

Automatic Enrollments in 401(k) Plans

Under PPA '06, "automatic enrollments" are now referred to by the term "automatic contribution arrangements" (ACA's). Prior to 2008, there are some rules under PPA '06 that affect ACA's. One allows ACA's in California and other states that do not allow deductions from paychecks without written permission from the employee. Now, federal law supersedes state law and employers in California can have ACA's. An ACA must provide for a uniform percentage of pay to be deducted as a 401(k) deferral absent an election from the employee to do otherwise. If the employee has not made investment selections, the ACA contributions must be invested under the DOL default investment regulations. An ACA must provide an ACA Notice at least annually, within a reasonable time before the beginning of the plan year or the date the ACA becomes effective, that is:

- Understandable by the average participant
- Accurate and comprehensive
- Explains the right to elect a different deferral rate (or no deferral)
- Explains the default investment selection

Participants must have a reasonable time after the notice is given and before the pay date to make an alternate deferral election.

For plan years beginning in 2008 and thereafter, an ACA can be an "eligible ACA" (EACA). To be an EACA, it must allow for participant direction of investments and it must follow the DOL default investment rules, as well as meeting all the above requirements. The EACA can (but is not required to) allow a participant withdraw all the default deferrals, plus earnings, within 90 days of the first pay date that the default deferrals were made. There is a problem with this rule the way Congress wrote it, because it says the participant can make this request any time in the 90-day period, but the plan is required to make the distribution by the end of the 90-day period. We will need some guidance from the DOL on this matter. These refunds will be shown on a form 1099-R (the employee's W-2 will not be corrected). Any match associated with the deferrals will be forfeited. There will be no 72(t) 10% penalty, and the deferrals will not be included in the ADP test.

For plan years beginning in 2008 and thereafter, if the plan is an "Eligible Automatic Contribution Arrangement" (EACA), corrective distributions made within 6 months after the close of the plan year will be exempt from the 10% excise tax on excess contributions (ADP test) or excess aggregate contributions (ACP test). Plans that are not EACA's will still have to make corrective distributions within 2 1/2 months after the close of the plan year to be exempt from this excise tax. There is no change to the rule that corrective distributions must be made within 12 months in order to keep the plan qualified.

In addition, no "gap period" income will be distributed on any corrective distributions for failed ADP or ACP tests starting with the 2008 plan year, regardless of whether the plan is an EACA or not, and regardless of the timing of the corrective distribution. Distribution of "gap period" income continues to be required for the 2006 and 2007 plan years for failed ADP or ACP tests under the Final 401(k) Regulations, and continues to apply for all plan years for excess deferrals (over the 402(g) limit for the calendar year).

Also for plan years beginning in 2008 and thereafter, corrective distributions for failed ADP or ACP tests that are made within the "required time frame" (i.e. within 2 1/2 months for non-EACA plans and 6 months for EACA plans) will no longer be taxable to the HCE in the year contributed, but instead will be taxable in the year distributed just like "late" correctives. Thus, the \$100 de minimus rule also goes away.

For the default deferral percentage, ACA's and EACA's have no set minimum or maximum. Starting in 2008, there is a special "safe harbor" for EACA's. Such plans will be called "qualified automatic contribution arrangements" (QACA's). A QACA must have a default deferral percentage of at least 3% for the first year, 4% for the second, 5% for the third, and 6% for the fourth and subsequent years. This is applied separately for each participant, based on the first year he or she is subject to the default deferral. A QACA cannot require a default deferral percentage that is greater than 10%. There is a mandatory match of 100% on the first 1% of comp deferred and 50% on the next 5%. This applies to all participants, not just those who are under the default deferral percentage. The match can be on a 2-year cliff vesting schedule. A QACA does NOT have to allow participant direction of investments and has the option to follow the DOL default investment rules but is not required to.