Automatic Enrollment Plan Designs

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It has been several years since the Pension Protection Act of 2006 (PPA) expanded on automatic contribution arrangements in 401(k) plans, yet there are still many qualified plans that are not taking advantage of automatic enrollment. While the addition of automatic enrollment provisions to a plan requires attention to notification requirements and tracking both positive and negative deferral elections, the increased plan participation and improved testing results that can be gained by adding this feature should not be overlooked.

Higher plan participation by the rank and file addresses two chief concerns for an employer:

1. the retirement welfare of their employees, and
2. more favorable compliance testing results.

Some employers value the ability to encourage employees to start saving for retirement by automatically enrolling them at a small percentage of pay as soon as they become eligible. For some, automatic enrollment in its various forms can offer solutions to problems with nondiscrimination testing, where the level of participation and contributions made by rank and file employees is compared to that of Highly Compensated Employees (HCEs). HCEs in plans that are subject to annual nondiscrimination testing frequently find that their own savings rates are limited, due to the limited participation and savings of the non-HCEs.

The PPA and subsequent regulations issued by the IRS define three options for automatic enrollment in 401(k), 403(b) and 457(b) plans:

- ✓ Automatic Contribution Arrangement (ACA),
- ✓ Eligible Automatic Contribution Arrangement (EACA), and
- ✓ Qualified Automatic Contribution Arrangement (QACA).

If you are interested in a detailed description of the three options, keep reading; but at a minimum, I hope you will take a moment and skip to the end and consider the potential for automatic enrollment for the plans with which you are involved.

The ACA is the basic automatic enrollment type, and its main benefit for plan sponsors is that it preempts state wage withholding laws. Prior to the PPA, there was no explicit protection for plan sponsors from state wage withholding laws that prohibit involuntary withholding. The PPA made it clear that ERISA expressly supersedes any state law that would otherwise prohibit the inclusion of an employee in any plan with an automatic contribution arrangement. An ACA requires that the default election for a participant must cease if the employee makes an affirmative election to NOT have contributions made on his behalf, or if the employee elects to defer a different amount or percentage of his compensation. In addition, if a participant who is automatically enrolled in a plan with an ACA does not make an investment election, he must be invested in accordance with regulations that relate to a Qualified Default Investment Alternative (QDIA). See QDIAs Under the Pension Protection Act. An ACA may be implemented at any time during the plan year.

An ACA that uses a uniform default percentage of compensation and meets certain notice requirements will be considered to be an EACA. The default percentage that is applied must be the same for all eligible employees, but may vary based on the number of years that the employee has participated in the plan. This means the plan may provide for escalation of the automatic deferral, within specific parameters. One important consideration for an EACA is that it may not be implemented mid-year UNLESS it only applies to employees who become eligible for the plan after it is added. Plans that contain an EACA are not required to invest employees in a QDIA, although the employer may want to use a QDIA to take advantage of the fiduciary relief provided by doing so. A plan that contains an EACA may elect to offer penalty-free return of deferrals within 90 days of automatic enrollment if requested by the employee and may be able to extend the non-penalty period for correcting certain nondiscrimination test failures to 6 months after the end of the plan year, instead of the usual 2 ½ months.

The primary appeal of the QACA is that it incorporates a built-in safe harbor employer contribution, which lets the plan avoid certain nondiscrimination tests. QACAs require a minimum default deferral percentage of at least 3% initially and must include automatic contribution increases of 1% each year, up to 6% of compensation but in no event more than 15%. In addition, QACAs commit the employer to make a nonelective contribution of at least 3% to all participants or a minimum nondiscretionary matching contribution of 100% of deferrals up to 1% of compensation plus 50% of deferrals between 1% and 6% of compensation. These required employer contributions must become fully vested after no more than 2 years of service.

Just like any safe harbor 401(k) plan, a QACA may be exempt from the top-heavy test in any plan year for which the only contributions are employee deferrals, required employer contributions, and additional employer matching contributions that satisfy the ACP safe harbor.

QACAs must comply with the safe harbor rules regarding when the safe harbor contribution is implemented. If the QACA uses a safe harbor matching contribution, then generally the plan must be amended for the QACA before the plan year begins. However, under the SECURE Act, if employees have been automatically enrolled during the year at deferral levels that meet QACA requirements, then the plan may be amended at any time before the 30th day before the close of the plan year to provide for a 3% nonelective safe harbor contribution, effectively converting the plan from an ACA or EACA to a QACA. Alternatively, if employees have been automatically enrolled during the year at deferral levels that meet QACA requirements, then an employer may amend to provide for a safe harbor nonelective contribution of at least 4% of compensation at any time before the last day by which the employer could distribute any excess contributions for the plan year, which is generally the last day of the plan year following the plan year for which the contribution applies. This would also convert the plan from an ACA or EACA to a QACA.

Plans that use an EACA or QACA require that notice be given to employees at least 30 days prior to their enrollment in the plan, so they may decide whether or not they would like to opt out. New employees who are immediately eligible must receive their first notice within a reasonable period of time before the first payroll deduction is made. Thereafter, eligible employees must receive the notice again annually, at least 30 days before the start of the plan year. These notice requirements are separate from other applicable notification requirements - for example, QDIA or safe harbor notices, but may be combined with those notices.

In the years since automatic enrollment plan designs became available, it has been frequently reported that most employers offering 401(k) plans are aware of automatic enrollment but feel they do not have enough information to make the decision to add this feature to their plan. Employers are concerned about employer contribution rates, the effect of employee turnover rates when combined with automatic enrollment, and they are particularly concerned that their employees will resent or resist having deferrals automatically withheld from pay. Fortunately, anecdotal evidence and industry surveys by some of the larger trust firms suggest that the majority of employees who have been automatically enrolled feel very positive about the experience.

If you are in the position to consider adding an automatic enrollment feature to your 401(k) plan, or if you are included in the decision-making process, there are options regarding which, if any, of the current employees will be affected by automatic enrollment when it becomes effective. Other main points to consider: the default percentage for deferrals; how and when to escalate deferrals; whether the default investment vehicle is appropriate; and the cost of implementing and administering the new plan features. Given the potential benefits to the company's owners and employees, automatic contribution arrangements deserve serious consideration.