STATE OF CALIFORNIA GRAY DAVIS, Governor

DEPARTMENT OF INDUSTRIAL RELATIONS
DIVISION OF LABOR STANDARDS ENFORCEMENT
LEGAL SECTION
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MILES E. LOCKER, *Attorney for the Labor Commissioner*

August 12, 2002

C. Frederick Reish
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Re: Supplemental Request In Connection With "Negative Elections To Participate In 401(k) Plans"

Dear Mr. Reish:

This is in response to your letter of February 28, 2000, wherein you request that the Division of Labor Standards Enforcement reconsider its previously published opinion on the above-referenced subject. Please accept my apology for the long delay in issuing this response.

The DLSE issued an opinion letter on September 18, 1998 in response to a request for an opinion on the use of "negative elections" to participate in 401(k) plans, and specifically, whether such "negative elections" were consistent with state law. In that letter, the facts were stated as follows:

> "Under the proposed procedure, the employees eligible to participate in the plan(s) would be automatically enrolled in such plans unless they affirmatively elected not to participate in the plan and so notified the plan administrator(s). The employees would be notified upon employment and/or eligibility concerning the negative election procedure."

As was pointed out in the opinion letter of September 18, 1998, the 1998 Revenue Ruling (Rev.Rul. 98-30, 1998-25 I.R.B. 8 (6/22/98)) which the request for an opinion relied upon, did not address state law minimum labor standards such as Labor Code

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Section 224, which requires written authorizations for deductions from wages. The February 2000 Revenue Ruling (Rev.Rul. 2000-8 (2/14/2000)), which you point to in your request for reconsideration, simply extends the 1998 Revenue Ruling to "new employees". Both address the same ultimate issue:

> "Will employer contributions to a profit-sharing plan fail to be considered elective contributions, within the meaning of §1.401(k)-1(g)(3) of the Income Tax Regulations, made under a qualified cash or deferred arrangement, within the meaning of §401(k) of the Internal Revenue Code, merely because they are made pursuant to an <u>arrangement</u> under which a fixed percentage of an employee's compensation is contributed to the plan unless the employee affirmatively elects to receive the amount in cash." (Underlined emphasis added)

Nowhere in the rulings you rely upon does the I.R.S. indicate that the employer is <u>required</u> or, indeed, even <u>empowered</u> by the federal statute to make a deduction without a written authorization as required by California law. The Ruling states that the definition of a "cash or deferred election" in the federal regulations "requires that the employee have an election between the employer paying cash...to the employee or making a contribution to a trust on behalf of the employee." The Ruling goes on to state that "[T]he regulation does not <u>require</u> that the employee receive an amount in cash in any case in which the employee does not make an affirmative election to have that amount contributed to the trust." The Ruling then makes the point that since such an arrangement is not prohibited by the federal regulation, "a cash or deferred election will not fail to be made under a qualified cash or deferred arrangement merely because, when an employee fails to make an affirmative election with respect to an amount of compensation, that amount is contributed on the employee's behalf to a trust, provided that the employee had an effective opportunity to elect to receive that amount in cash."

What the Rulings insure is that the contributions by the employer to a §401(k) plan will be treated as "elective contributions" despite the fact that the employee did not make an affirmative election (or with written authorization as required by

California law). This insures, of course, that the employer's contribution will enjoy the tax benefits available.

The I.R.S. rulings have nothing to do with the requirement that the employer must comply with the state-mandated minimum labor standard requiring written authorization for deductions from wages in California. Such labor standards, falling as they do within the traditional police powers of the state, if not inconsistent with a federal statutory scheme, will not be pre-empted. *Fort Halifax Packing Co. v. Coyne* 482 U.S. 1, 21 (1987)

In a previous letter to DLSE, dated August 27, 1999, you argued that deductions from an employee's paycheck to a 401(k) plan pursuant to "negative election" do not conflict with Labor Code section 221 at all, so that there is no need to reach the question as to whether such deductions fall within the exceptions to section 221 that are carved out by Labor Code section 224. In that letter, you contended:

> "The key words in Section 221, 'theretofore paid,' indicate that money is being deducted by the employer for a sum that has already been or has previously been paid to the employee. But in the case of money deducted for automatic deferrals the money is being deducted *before or concurrently with* the payment of the paycheck. Thus, an automatic deferral would not violate the provisions of Section 221."

But the courts have never interpreted Section 221, and related provisions in sections 222 and 223, in such a constricted manner; instead, "section 221 has long been held to prohibit deductions from an employee's wages for cash shortages, breakage, loss of equipment, and other business losses that may result from an employee's simple negligence." *Hudgins v. Neiman Marcus Group, Inc.* (1995) 35 Cal.App.4th 1109, 1118. Moreover, these sections have been interpreted not only to prohibit kickbacks, but also, to prevent any sort of deduction from wages that is not authorized by Section 224. "Even where fraud is not involved, however, the Legislature has recognized the employee's dependence on wages for the necessities of life and has, consequently, disapproved of unanticipated or unpredictable deductions because they impose a

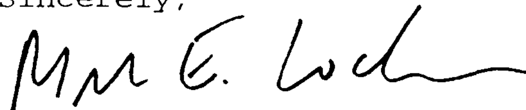
special hardship on employees." *Ibid.*, at 1119. In the words of our Supreme Court, "A further reason for legislative disapproval of deductions exists in the reliance of the employee on receiving his expected wage, whether it be computed upon the basis of a set minimum, a piece rate, or a commission." *Kerr's Catering Service v. Department of Industrial Relations* (1962) 57 Cal.2d 319, 329.

The practice of making paycheck deductions based on "negative election" is also at odds with Labor Code section 212, which prohibits the payment of wages due through any "order, check, draft, note, memorandum or other acknowledgment of indebtedness, unless it is negotiable and payable in cash, on demand, without discount . . . ." Under the "negative election" procedure, the portion of the employee's wages that is directed -- without any sort of express prior authorization from the employee -- into the employee's 401(k) account would not be "negotiable and payable in cash, on demand, without discount." And the absence of this express prior authorization is precisely what makes this procedure illegal under state law -- under Labor Code §213(d), section 212 does not prohibit "an employer from depositing wages due . . . in any bank, savings and loan association, or credit union of the employee's choice in this state, **provided the employee has voluntarily authorized such deposit.**"

In summary, for all of the reasons set forth above, the Division declines your request to reassess its position regarding so-called "Negative Elections to Participate In 401(k) Plans" as contained in the opinion letter of September 18, 1998.

Thank you for your continuing interest in California labor law. If you have any questions or comments, please contact the undersigned.

Sincerely,



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