with fewer than 100 employees. The *Bulletin* then observed that small employers do not sponsor retirement plans in part due to the "administrative complexity and burden" and the "risk of commitment to an ongoing expense in the face of financial uncertainties." While noting that employees could set up their own IRAs, the DOL concluded that they are more likely to "make use of an individual retirement savings vehicle that is offered in an employment setting and features regular withholding." The *Bulletin* stressed the DOL's "long-held view that an employer who simply provides employees with the opportunity for making contributions to an IRA through payroll deductions does not thereby established a 'pension plan.'"

The *Bulletin* also said that the employer endorsement and voluntary participation requirements are interrelated. Thus, according to the *Bulletin*, for a program to be completely voluntary, the employer cannot "endorse or recommend either the [IRA] sponsor or the funding media" and should inform employees that other IRA vehicles are available outside the program and that an IRA may not be appropriate for an employee. On the other hand, an employee's participation would not be voluntary if they were coerced into contributing.

Some employer involvement is allowed in a payroll deduction IRA. Thus, in a payroll IRA program that was invested in a Prudential Insurance group annuity contract, the DOL permitted the employer to accept Prudential's upcoming plan of demutualization/public offering and decide how the demutualization proceeds should be divided among IRA participants.<sup>54</sup> The DOL noted that the ruling was based on three factors: (1) actions of an independent third party caused the need for the employer to act; (2) the employer would be acting in accordance with New Jersey insurance law; and (3) the employer's actions were one-time acts that would not involve their employer retaining any ongoing discretion in administering or operating the IRAs.

The DOL allowed an even greater and ongoing level of employer involvement when it ruled that an employer could select three IRA sponsors from a pool of applicants, periodically review each sponsor's performance, replace any underperformers, and negotiate for and receive a written indemnification from each sponsor.<sup>55</sup>

<sup>53</sup> DOL Reg. § 2510.3-2(d).

<sup>54</sup> AO 2001-03A (Feb. 15, 2001).

<sup>55</sup> AO 82-27A (June 16, 1982).



## Appendix B

### Obama Administration's DOL 2016 Auto-IRA Safe Harbor Rescinded by the Trump Administration and Congress

In 2016, during the waning days of the Obama administration, the DOL issued an extra IRA safe harbor specifically for state auto-IRAs ("2016 Safe Harbor").<sup>56</sup> One of the first actions of the Trump administration and the new Congress in 2017 was to "disapprove" (i.e., revoke) the 2016 Safe Harbor (along with a slew of other unrelated regulations by other government agencies) pursuant to the Congressional Review Act (CRA).<sup>57</sup> The CRA provides Congress with a simplified procedure to issue a "disapproval resolution" revoking certain recent federal regulations and prohibiting federal agencies from issuing a new rule that is "substantially the same" as the revoked regulation. The disapproval resolution simply provided that the 2016 Safe Harbor will have "no force or effect." The 2016 Safe Harbor disapproval resolution also appears to have revoked the related "preambles" published with the regulation by the DOL. The disapproval resolution revoking the 2016 Safe Harbor does not reference the 1975 Safe Harbor.

While there is little judicial precedent on the effect of a CRA disapproval resolution, most experts understand that the regulatory landscape is as if the 2016 Safe Harbor had never been issued.

*Remaining Precedential Value of the 2016 Safe Harbor.* The 2016 Safe Harbor provided 11 conditions, essentially derivative of the 1975 Safe Harbor, but applicable only to state IRA programs. The 2016 Safe Harbor conditions were: (1) the program is established by state law; (2) the program is implemented and administered by the state or its delegate; (3) the state or its delegate is responsible for the security of payroll deductions and employee savings (including through existing state wage and antitheft laws); (4) the state or its delegate provides for employee notices and an enforcement mechanism; (5) employee participation is voluntary; (6) rights of participants and beneficiaries are enforceable only by such individuals, their representatives, and the state or its delegate; (7) employer involvement is limited to processing and remitting payroll withholdings, distributing notices and program information to employees, and providing information to the state or its delegate; (8) the employer does not contribute to the program and does not give employees compensation or other financial incentives to contribute; (9) employer participation is mandated by state law; (10) the employer has no discretionary authority or responsibility under the program; and (11) the employer is not compensated (directly or indirectly) for participating in the program except for certain state provisions of the employer's actual or reasonably estimated program costs.

In deliberating whether, and under what terms, to issue the 2016 Safe Harbor, the DOL argued that a payroll withholding program that nudged employees into saving through automatic enrollment elections would not satisfy the "completely voluntary" condition of the 1975 Safe Harbor. The DOL concern was that a program's auto-enrollment or escalation feature could cause an employer to exercise undue influence over an employee's participation and that contributions that were made without an affirmative opt-in election might not be completely voluntary. Although there is no semantic or logical difference between "voluntary" and "completely voluntary" participation, the DOL's concern, expressed in the preambles to the 2016 Safe Harbor, appears to have been directed at programs in which there is some employer involvement in the auto-enrollment process.

Conversely, the preambles do not argue that a program with automatic employee elections in which an employer had no control over the program's terms, was neutral about whether employees should contribute, did not solicit employee elections, and was required by state law to make the program available to employees would fail the completely voluntary condition. Thus, for example, if a state program mandates employer participation and limits employer activity to facilitating wage deferrals and transmitting contributions to the program IRAs, there is no "volition" by employers that would constitute an "establishment" of the IRAs.

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<sup>56</sup> DOL Reg. § 2510.3-2(h).

<sup>57</sup> H.J. Res. 66, 115th Cong. (2017).

# Appendix C

## ERISA Coverage and Preemption: An Overview of Judicial Case Law and Interpretation

**Introduction.** Auto-IRA preemption analysis boils down to two simple questions. First, is the state program itself an ERISA plan? Once it is determined that an auto-IRA is not an ERISA plan, the preemption question is whether a state law requiring certain employers to facilitate the program (make it available to workers) “relates to” an ERISA-regulated plan. In other words, does the state law affect employers’ operation or management of any 401(k), DC, or other ERISA plans that they offer or require them to establish an ERISA plan?

**The Courts on Defining What is an ERISA Plan.** The Supreme Court has found that an ERISA plan does not exist when an employer assumes no responsibility to pay benefits on a regular basis, and there is no need for ongoing administrative practices associated with providing benefits.<sup>58</sup> The question of whether a plan is “established or maintained by an employer” is one of fact “to be answered in light of all the surrounding facts and circumstances from the point of view of a reasonable person.”<sup>59</sup> In applying this test, the crucial factor is whether the employer intends to provide benefits on a regular and long-term basis.<sup>60</sup> To ascertain whether an employer has established an ERISA benefits plan, courts will look to (1) internal or distributed documents, (2) oral representations, (3) the existence of a fund or account to pay benefits, (4) actual payment of benefits, (5) a deliberate failure to correct known perceptions of a plan’s existence, (6) the reasonable understanding of employees, and (7) the intentions of the putative sponsor.<sup>61</sup>

ERISA’s regulation of employee benefit plans presumes a level of administrative and operational activity, since the employer’s activities with respect to a plan are vulnerable to abuse.<sup>62</sup> The purpose of the “established or maintained by an employer” requirement is to “ascertain whether the plan is part of an employment relationship by looking at the degree of participation by the employer in the establishment or maintenance of the plan.”<sup>63</sup> A plan is established when the employer has taken affirmative steps to extend benefits, for example, by financing or arranging financing to fund benefits, establishing a procedure for disbursing benefits, or representing to employees that the employer has established a plan.<sup>64</sup> Without documentary evidence, even an employer’s alleged promise to provide benefits does not establish an ERISA plan.<sup>65</sup> A plan is established when the employer has taken affirmative steps to extend benefits by, for example, financing or arranging financing to fund benefits, establishing a procedure for disbursing benefits, or representing to employees that they have established a plan.<sup>66</sup> Even an employer’s alleged promise to provide benefits, without documentary evidence, does not establish an ERISA plan.<sup>67</sup>

The Supreme Court has found that a plan does not exist when an employer assumes no responsibility to pay benefits on a regular basis and there is no need for ongoing administrative practices associated with providing benefits.<sup>68</sup> The question of whether a plan is “established or maintained by an employer” is one of fact “to be answered in light of all the surrounding facts and circumstances from the point of view of a reasonable person.”<sup>69</sup> In applying this test, the crucial factor is whether the employer intends to provide benefits on a regular and long-term basis.<sup>70</sup> To ascertain whether an employer has established an ERISA benefits plan, courts will look to (1) internal or distributed documents, (2) oral representations, (3) the existence of a fund or account to pay benefits,

<sup>58</sup> *Fort Halifax Packing Co.*, 482 U.S. at 12.

<sup>59</sup> *Deibler v. United Food & Commercial Workers’ Local Union 23*, 973 F.2d 206, 209 (3d Cir. 1992).

<sup>60</sup> See *Deibler*, 973 F.2d at 209 (citing *Wickman v. Nw. Nat’l Ins. Co.*, 908 F.2d 1077, 1083 (1st Cir. 1990)).

<sup>61</sup> *Henglein v. Informal Plan for Plant Shutdown Benefits for Salaried Employees*, 974 F.2d 391, 400 (3d Cir. 1992).

<sup>62</sup> *Fort Halifax Packing Co. v. Coyne*, 482 U.S. 1, 16 (1987).

<sup>63</sup> *Peckham v. GEM State Mut. of Utah*, 964 F.2d 1043, 1049 (10th Cir. 1992) (holding that an employer’s subscription to a multi-employer group insurance trust that provides employers with insurance for their employees, the purchase of insurance for its employees, and the listing of insurance in the company manual as an employee benefit created an employment relationship that satisfied the “established or maintained” requirement).

<sup>64</sup> *Ed Miniati, Inc. v. Globe Life Ins. Group, Inc.*, 805 F.2d 732, 739 (7th Cir. 1986).

<sup>65</sup> See, e.g., *Harris v. Arkansas Book Co.*, 794 F.2d 358, 360 (8th Cir. 1986) (holding that an employer’s alleged promise to provide retirement benefits did not constitute the establishment of an employee pension plan, despite making payments to another employee after that employee’s retirement).

<sup>66</sup> *Ed Miniati, Inc. v. Globe Life Ins. Group, Inc.*, 805 F.2d 732, 739 (7th Cir. 1986).

<sup>67</sup> See, e.g., *Harris v. Arkansas Book Co.*, 794 F.2d 358, 360 (8th Cir. 1986) (holding that an employer’s alleged promise to provide retirement benefits did not constitute the establishment of an employee pension plan, despite making payments to another employee after that employee’s retirement).

<sup>68</sup> *Fort Halifax Packing Co.*, 482 U.S. at 12.

<sup>69</sup> *Deibler v. United Food & Commercial Workers’ Local Union 23*, 973 F.2d 206, 209 (3d Cir. 1992).

<sup>70</sup> See *Deibler*, 973 F.2d at 209 (citing *Wickman v. Nw. Nat’l Ins. Co.*, 908 F.2d 1077, 1083 (1st Cir. 1990)).

(4) actual payment of benefits, (5) a deliberate failure to correct known perceptions of a plan's existence, (6) the reasonable understanding of employees, and (7) the intentions of the putative sponsor.<sup>71</sup>

**The Courts on ERISA Preemption.** A good example of the Supreme Court's current thinking about when ERISA preempts a state law involved Vermont's so-called "all-payer" health data collection law. In *Gobeille v. Liberty Mutual Ins. Co.*,<sup>72</sup> the Supreme Court held that the Vermont law was preempted because it imposed significant data collection and reporting requirements on all health programs in the state, including "self-insured" ERISA-regulated plans. The court noted that since everything is "related" to everything else, ERISA use of that term must be narrowly construed; Congress intended to protect plans and plan administrators from "interference with the uniformity of ... administration" and financial burdens of compliance; and preemption should keep the states from regulating "a central aspect of plan administration." The court described ERISA's reporting, disclosure, and recordkeeping rules as a "central" and "essential part" of ERISA and thus preempted the Vermont law because it added a significant level of reporting rules onto ERISA plans.

With the Supreme Court setting the standards for addressing preemption, two California cases show that states may address the health and retirement needs of private sector workers without running afoul of ERISA. The first is a Ninth Circuit analysis of a local health ordinance and the second is a 2020 District Court decision ruling that CalSavers, California's auto-IRA program, is not preempted by ERISA.

**Golden Gate Restaurant Association v. City and County of San Francisco.** In *Golden Gate Restaurant Association v. City and County of San Francisco*, the Ninth Circuit found that the San Francisco Health Care Security Ordinance, which included a mandate that employers spend a specified amount each year for their employees' healthcare, either through payment of insurance premiums, reimbursement for medical expenses, or paying into a medical program administered by San Francisco, was not preempted by ERISA.<sup>73</sup> The court determined that the ordinance did not regulate benefits or charges for benefits because it "did not require employers to establish their own ERISA plans or to make changes to any existing ERISA plans" and it was "not concerned with the nature of the health care benefits an employer provides to its employees." Further, the court determined that the ordinance provided discretion to ERISA administrators to determine plan eligibility and entitlement to particular benefits, and that the city payment option gave employers a realistic alternative to paying benefits under an ERISA plan and something in return for their payments to San Francisco.

**The Courts and State Auto-IRAs: *Jarvis v. California Secure Choice*.** In the only legal challenge to an auto-IRA, the District Court for the Eastern District of California ruled that CalSavers, California's auto-IRA program, was not an ERISA plan and that the state enabling legislation was not preempted by ERISA. Relying on *Golden Gate*, among other decisions, the court found in *Howard Jarvis Taxpayers Association v. The California Secure Choice Retirement Savings Program*<sup>74</sup> that the degree of employer involvement in facilitating CalSavers was minimal and the program was not established or maintained by an employer. The court also found that "an employer's administrative duties must involve the application of more than a modicum of discretion in order for those duties to amount to an ERISA plan" and "an employer who makes no promises to its employees regarding an employee benefit plan or its coverage" has not established or maintained such plans. Simply remitting payroll deductions to an auto-IRA without discretion regarding the monies does not turn an employer into a plan sponsor.

After ruling that CalSavers was not an ERISA plan, the court went on to hold that the statute creating the program was not preempted by ERISA because it did not interfere with existing ERISA plans or impose additional requirements on ERISA plans. Indeed, the statute only applied if there were no ERISA plan. (The plaintiffs have appealed the decision to the Ninth Circuit.)

**Conclusion.** With the state (not employers) in charge of all aspects of program management and decision-making, auto-IRAs should be considered non-ERISA plans. State auto-IRA laws only affect employers that do *not* sponsor or maintain an ERISA retirement plan; state auto-IRA requirements do not apply to employers offering workers a 401(k), DC, or pension plan. Thus, state auto-IRAs should not be regulated by ERISA and the state mandate should not be preempted under the "relates to" clause.

<sup>71</sup> *Henglein v. Informal Plan for Plant Shutdown Benefits for Salaried Employees*, 974 F.2d 391, 400 (3d Cir. 1992).

<sup>72</sup> *Gobeille v. Liberty Mutual Ins. Co.* 136 S. Ct. 936 (2016).

<sup>73</sup> 546 F.3d 639, 642-43 (9th Cir. 2008).

<sup>74</sup> *Howard Jarvis Taxpayers Assoc. v. Cal. Secure Choice Retirement Savings Program*, E.D. Cal., No. 2:18-cv-01584-MCE-KJN.

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