

## Automatic Enrollment: What was old is new again . . . with a twist??

We have all noticed it. Your daughter pulls out the go-go skirt in the attic that you wore in 1972. She thinks she has found your Christmas hiding place, but later learns that “Mom, actually wore this!?” Or, your son drools over a photograph of the 1967 Shelby GTO you drove in high school. If you wait long enough, everything comes back in style. What was once “cool” is now “kickin.” Like classic cars and fashion throwbacks, Congress has renewed the excitement surrounding automatic enrollment.

Automatic enrollment has been around since 1984, when McDonalds instituted it for its employees (McDonalds subsequently eliminated automatic enrollment in its plan in 2002). Sometimes called “negative election” provisions or “automatic contribution” arrangements, the bottom line is the same: unless a participant elects to do something different, the plan will automatically begin taking deferrals out of an employee’s paycheck at a default rate. Unfortunately, until now, state garnishment statutes, concern over fiduciary liability, and a host of administrative issues made automatic enrollment unattractive to most plan sponsors. In the Pension Protection Act of 2006 (PPA), Congress strived to end the impediments to automatic enrollment. One question remains: was it enough?

Very few Americans are on track to save enough for their own retirement. With the decline in the use of defined benefit plans as a primary retirement vehicle, Congress and plan sponsors have struggled to find practical options that encourage individuals to save for their own retirement. The 401(k) plan has developed as the vehicle of choice for retirement savings, but we are still not there.

According to the 2005/2006 Edition of Deloitte Consulting LLP’s *Annual 401(k) Benchmarking Survey*, only 75% of employees who are eligible to participate in a 401(k) plan actually choose to participate and contribute part of their earnings to the plan. Inaction has been one of the biggest impediments to participation in a 401(k) plan. Quite simply: Employees do not execute the necessary paperwork. Faced with confusing investment options, conflicting financial goals, present financial needs, and other overwhelming issues, employees throw up their hands and do nothing. It is the path of least resistance. The reality, however, is that individuals are not saving money for retirement.

Automatic enrollment was designed to counter an employee’s inaction and redefine the path of least resistance. Automatic enrollment is a theoretically simple

option for plans with salary deferral provisions (i.e. 401(k), 403(b), and 457(b) plans). Because eligibility to participate in the plan triggers the deferral of an employee's income into the plan, no election or other action is needed by the employee. The result: more employees saving for their own retirement, on a pre-tax basis to boot. The path of least resistance becomes acceptance of the automatic provisions set out by the plan. By redefining the path of least resistance, plans with automatic enrollment have increased average participation to 90% according to the Deloitte survey.

Like the teacher's pet, automatic enrollment has become Congress's favored method to increase individual retirement savings. The PPA takes up this issue with vigor. As a result, automatic enrollment received a major facelift that includes:

1. Clarification that state withholding laws may be preempted by ERISA;
2. Relief from fiduciary liability for investment decisions with the use of qualified default investment alternatives;
3. Clean-up options that relieve many of the administrative issues, and create a few more; and
4. New safe harbor options.

### **Eligible Automatic Contribution Arrangements**

Various states have garnishment statutes on the books limiting deductions that can be made from an employee's paycheck without the employee's consent. Prior to the enactment of the PPA, it was argued that these state garnishment statutes might not be preempted by ERISA, prohibiting an employer from implementing an automatic enrollment provision in a plan. Putting the issue to rest once and for all, Congress amended ERISA Section 514 to provide specific preemption of any state law that would prohibit automatic enrollment, if certain conditions are met.

To rely on ERISA's preemption of state garnishment statutes, the automatic enrollment provisions in the plan must comply with the following:

1. The participant must be allowed to opt out or elect a different deferral amount.
2. If the participant has not affirmatively elected how to invest his or her employee contributions, the contributions must be invested pursuant to the "default investment" rules prescribed by the Department of Labor (DOL) pursuant to ERISA Section 404(c)(5).
3. The plan administrator must provide notice to the employee.

The required automatic enrollment notice must:

1. be given to the employee within a reasonable time before the beginning of the plan year in which the employee is affected;
2. be a “sufficiently accurate and comprehensive” explanation of the employee’s rights and obligations;
3. be written such that it can be understood by the average participant;
4. inform the participant that he or she may opt out of the arrangement entirely or choose to make a contribution at a different percentage; and
5. explain how his contributions will be invested unless he makes an affirmative election to invest in another option.

Furthermore, the participant must be allowed a reasonable time between the time of the notice and the time of the first withholding from his paycheck to make a decision.

If all of the requirements are met, the arrangement is said to be an “eligible automatic contribution arrangement.”

### **Benefits of being having an “eligible automatic contribution arrangement.”**

In addition to enabling the reliance by the plan sponsor on the preemption of state antigarnishment statutes, eligible automatic contribution arrangements receive several bonus benefits under the PPA, as an incentive for plan sponsors to adopt an automatic enrollment feature.

*ADP/ACP Refunds and Excise Tax Relief.* If the plan meets the qualifications, the plan has additional time to make corrective distributions without being subject to the 10 percent excise tax under IRC Section 4979. The plan must make corrective distributions within six months of the end of the plan year, instead of the 2 ½ months currently allowed.

*90 Day Distribution Option.* The plan sponsor may include a provision in the plan to permit a new participant to retroactively opt out of the automatic enrollment feature, and to obtain a full refund of his or her deferrals. This is discussed further below.

*Fiduciary Protection.* By using the default investment rules promulgated by the DOL, fiduciaries are protected from claims of a breach of fiduciary duty based upon their selection of investments even though the participant has not made an affirmative independent election, as was previously required by ERISA Section 404(c) for similar fiduciary protection.

## **And here comes the twist . . .**

In principle, the automatic enrollment rules appear to be very easy to follow. On closer inspection and in practice, implementation may be much more difficult. Several issues will require careful consideration before a plan sponsor adopts an automatic enrollment feature.

*Default Investments.* The statute makes the preemption section effective immediately. Yet the statute requires that, unless the employee elects another investment option available under the plan, all employee contributions must be invested in accordance with the default investment rules promulgated by the DOL. The DOL has worked fervently to establish the default investment rules in accordance with Congress' mandate. Although proposed regulations have been issued, depending on the comments received by the DOL, the final regulations are likely to be different. Any employer that implements an automatic enrollment feature prior to the issuance of final regulations must be prepared to modify its default investment option once the regulations are finalized. Further, if an employer has employees in one of the states that have an anti-garnishment statute on the books, the employer may still be at risk of litigation if the plan's default investment option does not comply with the final regulations. [For a more in depth analysis of this issue, see Brad Huss' discussion of this issue on page \_\_\_\_]

*Employee Notices.* The notice provisions of the statute may be the most difficult to implement. Employees must receive their notice and be provided a reasonable amount of time to make a different election or to opt out before the first deferral is made from the employee's paycheck. Until regulations are issued, it is unclear what a "reasonable" time will be. For 401(k) safe harbor plans, the IRS has ruled that thirty days is sufficient "reasonable" notice.

One problem is that, if the plan has immediate entry, the notice requirement as currently written cannot be met. Except in the rare instance of a monthly payroll and an employee hired on the first day of the month, in a plan that has immediate entry, the employee's deferral under the automatic enrollment provision will be taken out of the employee's paycheck before the end of the thirty day notice period. If the IRS regulations for automatic enrollment mirror regulations for 401(k) safe harbor plans, plan sponsors will be required to modify their eligibility and entry provisions to provide sufficient time to pass between the notice and the employee's entry into the plan.

*Impact of Personnel Policies.* Plan sponsors should consider automatic enrollment issues in concert with personnel policies to have the desired results. Probationary periods, raise schedules, employee turnover, and administrative cost can impact the effectiveness of a plan's design. If the deferral options work for the participant, the participant will be less likely to opt out of the plan or modify the deferral election. Well timed entry into the plan can be particularly important to the effectiveness of the program and to eliminate impediments to the plan sponsor's goals.

If an employer has a lot of employee turnover, immediate entry is less likely to accomplish the goal of increased participation. Instead, immediate entry dates will create short term participants with small accounts, producing substantial administrative burdens. Automatic enrollment may improve plan participation and help employers with high employee turnover to pass ADP testing, but this must occur in a structure that meets the notice requirements, keeps employees content with the default elections, and minimizes administrative burdens.

*90-Day Distribution Option.* The PPA allows employers the option to incorporate a new distribution procedure for participants who opt out of automatic enrollment and request a return of their deferrals within 90 days of the first deferral. The option was designed to allow plan sponsors the ability to eliminate the administrative costs of maintaining small accounts for participants who opt out of their automatic enrollment deferral within a short period of time. However, implementation of the option may create different administrative concerns.

Under the 90-day distribution rule, if the employee timely elects, all of his or her salary deferrals, plus earnings, must be refunded to the employee. The distribution is taxed as regular income to the participant in the year that the distribution occurs. All employer matching contributions attributable to the distribution are forfeited. Further, the amounts distributed are not included in nondiscrimination testing.

The exclusion of the distributions in nondiscrimination testing may create the most challenge. For example, if an employee enters the plan (and becomes subject to automatic enrollment) at the end of a plan year, he may opt out in the following year. By the time of the participant opts out, the participant's deferrals and refund may have already been included in the ADP and ACP testing for the plan year. However, as a result of the participant opting out, a portion of the refunded deferrals will not be included for testing purposes. Plan administrators will be forced to recalculate the ADP and ACP tests accordingly.

Suppose Max is hired by New Gen, Inc. on September 1, 2007. Pursuant to the New Gen, Inc. 401(k) Plan, an employee is eligible to participate after ninety days (the same as the employer's probationary period) and the plan has monthly entry dates. Max completes his probationary period and, pursuant to the automatic enrollment provisions of the plan, is automatically set to defer at the default rate of six percent, beginning with the first pay period after December 1, 2007, the next entry date. Max rocks along for 80 days until mid-February, 2008 without opting out of the automatic contribution. For whatever reason, Max decides he does not like having extra money taken out of his paycheck, and takes the initiative to sign his opt out paperwork and change his deferral rate to zero percent on February 19, 2008. In addition, Max requests his money back, plus earnings, of course.

Now, the fun begins. First, the plan administrator must determine what Max's refund should be. As it turns out, this task is not so difficult. After all, many, if not most, 401(k) plans use participant direction and daily valuation. You just look at the account balance and issue the check (don't forget to put him on the list to be issued a 1099 by January 31, 2009). Next, because the distribution will not be included for testing purposes, the plan administrator must determine how much of Max's distribution must be deducted from the numbers used for testing that may have already taken place (in an attempt to beat the March 15 deadline on refunds to avoid the 10 percent excise tax under IRC Section 4979).

Prior to adopting a 90-day distribution feature, plan sponsors should discuss the costs associated with each option with plan administrators. Only at that point can a plan sponsor effectively weigh the additional administrative cost of the distributions against the administrative cost of maintaining small accounts, enabling it to make a wise choice.

### **Safe Harbor Option: Qualified Automatic Contribution Arrangement – *The Bonus Round***

The automatic enrollment provisions of the PPA give us a new alternative safe harbor method for meeting nondiscrimination testing, the Qualified Automatic Contribution Arrangement (QuACA). (This acronym always seems to invoke images of the Aflac duck!) To receive the safe harbor benefits, a QuACA must meet all of the requirements of an Eligible Automatic Contribution Arrangement plus the following.

*Employee Contribution.* The default deferral rate for automatically enrolled employees is a rolling percentage: no less than three percent in the employee's first year of participation, four percent in the second year, five percent in the third year, and

six percent in the fourth year and thereafter. However, the default deferral rate may not exceed ten percent.

*Employer Contribution.* Employer contributions can take one of two forms to satisfy the safe harbor requirement:

- a three percent nonelective contribution; or
- a matching contribution equal to at least a 100 percent match on deferrals of the first one percent of compensation and a 50 percent match thereafter on deferrals up to six percent of compensation. If the matching contribution is used, the plan must meet certain other requirements to satisfy the ACP test as a safe harbor. The plan cannot have matching contributions on any deferral over six percent of compensation. The plan cannot increase the rate of match proportionate to an increase in the rate of deferrals. The same match rate must be used for nonhighly compensated employees and highly compensated employees.

*Vesting.* The plan can require no more than two years of service for employer contributions to become vested. Compared to the 401(k) safe harbor immediate vesting requirement, the automatic enrollment vesting requirement will provide more flexibility for employers, especially employers with high employee turnover.

*Notice.* In addition to the notice requirements discussed above for an Eligible Automatic Contribution Arrangement, if an employee has a choice between two or more investment options, a QuACA notice must also explain to the employee how contributions will be invested if he or she does not make an investment election.

### **Benefits of a QuACA Safe Harbor Design.**

As with other safe harbor 401(k) designs, if a plan meets the requirements of the QuACA safe harbor, the plan will be deemed to meet ADP and ACP testing. Further, if no other employer contributions are made to the plan, the plan will be deemed to meet the top-heavy requirements. These benefits are in addition to the benefits safe harbor automatic contribution arrangements receive for being an Eligible Automatic Contribution Arrangements.

### **And here comes another twist . . .**

*Rolling increases in default deferrals.* The safe harbor provisions of the PPA, and indeed the success of an automatic enrollment feature, hinge upon keeping

employees content with the automatic provisions. The rolling increases in default employee contributions are designed to encourage but to take the sting out of increasing saving for retirement. However, much has been said about the difficulty in keeping up with the rolling increases on an individual employee basis.

Because the statute outlines that the automatic deferrals cannot be less than the rolling rates, a plan may avoid having different automatic rates of deferral by simply using a set rate of six percent of compensation (or more, but not more than ten percent of compensation). In that situation, the minimum deferral rates would be met at each service level, but only one default deferral rate would be needed.

If the rolling rates are used, when do the rates need to change? The language of the statute indicates that the rates apply “during the period ending on the last day of the first plan year which begins after the date on which the first elective contribution ... is made.” [IRC Section 401(k)(13)(C)(iii)(I), as amended by the PPA] This would seem to indicate that the rates would change on the first day of a given plan year with regard to all participants. However, regulations may permit changes at an earlier date, so that the rate of automatic deferral is never less than mandated rate, but the changes are simply timed differently. This would provide plan sponsors with more flexibility. For example, a plan sponsor would be permitted to set the date for the automatic roll up of the default deferral rate to correspond with compensation increases during the plan year or other triggering events.

Assume for a moment that New Gen, Inc. adopts a plan with rolling increased default deferrals effective April 1 of each plan year and based upon years of participation in the plan. An employee will fall into only one category between April 1 and March 31 of any given plan year. Let us assume further that the automatic enrollment feature is adopted effective on April 1, 2007, only new hires are automatically enrolled, and the plan has daily entry. Participation in the plan for new hires looks like this:

Category 1 = employees that enter the plan between April 1, 2007 and March 31, 2008.

Category 2 = employees that enter the plan between April 1, 2008 and March 31, 2009.

Category 3 = employees that enter the plan between April 1, 2009 and March 31, 2009.

Category 4 = employees that enter the plan between April 1, 2010 and March 31, 2011.

The categories of employees would continue in this manner based upon the date of the employee’s entry into the plan. Let us also assume that the employer has adopted the

rolling deferral minimums outlined in the statute: three percent during the first year of participation; four percent in the second year of participation; five percent during the third year of participation; six percent in the fourth year of participation and thereafter. In that case, the deferral changes look like this:

Employee Category	April 1, 2007 to March 31, 2008	April 1, 2008 to March 31, 2009	April 1, 2009 to March 31, 2010	April 1, 2010 to March 31, 2011	April 1, 2011 to March 31, 2012
Category 1	3%	4%	5%	6%	6%
Category 2	N/A	3%	4%	5%	6%
Category 3	N/A	N/A	3%	4%	5%
Category 4	N/A	N/A	N/A	3%	4%

In the foregoing example, no employee’s default deferral percentage would be lower than the statutory minimum “during the period ending on the last day of the first plan year which begins after the date on which the first elective contribution . . . is made,” as required by the PPA. In the example given, at any given point in time, the employer would have four different categories. The automatic increase in the default deferral rate would be treated like a new election.

Although this may seem simple in theory, this plan structure may still be difficult to implement, depending upon the plan administrator’s time, capabilities, and software.

*Existing employees.* Implementing an automatic enrollment provision for existing employees could also prove to be challenging. IRC Section 401(k)(13)(C)(iv) as amended by the PPA provides that, if an employer implements an automatic enrollment provision, the employer is not required to include current employees if the employee has made an election to either participate or not participate. If the employee made an affirmative election, even if the election is to defer zero, the employee can be excluded under the arrangement. However, if the employee did not make an affirmative election, the employee must be included in the automatic enrollment program.

Unfortunately, many employers and recordkeepers lack the detail to confirm whether a participant that is deferring nothing has done so by default or through an affirmative election (such as a change from a previous deferral rate to no deferrals).

Therefore, correctly instituting this program for existing participants may not be possible, even though concerns about savings rates by existing employees weigh as heavily on the employer's mind (if not more heavily) than those concerns for yet-to-be-hired employees.

### **Well, is this a good thing?**

Like the proverbial kid in the candy store, automatic enrollment looks good; it smells good; it sounds good; we want it. As a smart mentor once told me however, "let's slow down and think about this for a minute." Plan sponsors should discuss issues of feasibility and cost with service providers prior to implementing any automatic enrollment structure. Wiser plan sponsors will also tailor their automatic enrollment plan to complement other personnel policies and their payroll vendor (if one is used). And the wisest plan sponsors may be those who wait for regulations from the IRS and the DOL prior to implementing any automatic enrollment plan. We are hopeful the IRS and DOL will provide workable, cost effective, and encouraging regulations to complement this Congressional stimulus for retirement saving.