The Alphabet Soup of Automatic Enrollment: Comfort Food or Empty Calories?

by Adam C. Pozek, QKA, QPFC, RHU, REBC

Abstract: *Twenty years after the McDonald's Corporation broke new ground by automatically enrolling participants in its 401(k) plan, the Pension Protection Act of 2006 (PPA) breathed new life into the practice by creating several new plan design options and providing for federal preemption of state laws preventing withholding absent a participant's affirmative election. While various sources estimate these changes will add $70 billion to $2 trillion to retirement accounts over the next 25 years, automatic enrollment may not be the panacea to America's shortfall in retirement savings as some suggest. In addition to many potentially expensive compliance traps for the unwary plan sponsor, automatic enrollment plans may risk exacerbating the common misconception among American workers that they will have a sufficient nest egg on which to retire.*

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Introduction

A "traditional" 401(k) plan allows an eligible employee to elect to defer a portion of his or her salary into the plan, typically on a tax-deferred basis. Automatic enrollment plans, on the other hand, provide that eligible employees are deemed to have made a deferral election at a predetermined default rate unless they choose a different contribution level or affirmatively elect not to defer. Since the McDonald's Corporation first implemented automatic enrollment more than 20 years ago, the design option has continued to evolve. In addition to a default deferral percentage, some plans have introduced automatic escalation whereby a participant's deferral amount is increased each year according to a set schedule. Other plans have added to the autopilot 401(k) concept by using target-maturity-date-type funds as the default investments. However, due to a lack of clear regulatory guidance and state laws preventing automatic withholding from employee paychecks, automatic enrollment has not seen widespread adoption.

Alphabet Soup: Types of Automatic Enrollment Plans

The Pension Protection Act of 2006 (PPA) continued the evolution of automatic enrollment designs as Congress sought to remove some of the barriers and encourage plan sponsors and practitioners to implement such designs. While the pre-PPA automatic enrollment options remain available, the PPA and related regulations[1] generally create three new alternatives with varying features and requirements. In addition, both Congress and the Department of Labor (DOL) have clearly indicated that state laws prohibiting default withholding are preempted with regard to automatic enrollment plans.[2]

Eligible Automatic Contribution Arrangement

The Eligible Automatic Contribution Arrangement or EACA allows many of the design features that have been widely touted in the post-PPA world of automatic enrollment. Plans satisfying all of the EACA requirements can allow permissive withdrawals (described in more detail below) of default deferrals within specific time frames. They also enjoy an extended deadline of six months following the end of the plan year to avoid the excise tax on the refund of excess contributions and excess aggregate contributions due to failed ADP/ACP tests.

To qualify as an EACA, an automatic enrollment plan must satisfy two key requirements. First is the newly established uniformity rule. With only the few specific exceptions noted below, this rule requires the plan to apply a uniform percentage of compensation as the default deferral percentage for all employees who are eligible to make cash or deferred elections under the plan. Thus, an EACA plan sponsor does not have the ability to use different default percentages for different employee groups, nor can it apply the default rate to only certain segments of employees, e.g. all employees hired after a certain date.

There are several exceptions to the uniformity rule. Eligible employees that have made affirmative deferral elections, including elections not to defer, are not required to be enrolled at the default percentage. A second exception is for plans that uniformly increase the default percentage according to a set schedule. For instance, an EACA can provide that all automatically enrolled participants will have their default rate increase by one percentage point on the first day of each plan year. The final exception is for participants who have taken hardship distributions and are suspended from making salary deferrals as a result.

The second main requirement a plan must satisfy to be an EACA is that it must select its default investment in accordance with the DOL's Qualified Default Investment Alternative (QDIA) regulations.[3]

Qualified Automatic Contribution Arrangement

The PPA also creates the Qualified Automatic Contribution Arrangement (QACA), a new design-based safe-harbor 401(k) design that requires a minimum, escalating default deferral rate.

For the initial period, the default percentage must be at least 3% of eligible compensation. The initial period starts on the date a participant is first automatically enrolled and ends on the last day of the subsequent plan year. The default deferral rate must increase by a minimum of one percentage point at the end of the initial period and each of the next two years up to a minimum of 6%. The default rate cannot exceed 10% in any year. The following example helps to illustrate the mechanics of this requirement.

Example: XYZ Company adds the QACA (starting at 3%) to its existing 401(k) plan on January 1, 2008.

- Participants A, B, and C are eligible participants in the plan prior to 2008.
- Participant A never returned a deferral election form and is, therefore, not contributing to the plan.
- Participant B completed a form and affirmatively elected not to contribute.
- Participant C is contributing at the rate of 2% of pay.
- Participants D and E become eligible for the plan on April 1, 2009, and January 1, 2010, respectively, and neither one makes a formal deferral election.

Since the autoenrollment/autoescalation features are applicable only to participants without a deferral election on file, Participant A is the only one of the three current participants who will be automatically enrolled in the plan at 3% on January 1, 2008. Since B and C have elections on file, they will remain at 0% and 2%, respectively. D and E will be automatically enrolled and begin automatic escalation as they become eligible for the plan.

Participant	2008	2009	2010	2011	2012
A	3%	3%	4%	5%	6%
B	0%	0%	0%	0%	0%
C	2%	2%	2%	2%	2%
D	N/A	3%	3%	4%	5%
E	N/A	N/A	3%	3%	4%

QACAs are subject to the uniformity rule (and the exceptions, thereto) as described above. Since failure to follow the automatic escalation schedule is an operational failure that could disqualify the plan, it is important for plan sponsors to work closely with their payroll providers to ensure compliance. One potential means of minimizing the administrative complexity inherent in this arrangement is to set the default deferral level for the initial period at 6% of pay, thereby avoiding the need to automatically increase deferral percentages each year.

In addition to the escalating default deferral rate, a QACA must also provide for either an employer-matching contribution or an employer nonelective contribution (NEC). The match option must use a formula that is at least as generous as the following:

- 100% of the first 1% deferred, plus
- 50% of the next 5% deferred

The NEC must be equal to at least 3% of pay. Unlike the immediate vesting required in existing safe-harbor 401(k) designs, both the match and NEC in a QACA must be fully vested after no more than two years of service. All distribution restrictions and notice requirements applicable to existing safe-harbor 401(k) plans continue to apply to the QACA.

Like the "traditional" safe-harbor designs, QACAs are deemed to satisfy the ADP/ACP tests, and as long as the only contributions are salary deferrals and safe-harbor contributions, they are also deemed to satisfy the top-heavy requirements. It is important to note, however, that a QACA does not necessarily qualify as an EACA unless the sponsor also complies with the QDIA regulations in selecting a default investment option. In order to take advantage of the permissive withdrawal option, the sponsor must take this extra step to be both a QACA and an EACA.

Automatic Contribution Arrangement and Pre-PPA Automatic Enrollment Plan

The Automatic Contribution Arrangement (ACA) is the "base model" in the new lineup. ACAs must satisfy uniformity requirement, though there is some question as to whether the allowable exceptions for EACAs and QACAs are applicable to ACAs.[4] It also appears the ACA is subject to the more formalized notice requirement (described below). If the default ACA investment is selected in accordance with the QDIA regulations, it qualifies as an EACA and can offer permissive withdrawals and take advantage of the extended ADP testing deadline.

Employers not seeking to take advantage of the new features can implement a pre-PPA automatic enrollment (AE) plan at any time by adopting the appropriate amendments. Existing AE plans can continue with little or no change to their day-to-day operations. AE plan sponsors are not required to satisfy the uniformity requirement, so they retain flexibility in how they apply the default deferral percentage, and they are not required to select the plan's default investment(s) in accordance with the QDIA regulations.

Permissive Withdrawals

One oft-cited barrier to implementing autoenrollment has been that there was no mechanism to distribute deferrals withheld from participants who did not opt-out in a timely manner. Plans have either made improper distributions (a disqualifying defect) or carried a number of small balances that increase administrative burden and expense.

To remove this impediment, the PPA introduced the permissive withdrawal provision that allows participants to request a distribution of default deferral amounts. The participant must request the distribution within 90 days of the first automatic withholding and must withdraw the full amount of the default deferrals plus associated earnings. The refunded amount is reported on Form 1099-R, included in the participant's income in the year of distribution and is disregarded for testing purposes. The 10% early withdrawal penalty is waived. In addition, the proposed regulations specifically note that any related match cannot be treated as a mistaken or erroneous contribution and, therefore, must be forfeited and not returned to the employer.

The permissive withdrawal feature is only available in EACAs. Sponsors of such plans have the option to offer it, but sponsors of other types of automatic enrollment plans are prohibited from including it. Those that decide to implement the provision must make it available to all participants. Further, no participant can be restricted or penalized for electing a permissive withdrawal. Therefore, an eligible employee could not be prohibited from reenrolling in the plan just because he or she previously took a permissive withdrawal.

The proposed regulations indicate that any transaction fees for processing the withdrawal can be charged to the participant as long as those fees are not different than those charged for other types of distributions. In many situations, the applicable distribution fee is likely to exceed the amount being distributed. Thus, the distribution would be completely offset, and the fee actually paid may be less than the full amount that is normally charged. Since the regulations state that the fees cannot be different (as opposed to specifying that they cannot be greater than the normal fee), this raises the question of whether the service provider must charge the additional amount to the plan sponsor.

Permissive withdrawals requested after year-end may pose challenges with regard to data collection for testing purposes. For example, assume Participant A is automatically enrolled in the XYZ Company 401(k) plan on December 1, 2008. XYZ Company provides census information to its third-party administrator (TPA) on January 31, 2009, and Participant A requests a permissive withdrawal on February 28, 2009. XYZ Company must provide its TPA with revised testing data for Participant A. While this timing concern is not likely to be a frequent problem, the corrective measures that may be required for using incorrect testing data could be significant.

Notice Requirement

While previous guidance peripherally addressed participant notification in AE plans,[5] the ACA, EACA, and QACA include more formalized notice requirements. The notice must explain participants' rights under the plan, e.g., their right not to select an amount different than the default deferral percentage, including zero. It must also describe the default investment to be utilized should participants fail to make affirmative investment elections. The notice must be provided within a reasonable time (usually 30 to 90 days) prior to the first default withholding and prior to each subsequent plan year. There is a civil penalty of up to $1,100 per day for failure to satisfy this notice requirement.

There are several open questions with regard to the notice. First, the preamble to the proposed regulations indicates that the notice need only be provided to those participants subject to the default deferral provision, e.g. those without an affirmative election on file. However, the proposed regulations themselves state the requirement is satisfied if "each eligible employee is given notice."[6] This wording indicates the notice must be provided to all employees eligible to make a cash or deferred election in the plan, regardless of whether or not they are subject to the default deferral provision.

A second question relates to the types of plans required to provide the new notice. The proposed regulations specifically indicate that ACAs, EACAs, and QACAs must comply with the expanded notice requirement. There is no reference to pre-PPA automatic enrollment plans, making it unclear whether such plans must provide the new notice or comply with the 1998 and 2000 Revenue Rulings. The more conservative approach is to provide the new notice absent further guidance.

Implementation

The ERISA preemption of state withholding laws for automatic enrollment plans is effective on the date of PPA's enactment—August 17, 2006. All other new provisions, including the notice requirement and permissive withdrawal feature, are effective for plan years beginning after December 31, 2007. Since the ACA, EACA, and QACA designs are all PPA provisions, formal amendments implementing them are not required until the end of the 2009 plan year. In the meantime, plans are required to operate in accordance with all applicable rules as soon as the provisions are adopted.

An employer can implement an AE or ACA plan at any time, but EACAs and QACAs must be adopted prior to the start of a plan year and must remain in effect for the entire 12-month plan year.

Panacea or False Security

Automatic enrollment plans have been widely heralded as a "silver bullet" that will address the retirement savings crisis for many Americans. However, there are a number of factors that may limit its long-term effectiveness.

As described throughout this article, there are many new requirements an employer must satisfy in order to implement and operate an automatic enrollment plan. In order to offer permissive withdrawals, a plan must not only be an automatic enrollment plan, it must meet all of the conditions to be an EACA, which includes application of the default deferral percentage to all eligible employees. However, according to the "PLANSPONSOR Sponsor 2007 Defined Contribution Survey," more than 62% of the companies that implemented auto enrollment did so only for new employees.[7]

Potential compliance traps abound, which lead to increased liability. A plan sponsor or its payroll provider could accidentally overlook an employee that should be automatically enrolled or escalated. The default deferral percentage might not properly be applied to certain forms of postseverance compensation that are now included in the definition of compensation used by many plans. Both of these constitute failures to operate a plan in accordance with its terms—operational failures that could lead to sanctions or plan disqualification. There are also potentially substantial penalties for failure to provide the required notices even to a single participant.

In addition to these compliance concerns, there are additional factors that call into question whether automatic enrollment is in the best interest of plan participants. Participant inertia has been cited as an argument in favor of automatic enrollment. Surveys have shown that plans implementing automatic enrollment experience increases in plan participation with averages as high as almost 73%.[8] These rates refer to the number of eligible employees actively contributing and not to the percentages of pay at which automatically enrolled participants are deferring. However, it is inertia with regard to the amount being contributed that may be the very reason automatic enrollment plans can be detrimental over time.

A 30-year old participant, whose present salary is $50,000 per year and receives annual cost-of-living adjustments of 3%, will have an annual salary of just under $150,000 by age 65. According to a study conducted by Aon Consulting and Georgia State University,[9] an individual at that income level will require a replacement ratio of 69% of preretirement income (in addition to Social Security) to maintain his or her standard of living. If this individual is automatically enrolled in a 401(k) plan at 3% of salary, remains at that level due to inertia, experiences an 8% annual rate of return and begins withdrawing 69% of preretirement income each year beginning at age 65, he or she will run out of retirement savings by the age of 70. Using the escalating default rates applicable to the QACA only extends retirement savings through age 78. With life expectancies into the 80s for at least 50% of the population, the inertia of automatic enrollment may result in an individual spending his or her final years in poverty.

Conclusion

PPA's newly expanded automatic enrollment options will likely lead to increased participation in 401(k) plans. While even a minimal level of savings is better than none at all, automatic enrollment is not the panacea that will solve the looming retirement-savings crisis.

Employers seeking to assist their employees in achieving realistic retirement goals need to take additional steps to increase understanding of the amounts needed to maintain a postretirement standard of living. According to the Employee Benefit Research Institute, only 43% of workers have attempted to calculate their retirement income needs.[10] When participants have the advice and assistance they often require to identify the total savings needed, they are better able to make appropriate decisions on the amount they should defer into their 401(k) plan. TagData.com published an article in May of 2006 referencing a CitiStreet survey showing that participants who took advantage of investment advice offered by their employer saved an average of 140% more than those who did not take advantage of the advice. The article also notes that the contribution rates per eligible employee in plans offering advice doubled by the end of the third year.[11]

Automatic enrollment plans are a first step in encouraging employees to save, but until participants are provided access to advisors who can help them navigate the maze of complex retirement decisions, inertia may only provide a false sense of security. ■

Adam Pozek, QKA, QPFC, RHU, REBC, is [a partner at DWC ERISA Consultants, LLC] He specializes in plan design and compliance issues related to qualified retirement plans and works with clients of all sizes.

Adam serves on the board of directors and Government Affairs Committee of the American Society of Pension Professionals and Actuaries (ASPPA). He can be reached at [adam.pozek@dwcconsultants.com].

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(1) PPA §902. Proposed regulations published November 7, 2007.
(2) DOL Reg. §2550-404c-5(f)(2)
(3) DOL Reg. §2550-404c-5
(4) DOL Reg. §2550.404c-5(f)(1) imposes the uniformity requirement on ACAs but does not include the exceptions allowed for EACAs and QACAs in the proposed treasury regulations.
(5) IRS Revenue Rulings 98-30 and 2000-8.
(6) Prop. Treas. Reg. §1.414(w)-1(b)(3).
(7) "2007 PLANSPONSOR Defined Contribution Survey: Picking up the Pace,"available online at www.plansponsor.com/hp_type2/?RECORD_ID=4874.
(8) *Ibid.*
(9) "Replacement Ratio Study: A Measurement Tool for Retirement Planning," (Aon Consulting, May 2004); (www.aon.com/about/publications/pdf/issues/rs_2004_06_replacement_ratio_study_674.pdf).
(10) "2007 Retirement Confidence Survey," *EBRI Issue Brief No. 304* (April 2007).
(11) "CitiStreet Surveys Show Investment Advice Spurs Action," http://subscribers.tagdata.com/WebDocs.nsf/Pages/5-4-06citistreet1.