APPENDIX

AUTOMATIC ENROLLMENT ARRANGEMENTS UNDER THE PENSION PROTECTION ACT OF 2006

Introduction

One of the important plan design decisions a 401(k) plan sponsor must make as a result of the Pension Protection Act of 2006 (PPA) is whether to introduce automatic enrollment features. There is extensive literature on the potential benefits of automatic enrollment on participation rates, especially for lower-paid employees.[1]

The PPA provides a significant incentive for employers that have not already adopted automatic enrollment to reconsider their decisions. The PPA pre-empts state laws that might affect plans adopting automatic enrollment provisions[2] and provides additional nondiscrimination safe harbor protections.

Automatic Enrollment Arrangements

Under the PPA, there are two types of automatic contribution arrangements: eligible automatic contribution arrangements and qualified automatic contribution arrangements.

Eligible Automatic Contribution Arrangement (EACA)—If plan sponsors apply a uniform automatic contribution percentage for all employees, invest the contributions in a qualified default investment alternative (discussed below), and provide the required notices to employees, their plans are considered "eligible." Plan sponsors providing EACAs will have six months after the end of the plan year to perform nondiscrimination tests (such as the actual deferral percentage test, actual contribution percentage test, and top-heavy rules) and make corrections. Plan sponsors can allow a 90-day revocation withdrawal provision in an EACA, meaning that an

[1] For more details, see Jack VanDerhei, "The Expected Impact of Automatic Escalation of 401(k) Contributions on Retirement Income," *EBRI Notes*, no. 9 (Employee Benefit Research Institute, September 2007: 2–8) and Jack VanDerhei and Craig Copeland, "Impact of PPA on Retirement Savings for 401(k) Participants," *EBRI Issue Brief*, no. 318 (Employee Benefit Research Institute, June 2008).

[2] The PPA preemption eliminates any concern employers may have about violation of state or local laws that require an employee's written consent to deductions from the employee's paycheck. Some employers were reluctant to use automatic enrollment because of a concern about liability for violating state payroll-withholding laws (O'Hare and Amendola, 2007).

employee must make the election to receive a distribution of erroneous automatic contributions within 90 days after automatic enrollment begins.[3]

Qualified Automatic Contribution Arrangement (QACA)—The PPA waives the nondiscrimination testing requirement for a plan sponsor that has a QACA. This is often referred to as a safe harbor automatic enrollment arrangement. It requires meeting the EACA requirements and complying with two additional requirements:[4]

- The initial automatic enrollment amount must be at least 3 percent (but not more than 10 percent) of compensation. The plan sponsor must increase in annual 1 percent increments to 6 percent of compensation (e.g., at least 4 percent in the second year, at least 5 percent in the third year, and at least 6 percent in the fourth year), but not exceed 10 percent of compensation.
- The plan sponsor must fund a "safe harbor" contribution which must be 100 percent vested after two years of service.[5] The minimum employer safe harbor contributions are required. The plan sponsor must make either a matching contribution of 100 percent of the first 1 percent of compensation deferred plus 50 percent of the next 5 percent deferred (for a maximum match of 3.5 percent of compensation) *or* a non-elective contribution of at least 3 percent of compensation to all eligible nonhighly compensated employees.

Qualified Default Investment Alternatives (QDIA)—Plan sponsors must decide how to invest automatic enrollment contributions, because the employee is not making this election. The PPA offers fiduciary protection, if plan sponsors invest the automatic enrollment contributions in a QDIA. The Department of Labor recently issued final regulations providing for four types of QDIAs: (a) an investment fund product that takes into account the participant's age or retirement date (e.g., a life-cycle or targeted-retirement-date fund), (b) an investment fund product that takes into account the characteristics of the group of employees as a whole (e.g., a balanced fund), (c) an investment management service where assets are allocated based on the participant's age or retirement date (e.g., a professionally managed account), and (d) a capital preservation product that may be chosen for

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[3] The corrective distributions of erroneous automatic contributions from a plan are not subject to the IRC Sec. 672(t) 10 percent early withdrawal penalty, and such distributions are not taken into account for purposes of applying the nondiscrimination tests or the limit on elective deferrals (O'Hare and Amendola, 2007).

[4] To satisfy the QACA provisions, the plan sponsor does not need to invest the automatic contributions in a qualified default investment alternative (QDIA). In most situations, plan sponsors may want to invest money in a QDIA for fiduciary protection, but it is not required.

[5] In regular 401(k) safe harbor arrangements (i.e., those that are not QACAs), however, *immediate* full vesting of safe harbor contributions is mandated.

the first 120 days after the first elective contribution is made in an eligible automatic contribution arrangement. However, the investment must be redirected to one of the other QDIAs, for use after the 120-day period ends. Overall, with QDIAs, the participant can be automatically enrolled, have the contributions automatically invested in the appropriate QDIA, and the plan sponsor is protected from liability.

Bibliography

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