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Pension ANALYST

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Pension Protection Act of 2006
Provides Retirement Savings Incentives

This is the first of a series of *Pension Analyst* publications providing information on specific aspects of the 2006 pension reform legislation affecting defined contribution plans. Of course, the 1000 pages of this new law are only the starting point for changes affecting plan design and administration. In the upcoming weeks, months, and years, regulatory agencies will publish guidance to add substance to the general directives provided by the law. To make this information more meaningful to plan sponsors, we are presenting it in discrete pieces, beginning with this discussion of the new automatic enrollment provisions.

WHO'S AFFECTED The automatic enrollment, escalation, and investment provisions of the Pension Protection Act of 2006 (PPA) apply to 401(k) plans, 403(b) arrangements and section 457(b) plans and participants.

BACKGROUND AND SUMMARY In the late 1990's, sponsors of 401(k) plans looked for new ways to increase participation in their plans. One design that became popular was automatic (or "negative election") enrollment, which automatically enrolled employees at a specified deferral rate, unless they took action to not participate. This design became more popular in 2000, when the federal government began to encourage its use by 401(k) plans, 403(b) arrangements and section 457(b) plans.

However, the basic automatic enrollment design gave rise to a number of concerns that tended to slow its growth:

- Some states and other jurisdictions have laws that prohibit involuntary wage withholding. Were these laws preempted by ERISA? What about plans that are not subject to ERISA (e.g., governmental and church plans)?
- When employees were automatically enrolled in a plan, their deferral contributions were typically invested in a default investment vehicle. The Department of Labor indicated that without participant direction such default investments did not have ERISA section 404(c) protection. Many plan sponsors were concerned about losing that protection.
- Many automatically enrolled employees were not pleased to discover that part of their paychecks was going into the retirement plan, when they needed that money to cover day-to-day living expenses. However, plan sponsors were powerless to return any of these contributions if the employees were too young to qualify for in-service distributions. The employees were unhappy to have their money locked up in these plans and the employers were unhappy to have to maintain stagnant and typically small balance accounts.

- The same inertia that caused employees to be automatically enrolled in a plan tended to keep them at the same deferral level for many years. Since the initial deferral levels were usually quite low (typically 3%), these participants were not saving nearly enough to provide them with a secure retirement. Was it permissible to automatically increase deferral percentages for automatically enrolled participants?
- Even with the automatic enrollment design, plan sponsors generally had to perform annual nondiscrimination tests and often had to return excess contribution to highly compensated employees.

In an effort to stimulate greater use of this plan design and provide additional retirement security for employees, PPA now provides solutions for many of these concerns. For example, ERISA section 404(c) protection for default investment arrangements will be available for plan years beginning after December 31, 2006. An automatic enrollment safe harbor design will be available for plan years beginning after December 31, 2007.

ACTION AND NEXT STEPS Sponsors of plans that currently provide for automatic enrollment should review the information regarding default investments and ERISA section 404(c) protection, to determine if they need to make any changes in their investments or participant communications. Plan sponsors that have been considering the adoption of an automatic enrollment design should review the safe harbor design to determine if their plans should follow this approach.

IN THIS ISSUE

Even as defined benefit plans have become a dying breed, the federal government has recognized that many of their standard features, such as automatic coverage and investment management, promote a more secure retirement for employees. As a result, PPA encourages sponsors of 401(k) plans, 403(b) plans and section 457(b) plans to provide participants with the opportunity to achieve a more secure retirement through the use of automatic participation, contribution escalation, and investment provisions. PPA addresses the major concerns raised by these plan sponsors regarding these features by providing that:

- ERISA preempts state wage withholding laws that prohibit involuntary wage withholding;
- Default investment vehicles for deferral contributions made through the automatic enrollment process are eligible for ERISA section 404(c) protection;
- "Accidental" automatic deferral contributions may be distributed to participants;
- Automatic deferral percentages may be automatically increased from year to year; and
- Annual nondiscrimination testing may be avoided if the plan sponsor adopts a Safe Harbor plan design.

ERISA Preempts State Wage Withholding Laws

PPA adds a provision to ERISA that immediately preempts *any* state law that would directly or indirectly prohibit or restrict the use of an automatic contribution arrangement. This includes state laws that prohibit involuntary wage withholding.

For purposes of this provision, an “automatic contribution arrangement” is a 401(k) plan or a 403(b) arrangement that:

- Provides for deferral contributions to be made automatically at a specified percentage of compensation, unless a participant specifically elects not to participate or elects a different deferral rate;
- Invests automatic deferrals in accordance with default investment regulations to be issued by the Department of Labor (DOL); and
- Provides advance notice of the automatic contribution arrangement to all affected participants.

Of course, this state law preemption, which became effective August 17, 2006, only applies to plans that are subject to ERISA. As a result, it does not apply to governmental plans or non-electing church plans. It is not clear if this preemption applies to the Puerto Rico wage withholding laws.

Default Investments May Have ERISA Section 404(c) Protection

Effective for plan years beginning after December 31, 2006, default investment arrangements that comply with forthcoming DOL regulations will be eligible for ERISA section 404(c) protection if the plan provides appropriate notices to participants.

PPA directs the DOL to provide final regulations, including guidance regarding the appropriate mix of investment and asset classes to provide long-term appreciation or preservation or both, within six months of enactment (i.e., by February 17, 2007). It is our understanding that the DOL was already working on these regulations before PPA was enacted. We believe that the DOL will provide guidance in the form of descriptions of types of funds that would be appropriate default investments. These could include age-appropriate or targeted-to-maturity type funds, as well as balanced funds.

Plan sponsors must provide advance notice to participants of their right to designate investments and what will happen if no investment designation is made. Participants must be given a reasonable period of time after receipt of the notice and before contributions are made to make this designation.

Accidental Deferral Contributions May Be Distributed

Effective for plan years beginning after December 31, 2007, eligible automatic contribution arrangements may distribute automatic contributions made within 90 days following the date the first automatic contribution was made, regardless of the participant’s age. The affected participant must request the distribution, which will include all contributions made under the automatic contribution arrangement and related earnings, within 90 days following the date the first automatic contribution was made. The amount of this distribution will be included in the participant’s gross income in the year the distribution is made, but will not be subject to the 10% excise tax on early withdrawals. Any employer matching contribution made on account of the distributed deferrals must be forfeited.

For purposes of this provision, an "eligible automatic contribution arrangement" is a 401(k) plan, 403(b) arrangement or governmental section 457(b) plan that:

- Provides for deferral contributions to be made automatically at a specified percentage of compensation, unless a participant specifically elects not to participate or elects a different deferral rate;
- Invests automatic deferrals in accordance with default investment regulations to be issued by the Department of Labor (DOL); and
- Provides advance notice of the automatic contribution arrangement to all affected participants.

Extended Deadline for Correcting ADP and ACP Test Excesses

Also effective for plan years beginning after December 31, 2007, eligible automatic contribution arrangements will have a later deadline for making corrective distributions of excess contributions from failed ADP Tests and excess aggregate contributions from failed ACP Tests. The plan sponsor will not have to pay a 10% excise tax on these excesses if the plan makes the corrective distributions by the last day of the sixth month following the end of the plan year. In addition, both the excess amounts and the related earnings paid out within this six-month period will be taxable to the employees receiving them in the year distributed, regardless of the amount distributed.

Automatic Contribution Safe Harbor Design Available

Effective for plan years beginning after December 31, 2007, 401(k) plan sponsors may avoid ADP Testing, ACP Testing, and Top-Heavy Testing, and 403(b) plan sponsors may avoid ACP Testing, by adopting a qualified automatic contribution arrangement.

A "qualified automatic contribution arrangement" contains three components: required automatic deferral contributions, required employer contributions, and participant notification.

Automatic Deferral Contributions

A qualified automatic contribution arrangement must provide for deferral contributions to be made automatically at specified percentages of compensation, unless a participant specifically elects not to participate or elects a different deferral rate. The minimum required deferral amount increases following the first year of participation (automatic escalation), but may never exceed 10% of compensation. The minimum required automatic deferrals are as follows:

Plan Year of Participation	Minimum Deferral Percentage
First Year	3% of Compensation
Second Year	4% of Compensation
Third Year	5% of Compensation
All Later Years	6% of Compensation

In general, these automatic deferral requirements must apply to all eligible employees. However, plan sponsors are not required to apply them to employees who had already made a deferral election or an affirmative election not to participate immediately before the date the plan adopts these safe harbor provisions. If a plan converts from a traditional enrollment design to this safe harbor design, it is likely that employees who are not making deferral contributions have not made an affirmative election not to participate. As a result, these employees would be subject to these automatic deferral rules.

Required Employer Contributions

In addition, the employer must make either:

- A nonelective contribution equal to at least 3% of compensation; or
- A matching contribution that matches 100% of the first 1% of compensation deferred and 50% of deferrals that exceed 1% of compensation, with no match on deferrals exceeding 6% of compensation. Alternatively, the plan may provide an enhanced matching formula that results in matching contributions that are at least equal to the amount provided under the standard matching formula, with a rate that does not increase as the employee's rate of deferral contributions increases. To avoid ACP Testing, no matching contribution may be made on deferrals exceeding 6% of compensation.

Contributions made to satisfy this requirement may only be distributed when the participant reaches age 59½, dies, becomes disabled, or terminates employment. These contributions are not eligible for hardship withdrawals. In addition, participants must be 100% vested in these contributions after they complete two years of service.

Participant Notification

To qualify for safe harbor treatment, the plan must provide annual notices to participants about the plan's provisions. This notice must:

- Be provided before the start of the plan year;
- Accurately apprise employees of their rights and obligations under the plan;
- Be written in a manner that can be understood by the average eligible employee;
- Explain the employee's right to elect not to have deferral contributions made or elect a different contribution percentage;
- Explain default investment provisions; and
- Give the employee a reasonable time after receipt of the notice and before the first contribution is made to make contribution and investment elections.

ADP/ACP Safe Harbor Design is Also an Option

The new automatic contribution safe harbor design does not replace the existing ADP/ACP safe harbor design. In fact, the two safe harbor designs are very similar, but they are not identical. Some important differences include the following:

- The original ADP/ACP safe harbor design may include an automatic enrollment provision; the automatic contribution safe harbor must contain an automatic enrollment provision.
- There are no required deferral or escalation percentages for automatic deferrals made under the original ADP/ACP safe harbor design; automatic deferrals under the automatic contribution safe harbor are subject to minimum and maximum deferral and escalation requirements.
- The overall minimum required employer matching contribution made under the original ADP/ACP safe harbor design is 4% of compensation; the overall minimum required employer matching contribution under the automatic contribution safe harbor is 3.5% of compensation.
- Employer contributions made under the original ADP/ACP safe harbor design must be immediately 100% vested; employer contributions made under the automatic contribution safe harbor must be 100% vested after the employee has completed 2 years of service.

Since both safe harbor designs provide exemptions from ADP Testing, ACP Testing and Top-Heavy Testing, plan sponsors should look at the interaction of these design differences with their employee populations to determine which approach may be preferable, keeping in mind that the automatic contribution safe harbor is not available until 2008.

Immediate Next Steps

Sponsors of plans that currently contain automatic contribution provisions and are subject to ERISA should:

- Review their plan design to determine if these provisions may now be extended to additional employee populations due to the new state law preemption. Many plan sponsors had exempted employees living in New York, California, and Arizona from automatic enrollment provisions due to the uncertainty about the application of state wage withholding laws. With that uncertainty removed, plan administration may be streamlined by applying the same set of enrollment rules to all employees.

- Be aware of DOL regulatory activities regarding default investment arrangements. It is possible that plans will have to provide participants with special notices about these arrangements as early as December 1, 2006, for plan years beginning on January 1, 2007. In addition, plan sponsors may need to consider making changes to their default investment arrangements, in reaction to the forthcoming DOL guidance. Prudential Retirement will continue to monitor these activities and provide appropriate updates.

Future Action

Sponsors of plans that currently contain automatic contribution provisions, as well as sponsors of plans that do not contain these provisions, may want to begin considering the possibility of adopting the automatic contribution safe harbor design for 2008 or beyond.

In fact, even though the actual safe harbor will not be available until 2008, plan sponsors might consider incorporating some of these provisions (such as automatic escalation) into their plans before the start of the 2008 plan year. While these plans will still be subject to ADP, ACP and Top-Heavy Testing (unless they meet the existing ADP/ACP safe harbor design requirements), they will begin to put employees on the path to creating secure retirements for themselves.

If Prudential provides document services for your plan, we can assist you with incorporating some of these features into your existing plan, even though the actual automatic contribution safe harbor design will not be available until the start of the 2008 plan year. For more information, please contact your Prudential Retirement representative. As the IRS provides additional guidance with respect to these provisions (for example, specific participant notice timing and content rules), we will communicate that information to you as well.

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