401(k) Automatic Enrollment
What You Need to Know

Based on current articles in both the popular and business press, it should come as no surprise that Americans are currently not saving adequately to fund their retirement. Legislators have become increasingly concerned, and with the Pension Protection Act of 2006 (PPA), they took action. Although many employers historically have had automatic enrollment, one of PPA's provisions encourages employers to enroll their employees automatically in an employer-sponsored 401(k) plan without the employees' written authorization.

The new legislation also provides an ERISA preemption to state laws that often prohibit employers from taking paycheck deductions without the employee's written permission, as long as the provisions discussed below are met. The state preemption was previously a barrier to implementing automatic enrollment.

The automatic enrollment feature is growing rapidly in popularity. Employers are adopting it for two main reasons:

- **Employers are committed to raising 401(k) participation levels.** Research shows that one of the biggest barriers to participation is inertia: employees mean to enroll but just don't get around to it. Employers help employees overcome this inertia by automatically enrolling them in the plan.
- **The Plan is failing its annual nondiscrimination testing**. By adding an automatic enrollment feature to the plan, the testing results are often dramatically improved because more non-highly-compensated employees participate in the plan.

What Types of Automatic Enrollments Does the New Law Allow?

The new law offers plan sponsors state preemption for automatically enrolling employees without written consent just by maintaining an "ERISA" qualified plan and providing notice to employees. There are two additional types of automatic contribution arrangements under the PPA: Eligible Automatic Contribution Arrangements (EACA) and Qualified Automatic Contribution Arrangements (QACA).

Eligible Automatic Contribution Arrangements (EACA)

If employers 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, they are rewarded as follows:

- The employer will have up to six months after the end of the plan year to perform nondiscrimination tests and make corrections; and
- Employers may refund 401(k) deferrals for those employees who do not want to participate and failed to opt out, within 90 days after automatic enrollment begins.

The Starting Point for Implementing an EACA:

- **Select an appropriate and uniform automatic contribution level:** The goal is to establish a reasonable but meaningful employee contribution given your organization's demographics. Based on surveys, the prevalent uniform automatic contribution is 3% of pay.

2006 - Percentage of Plans with Automatic Enrollment by Plan Size

Number of Employees	% with Automatic Enrollment
1 – 49	6.8%
50 – 199	10.3%
200 – 999	30.5%
1,000 – 4,999	31.3%
5,000+	41.3%
All Plans	23.6%

2006 – Deferral Percentage In Plans with Automatic Enrollment

Contribution Level	Percent of Plans
1%	4.2%
2%	14.2%
3%	58.5%
4%	8.5%
5%	6.1%
>5%	8.5%

Source: Profit Sharing/401(k) Council of America 2006 Plan Experience Survey (www.psca.org)

Deferral Percentage Increase In Plans with Automatic Enrollment

Type of Plan	% of Plans
401(k)	38.5%
Combination	23.9%
All Plans	31.2%

Source: Profit Sharing/401(k) Council of America 2006 Plan Experience Survey (www.psca.org)

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- **If the Plan allows Roth contributions, determine whether the contribution will be a pretax or Roth contribution**: Regular pretax contributions are free from most current taxation, and the benefit is taxed at retirement. Roth contributions are currently taxed, but the benefit in retirement is generally tax-free. The vast majority of automatic contributions are regular pretax contributions.
- **Provide the required notices:** Notice must be provided at least 30 days and no more than 90 days *before* the employee's automatic enrollment date, and annually thereafter (this period would be shorter for plans with a short waiting period where new hire notifications are involved). The notice must include: the participants' plan rights, the automatic contribution amount, how to opt out or elect a different percentage, the enrollment procedure, the 90 day withdrawal rules and how contributions will be invested. The information the notice contains will vary based on the type of automatic contribution arrangement an employer sponsors (ie ACA, EACA or QACA). There is an $1,100 per day penalty for not providing notice, so it is critical employers build the notice requirement into their Human Resource processes.
- **Determine how you will administer the 90 Day withdrawal period:** With the EACA, employers may allow employees who fail to opt out of the plan to withdraw their contributions within 90 days of the date of the first contribution to the plan. The rules surrounding these withdrawals are:
    - the full deferral amount plus earnings must be distributed;
    - the distribution is taxable in the year paid and a 1099R form must be prepared to report the withdrawal;
    - any corresponding matching contribution must be 100% forfeited and remain in the plan;
    - the distribution is not subject to the 10% early (pre 59 ½) withdrawal penalties;
    - a distribution processing fee may be charged (fees might exceed the actual distribution amounts);
    - these withdrawals are not included in the nondiscrimination testing.

Qualified Automatic Contribution Arrangements (QACA)

PPA waives the nondiscrimination testing requirement for plan sponsors who have a Qualified Automatic Contribution Arrangement. These are often referred to as safe harbor automatic enrollment arrangements. This requires meeting the EACA requirements discussed above *and* complying with two additional requirements:

1. The initial automatic enrollment amount must be at least 3% (but not more than 10%) of pay *and* you must annually increase this amount in accordance with the annual increase chart below.
2. The employer must fund a "safe harbor" contribution which must be 100% vested after two years of service. The minimum employer safe harbor contribution options are:
    1. **Matching contributions**: 100% of first 1% deferred + 50% of next 5% deferred for a maximum of 3.5% of pay match **– or –**
    2. **Non-elective contributions**: 3% of pay for *all* eligible employees, *whether or not they are contributing to the Plan..*

The QACA provisions must be in place *before* the beginning of the plan year and must stay in place for the *entire* plan year. The notice requirements discussed earlier also apply.

It appears under the published guidance from the IRS that to satisfy the QACA provisions, the employer does not need to invest the automatic contributions in a Qualified Default Investment Alternative. In most situations, employers will want to invest money in a QDIA for fiduciary protection, but it may not be required.

About Automatic Contribution Increases

Adoption of automatic annual increase provisions is rising rapidly. To take advantage of the eliminating nondiscrimination testing, employers must follow a minimum set of automatic employee contribution levels and annual contribution increase amounts. Plan sponsors who do not want to administer annual automatic increases could institute an initial automatic enrollment level of 6%. The "initial period" is the date the automatic withholding starts through the end of the following plan year. This allows employers to increase employees at the same time, each January 1.

Annual Increase Requirements

Period	**Required Automatic Enrollment Amount**
Initial Contribution	3% to 10%
2nd year	At least 4%
3rd year	At least 5%
4th year +	At least 6%

* after initial contribution period

***Challenges of Annual Automatic Contribution Increases* –** Plan sponsors must build a sound administration process for automatic enrollment and annual increases. There are many considerations:

- You must track who is automatically enrolled;
- If you already have automatic increases, you may need to audit existing employees and start tracking who was automatically enrolled;
- If you want your recordkeeper to track automatic enrollments, you will need to work out the tracking process with them;
- Once an employee affirmatively elects a contribution amount (even if zero), they must be taken off of the automatically enrolled listing;
- At the end of each year, you or your recordkeeper will need to determine any automatic increases based on your plan's rules;
- Annually, your payroll department must change the automatic enrollment percentages effective for the first payroll in January;
- Make sure to coordinate with your payroll provider to ensure that there are no unintended consequences to any of the changes you are making.

Example: May
Hire date: 6/15/08

- Automatically enrolled at 3% on July 1, 2008
- End of initial period: 12/31/09

Employee's deferral must be increased to:

- 4% on 1/1/2010
- 5% on 1/1/2011
- 6% on 1/1/2012

How Is the Money Invested?

Employers must also decide how to invest automatic enrollment contributions since the employee is not making this election. The Pension Protection Act now offers fiduciary protection if you invest the money in a "Qualified Default Investment Alternative (QDIA)."

***About Qualified Default Investment Alternatives (QDIA's)* –** To have fiduciary protection surrounding investment of automatic contributions, employers must invest the automatic enrollment contributions in a QDIA. With QDIA's, the participant can be automatically enrolled, have his/her money automatically invested in the appropriate QDIA, and the plan sponsor is protected from liability.

The Department of Labor recently issued final regulations defining which investments qualify as QDIA's:

- An investment fund product that provides varying asset allocations based on the participant's age, anticipated retirement date or life expectancy. Examples are life-cycle or targeted retirement date funds.
- An investment fund product that balances risk and return in a manner appropriate for the participants of the plan as a whole. An example is a balanced fund.
- An investment management service where assets are allocated based on the participant's age, target date or life expectancy. An example might be a professionally managed account.
- An investment designed to preserve principal and provide a reasonable rate of return (whether or not the return is guaranteed), consistent with liquidity. This type of investment product will only be considered a QDIA for no more than 120 days after the date of the participant's first elective contribution. An example is a money market account or other similar short-term investment.
- An investment product or fund designed to guarantee principal and a rate of return generally consistent with that earned on intermediate investment grade bonds, and provides liquidity with no fees or surrender charges at the time of withdrawal. These will be considered a QDIA for assets invested in them prior to December 24, 2007, but will not be QDIA's after that. An example is a stable value fund.

Default Investment Option for Automatic Deferrals

Default Investment Option	Percent of Plans
Stable Value Fund	19.2%
Money Market Fund	6.4%
Balanced Fund	14.6%
Lifestyle Fund	22.8%
Professionally Managed Account	3.7%
Target Retirement Date	30.6%
Other	2.7%

Source: Profit Sharing/401(k) Council of America 2006 Plan Experience Survey (www.psca.org)

Annual QDIA Notices – To meet the QDIA rules, the plan sponsor must provide notice to employees describing the QDIA. It must be given at least 30 days in advance of the first investment (note – timeline may be shorter for new hires if the waiting period is shorter), and annually thereafter. It must include easy-to-understand explanations of:

- Why, when and where money will be invested;
- Fund objectives, risk and return information, and disclosure of fees and expenses;
- Information on how to transfer money to other investments within the plan; and
- Instructions on where to obtain other plan investment information.

Action Steps to Implement Automatic Enrollment

- Determine if automatic enrollment or the "safe harbor" automatic enrollment makes sense for your plan by contacting your Client Service Manager;
- If your plan allows for Roth contributions, determine what type of contribution you will be withholding on behalf of the employee;
- Select a Qualified Default Investment Alternative for automatic enrollment contributions by discussing the QDIA rules with your investment advisor and selecting an option that meets the requirements;
- Determine the process for handling annual automatic enrollment increases;
- Determine when a plan amendment is necessary to change your plan;
- Provide notices to your employees at least 30 days before enrollment and then annually thereafter
    - Automatic Enrollment Notice
    - Qualified Default Investment Notice (generally provided by your investment advisor);
- Enroll employees automatically at a uniform percentage of at least 3% of pay;
- Deposit and invest automatic enrollment contributions in the qualified default investment; and
- Remember to make changes to election levels when the next annual change is due.

About the Author:

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Ms. Simons oversees TRI-AD's regulatory compliance functions. She has many years of experience designing, administering and consulting for defined benefit pension plans and defined contribution plans including 401(k), profit sharing, money purchase, target benefit pension, stock bonus and employee stock ownership plans.

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Although Pension Protection Act 2006 legislation has been passed, the IRS has not published their final guidance on automatic enrollments. These new rules are applicable for plan years beginning on or after December 31, 2007 so final guidance is expected soon. The information in this publication may change as a result of any forthcoming guidance so please contact your Client Service Manager for support.

This article is intended to be educational in nature and does not constitute legal advice. TRI-AD is a full-service benefits consulting and administration firm. If you need legal guidance as to how these provisions might apply to your particular situation, we suggest that you contact your ERISA attorney.