

Benefit Insights



Pension Services, Inc. PensionSite.Org

Telephone: 888.412.4120

Fax: 321.397.0409

Bill@PensionSite.Org

www.PensionSite.Org

A non-technical review of qualified retirement plan legislative and administrative issues

April 2015

Automatic Enrollment for 401(k) Plans

McDonald's may have been the automatic enrollment pioneer 30 years ago, but it wasn't until 2008 when the new Pension Protection Act rules kicked in that it really started to gain serious momentum.

Since that time, articles have regularly extolled the virtues and almost every new retirement-related bill introduced in Congress has included some provision designed to encourage more widespread adoption of automatic enrollment. Unfortunately, with that much attention comes a certain amount of hype. In this article, we will attempt to separate hyperbole from helpful.

What is Automatic Enrollment?

The "traditional" 401(k) plan is set up so that those who wish to enroll can and those who do not...do not. But, the default is that an employee does not make contributions until he or she takes the affirmative step to actually sign up for the plan.

Automatic enrollment turns that arrangement on its head. When an employee becomes eligible, he or she is automatically signed up to contribute to the plan at a pre-determined rate unless he or she makes an affirmative election to contribute at a different rate or opt out altogether. Depending on other plan variations, the default rate can be whatever percentage a company thinks makes sense for its workforce, but a relatively common default is 3% of pay.

Some plans take automatic enrollment one step further by automatically increasing the default rate at set intervals, for example starting at 3% and increasing it at the start of each subsequent year. This is usually referred to as automatic escalation.

There are several flavors of automatic enrollment. The underlying concept is essentially the same but each one has some unique bells and whistles. Here is a quick overview.

Eligible Automatic Contribution Arrangement (EACA)

The EACA has a couple of special features. One is that if the default deferral percentage is applied

uniformly to all employees who are eligible for the plan, the regular deadline to avoid the excise tax on corrective refunds for a failed Average Deferral Percentage (ADP) test is extended. Rather than 2½ months after the close of the year (March 15th for a calendar year plan), the due date is pushed to 6 months (June 30th).

A second bell (or maybe a whistle) relates to employees who forget to opt out of automatic enrollment until deferrals have already been withheld. In an EACA, those employees have up to 90 days to request a permissible withdrawal to have those deferrals (adjusted for investment gains or losses) returned to them rather than being stuck with a small balance in the plan.

Qualified Automatic Contribution Arrangement (QACA)

A QACA combines safe harbor 401(k) features with automatic enrollment. In other words, the plan is treated as automatically satisfying the ADP test, and if certain additional conditions are met, the ACP test and the top heavy requirements. The default deferral percentage for a QACA must start out at no less than 3% of pay and must automatically increase by one percentage point each year until it reaches at least 6%. The initial default rate can be set at 6% to avoid the escalation requirement or escalations can continue past 6%; however, the default rate can never be more than 10%.

The company must also commit to making a minimum contribution in the form of a match or profit-sharing-type contribution, both of which must be fully vested after no more than two years of service. The matching formula must be at least as generous at 100% of the first 1% deferred by each participant plus 50% of the next 5% deferred. This yields a match of 3.5% of pay for anyone who defers 6% or more. The profit sharing option comes in slightly lower at 3% of pay but

must be made on behalf of all eligible employees, including those who do not defer.

“Generic” Automatic Enrollment

This more flexible option allows a plan sponsor greater latitude in that there is no minimum default deferral rate, no required escalation, no mandate to apply it uniformly to all participants and no required company contributions. The trade-off is that it also does not come with any of the special features—no extended testing deadline, no permissible withdrawals and no testing safe harbor.

Regardless of which automatic enrollment method is used, all require initial and ongoing notices to participants. The Department of Labor has also indicated as long as all the rules are satisfied, implementing automatic enrollment in a 401(k) plan overrides state laws that would otherwise require an employee to make an affirmative election prior to withholding amounts from payroll.

Why Automatic Enrollment?

Now that we’ve covered the “what,” it is time to discuss the “why.” Although there may be any number of reasons to consider automatic enrollment, they generally fall into two broad categories—to prevent a testing failure and/or to help employees accumulate meaningful retirement savings by encouraging contributions. Both goals are admirable and automatic enrollment can indeed aid in both, but it is not a foregone conclusion that it will achieve either goal on its own. That makes it important to consider some of the details before jumping blindly into the automatic enrollment waters. Let’s look at a few examples.

Preventing a Test Failure

As a quick review, 401(k) plans are generally required to pass the ADP test each year. It compares the average deferral rate the highly compensated

employees or HCEs (owners and those earning north of \$115,000–\$120,000 per year) to that of the non-HCEs. If the spread is outside of accepted parameters, the test fails and must be corrected by either returning excess amounts to the HCEs or making special company contributions (called Qualified Nonelective Contributions or QNECs) to the non-HCEs.

Rather than focusing on the correction, some companies proactively seek to increase non-HCE contributions as a way to avoid the failure in the first place. How better to do that than to automatically enroll employees who aren't contributing?

There are several factors to consider, including existing deferral rates, the default rate required to pass the ADP test and other steps that might already be in place to encourage employees to contribute. Here are a couple of examples

Example #1

Out of Time, Inc.'s non-HCEs are currently deferring at the average rate of 3.75% due to the company's recent plan enrollment campaign; however, that average needs to be 4.25% to pass the ADP test. The company decides its campaign has not been successful enough, so they decide to discontinue it and implement 3% automatic enrollment instead.

Although some participants who weren't contributing remain at the 3% default rate, the scaling back of the enrollment campaign meant that very few new employees elect to defer any more than the default rate. After a year of automatic enrollment, the non-HCE average actually decreased to 3.6%, causing the plan to fail the ADP test by an even greater margin than before.

Example #2

Using the same basic facts as the previous example, Out of Time decides to increase the default

rate to 4.5% in order to achieve their testing goals. Rather than just applying the default rate to newly eligible employees, they decide to apply it to current participants deferring below that rate. At the 3% default, there was a relatively high acceptance rate with only about 25% of the impacted employees opting out. But at 4.5%, the opt-out rate increased to 30% and included some folks who were already deferring, causing the overall non-HCE average to decrease again.

In both situations, automatic enrollment failed to achieve the desired result, because it was used as a replacement for rather than a supplement to what the company was already doing.

Another consideration is the cost impact with regard to company matching contributions. Let's return to our friends at Out of Time, Inc.

Example #3

The plan fails the ADP test and Out of Time does not want to correct via refunds. The alternative is to make a \$25,000 QNEC on top of the match it already makes. The company cannot afford to spend the extra money so it explores automatic enrollment as an alternative.

Based on some projections, a default deferral rate of 3.5% would get the ADP test to pass; however, using the existing match formula, the additional deferrals increase the match cost by \$30,000, even more than the QNEC that was too expensive. Although they considered reducing the match formula to control cost, it was agreed that doing so would cause too many existing participants to reduce or discontinue their contribution rates.

None of this is to suggest that automatic enrollment cannot be an effective tool to improve test results, only that it is critical to consider all the factors and potential unintended consequences rather than assuming it will work.

Encouraging Savings

Use of automatic enrollment in this context is often predicated on the notion that something is better than nothing and that is certainly true. It can be very effective at creating savers out of people who would not otherwise set aside anything for their retirement. However, as with testing issues, automatic enrollment is not a cure-all for retirement shortfalls.

Using conservative estimates for investment returns, salary cost of living increases, etc., a participant whose only savings consists of a 3%–6% default deferral rate throughout his or her working years would likely run out of savings in their mid-70s. Certainly that is better than not being able to retire at all; but with ever-increasing life expectancies, these results can leave retirees with few resources in their later years.

Automatic enrollment is one of numerous tools that can be used to encourage savings. As

employees see their accounts accumulate, they may be more open to continuing automatic escalation beyond the 6% (or even the 10%) in the QACA schedule. When they see how even modest deferral increases in their earlier working years, compounded over time, can lead to sizeable increases in their projected retirement income, participants may be more likely to put raises and bonuses into the plan rather than spending them.

Conclusion

Automatic enrollment is here to stay. It is increasingly popular and sooner or later, it may become the norm in most 401(k) plans. Regardless of the goals you hope to accomplish, it is important to understand that it often will not achieve the desired result on its own. However, as part of an overall strategy, automatic enrollment can be an effective springboard to improve plan operations and create a culture of savings among employees.

This newsletter is intended to provide general information on matters of interest in the area of qualified retirement plans and is distributed with the understanding that the publisher and distributor are not rendering legal, tax or other professional advice. Readers should not act or rely on any information in this newsletter without first seeking the advice of an independent tax advisor such as an attorney or CPA.

©2015 Benefit Insights, Inc. All rights reserved.

Pension Services, Inc. PensionSite.Org

www.pensionnetwork.net

www.PensionSite.Org

Miami Office

7700 North Kendall Drive, Suite 405

Miami, FL 33156

Telephone: 305.595.5500

Fax: 305.274.1882

Orlando Office

Post Office Box 1869

Winter Park, FL 32790

Telephone: 888.412.4120

Fax: 321.397.0409

A Full Service Third Party Administration Firm