

Automatic Enrollment – Time To Plan And Act

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Saving for retirement is an important issue facing employers and employees alike. With Social Security's long-term viability in question, employees must be actively involved in creating their own retirement nest egg. One of the best ways an employee can save for retirement is through pre-tax elective deferrals to a cash or deferred arrangement (CODA), (*e.g.*, 401(k), 403(b), and 457(b) plans). However, it is often hard to get into the habit of saving, and many employers find it can be difficult if not impossible to get some employees (often, members of the rank and file) to contribute to a qualified retirement plan.

While employer contributions can be a boost – as well as a motivating factor – to retirement accounts, contributions can dip during a weak economy when employers are struggling to maintain a healthy bottom line. Even when times are good, it isn't uncommon for qualified plans to fail certain nondiscrimination tests because rank and file employees don't voluntarily make elective deferrals at a rate that allows highly compensated employees to defer at a desired or meaningful level.

But changes in the law that went into effect this year that clarify and expand the rules for automatic enrollment in a CODA may provide an unexpected win/win/win solution for employers, the rank and file and highly compensated employees, with little or no cost to the plan sponsor. This is an introduction to the basics of automatic contribution arrangements and an overview of how automatic enrollment (with or without employer matching contributions) can maximize retirement savings for all employees, with employee dollars.

ACA, EACA, QACA – NO, NOT A FRATERNITY FOR HUEY, DEWEY AND LOUIE

An automatic contribution arrangement (ACA) can be established by an employer to automatically enroll employees who fail to make an affirmative election to participate in or opt out of a CODA. Effective January 1, 2008, two new forms of automatic contribution arrangements became available: an eligible automatic contribution arrangement (EACA) and a qualified automatic contribution arrangement (QACA).

An ACA provides that in the absence of an affirmative election by an employee, the employee is treated as having elected to make a contribution to the employer's plan in an amount specified in the plan through the automatic enrollment process. An affirmative election is made if an employee elects either to defer in any amount, including 0%, or to not defer. An ACA may, but is not required to, include some or all of the features in an EACA or a QACA.

THE LAW - WHAT LET LOOSE THE CHANGE?

Prior to adoption of the Pension Protection Act of 2006, some employers were hesitant to consider an ACA over concerns that state wage laws might be violated, or that qualified plan fiduciaries would lose the fiduciary protections of participant-directed accounts in the case of those participants who were automatically enrolled. It made sense that if an employee was not willing to affirmatively opt in or opt out of the employer's 401(k) plan, the same employee was not likely to direct the investments of his or her account. When participant-directed accounts are available in a qualified retirement plan, the fiduciary protections under ERISA section 404(c) only apply to those accounts that are participant-directed, and only to the extent that the plan complies with the provisions thereof.

However, ERISA now expressly supersedes any state law that would directly or indirectly prohibit or restrict the inclusion of an automatic contribution arrangement in any plan. And, the Department of Labor (DOL) has finalized regulations that grant protection to plan fiduciaries with respect to default investments that qualify for ERISA section 404(c) protection even in an automatic contribution arrangement.

EACA – BROUGHT ON BOARD WITH FIDUCIARY PROTECTION

An EACA is an "eligible" automatic contribution arrangement. The plan's automatic deferral percentage must be a uniform percentage of pay, but it is not required to have an automatic escalator (an increase in elective deferrals), which is required in a QACA. Unlike an ACA or a QACA, in an EACA, automatic deferral contributions **must** be invested in accordance with the final regulations issued by the DOL relating to qualified default investment alternatives (QDIA) for plans that are subject to Title I of ERISA. A governmental 457(b) plan is not subject to Title I of ERISA; therefore, the QDIA requirement doesn't apply.

An employer can allow a 90-day revocation withdrawal provision in an EACA, meaning that if an employee fails to make an affirmative election and is automatically enrolled in the plan, the employee can subsequently opt out and withdraw the contributions made to the plan. If the 90-day withdrawal

provision is included, the election to withdraw the contributions must be made within 90 days of the first deferral made for the employee (first payroll date) and must be effective no later than the last day of the payroll period that begins after the election. This feature is particularly useful to employers since it provides a way to remove very small accounts from the plan if an employee opts out.

The employee's right to opt out may not be conditioned on not being able to contribute in the future. The plan may provide that the employee will be treated as having elected to stop deferrals by virtue of having opted out until the employee makes a subsequent affirmative election to defer under the plan. If an employee opts out, the refund amount is equal to all automatic deferrals made through the effective date of the opt-out election, adjusted for gains and losses, which is determined under rules similar to those that apply to refund of excess ADP contributions. The amount refunded is included in taxable income in the year distributed, but it is not subject to an early distribution tax, and it is not eligible for rollover. The amount refunded is reported on Form 1099-R.

A distribution fee may be assessed for processing refunds, but fees may not differ from the fee that would apply to other plan distributions. If the employer makes matching contributions relating to refunded amounts, those matching contributions must be forfeited and applied in the same manner as other plan forfeitures. Refunded amounts are not included in the ADP/ACP tests, provided the opt-out election is timely made.

In addition, the IRS has imposed strict notice requirements on ACAs, EACAs and QACAs and has posted a sample automatic enrollment notice on its website. The DOL has indicated that use of the IRS notice satisfies the notice requirements under ERISA; however, plan sponsors must modify the notice to fit its individual arrangement. The EACA notice and QDIA notice can be combined. The EACA notice must:

- Be in writing, sufficiently accurate, and written to be understood by the average employee.
- Be provided within a reasonable period **before** the beginning of each plan year ("reasonable period" is a facts and circumstances test).
- In the year an employee first becomes eligible for the plan, be provided within a reasonable period before the employee's eligibility date. If a plan provides for immediate eligibility, notice may be provided on the employee's hire date.

- Specify the automatic deferral percentage under the plan and the right of eligible employees to elect not to defer or to defer a different percentage, including 0%.
- Provide instructions on how eligible employees can change their deferral elections; designate how contributions will be invested in the absence of an affirmative investment election; and, if permitted by the plan, include a statement of their right and description of the process to request a withdrawal during the 90-day opt-out period.

As indicated above, a "reasonable" notice period applies, but notice is *deemed to be satisfied* if the notice is provided no earlier than 90 days and no later than 30 days before the **beginning** of the plan year (or eligibility date, if applicable). That's why now is the time to do preliminary nondiscrimination testing, plan and act for next year.

QACA AND THE SAFE HARBOR – BROUGHT ON BOARD WITH AN ESCALATOR

A QACA is a "qualified" automatic contribution arrangement, which like an EACA, couldn't exist prior to January 1, 2008. Because it is a traditional safe-harbor 401(k) plan with an automatic enrollment feature added, traditional 401(k) safe harbor rules (eligibility, distributions, *etc.*) apply. However, the following QACA requirements also apply:

- Automatic deferrals must be a uniform percentage of pay, and apply to all eligible employees who failed to make an affirmative deferral election.
- The plan must provide for a set schedule of minimum automatic deferral percentages with an escalator:
 - Initial minimum automatic deferral percentage must be at least 3% and no more than 10% of pay.
 - Initial minimum percentage must continue until the end of the plan year following the plan year an eligible employee's first automatic deferrals are withheld (the initial period).
 - After the initial period, minimum percentage must increase by 1% per year until it reaches 6%.
 - Automatic deferral percentage in any year (initial plus increases) may not exceed 10% of pay. The Treasury regulations are clear that except for the 10% maximum, these percentages are minimums.
 - A plan may choose (but is not required) to set the initial minimum percentage higher than 3%.

- The plan must provide one of two safe harbor minimum employer contributions:
 - A nonelective contribution of at least 3% of pay to all eligible nonhighly compensated employees, OR
 - Minimum matching contributions equal to 100% of elective deferrals that do not exceed 1% of pay plus 50% of elective deferrals that exceed 1% but do not exceed 6% of pay for each eligible nonhighly compensated employee.
- The plan must provide for vesting no more restrictive than 100% after 2 years of service.

Generally, a QACA must be in effect for an entire twelve month plan year. Eligible employees must be provided with an initial and an annual notice. The employer match may only be made on the first 6% of pay, and any additional discretionary match may not exceed 4% of pay. An employee who is suspended from making deferrals due to a hardship distribution (if allowed in the plan) may not be automatically enrolled during the six-month suspension period. At the end of the suspension, the plan must resume the employee's elective contributions at the level (percentage) that would apply if the suspension had not occurred.

The notice requirement for a QACA is the same as an EACA except the notice must also include information on the automatic increases in elective deferrals, the plan's safe harbor employer contribution and vesting. The statutory safe harbor notice must still be given, and if a QDIA is used, the QDIA and QACA notices can be combined.

ACA, EACA, QACA – What's The Dif?

The following table provides a brief snapshot of the main differences among an ACA, QACA, and EACA.

Plan Feature	ACA	EACA	QACA
Minimum automatic deferral	None	None	3%
Maximum automatic deferral	None	None	At least 6%, not to exceed 10%

Plan Feature	ACA	EACA	QACA
Escalator requirement	N/A	N/A	Yes, (plan may start at 6% to avoid escalator)
Employer contribution, matching or nonelective	Not required	Not required	Required
QDIA rules	Optional	Mandatory	Optional
Fiduciary protection	No, unless QDIA	Yes	No, unless QDIA
Safe harbor 401(k) provisions	Optional	Optional	Required
90 day withdrawal	No, unless also EACA	Yes, Regs permit employer to exclude options	No, unless also EACA

The primary benefit of a QACA is testing relief! The contribution requirements are fixed, but are less than a traditional safe harbor plan. Vesting is also more restrictive than a traditional safe harbor plan. If an employer's turnover in the first two years of employment is typically high, a QACA may be less costly and better serve longer-term employees than a traditional safe harbor plan. A QACA is *deemed* to satisfy the ADP/ACP tests if there are no additional employer contributions or forfeitures allocated in a plan year. Thus, no QNEC/QMAC or corrective distributions can occur. A QACA is also deemed to satisfy the top-heavy requirements for that year. This means more employees participate in the plan, and there are higher deferral rates and higher savings for both highly compensated employees and the rank and file.

Like a safe harbor plan, the employer contribution is fixed prior to the beginning of the year. If the employer doesn't want to commit to the safe harbor contribution, consider an EACA.

Time To Plan And Act

Simply stated, by adopting an ACA employers can take advantage of the inertia that often surrounds employee retirement planning. Employees who take no action to participate in a CODA may be just as likely to take no action to opt out if they are automatically enrolled – especially if they receive a raise at the beginning of the year and see no net loss in their take-home pay.

But due to the strict notice and timing requirements for implementing an ACA, EACA and QACA, **now** is the time for employers to consider how automatic enrollment will complement its current retirement plan strategy. Depending on the objectives of the employer, the historical rate of employer contributions and the potential opt-out rate of participation, an ACA, EACA or QACA may increase retirement savings with employee dollars and improve nondiscrimination testing results with little or no additional cost to the employer.

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