

All You Wanted To Know About 401(k) Automatic Enrollment

By Ary Rosenbaum, Esq.

Automatic Enrollment is one of the most successful features added to a 401(k) plan in the last 20 years, but it wasn't a perfect launch. Even today, it's not a perfect fit for every 401(k) plan sponsor and it might not be the best fit for you. Understanding what it is and the history behind it, it might give you an idea if it's the right choice for you as a 401(k) plan sponsor if you have a choice (more on that later).

Negative election

In 1998, the Internal Revenue Service ("IRS") issued Revenue Ruling 98-30 which allowed automatic contributions made on behalf of employees to be treated as "elective" deferrals under a section 401(k) plan. Automatic enrollment, which was called a negative election back in the day was developed to increase employee participation in retirement savings plans. Under these programs, an employee was automatically enrolled in a plan and contributions (at a set percentage or amount) were automatically deducted from their pay, unless the employee specifically elected not to participate (which is where we got the term, negative election from). The appeal of the negative election was that it helped raise the participation level of those employees who otherwise may not consider making elective contributions, thereby providing the employees with additional retirement savings. More importantly, it was used to raise the deferral rate for non-highly compensated employees to help the employer pass the Actual Deferral Percentage (ADP) test for non-discrimination. The problem with negative election was

one major thing: there was no protection under ERISA section 404(c), which may have otherwise shielded the plan sponsor from liability for investments made at the direction of the participants since the automatically enrolled employee didn't make an investment election under the plan. With no law on the books shielding the plan sponsor from liability for investments, employers who offered negative election parked the money of those automatically enrolled into

was that changing words has the perception of changing reality. Negative election between 1998 and 2006 wasn't very popular since there was zero protection for plan sponsors that offered it. Many thought that Negative Election wasn't a great selling term and that the feature could use a fresh coat of paint or paint of coat (obligatory Conrad and Bruce reference for the 5 people who will get it). The Pension Protection Act of 2006 (PPA) codified the Automatic

Enrollment arrangement into law. Since then, I think Negative Election has been stricken as a retirement plan term. The PPA helped eliminate some potential legal and administrative headaches, and established incentives for plan sponsors to implement such plan features. It was a game changer, the PPA enabled plan sponsors to make it easier for employees to participate in their retirement plan, as well as contribute to it and increase their savings rates over time. Studies have shown that 87% of plan sponsors participate in plans with automatic enrollment, compared to just 52%



a stable value or money market investment which in the days of cheap money, garnered very little interest. Additionally, state laws regulating wage payment and collection issues (that are not otherwise preempted by ERISA) could have had conflicting standards before implementing such a program.

Automatic enrollment codified by PPA

I was a huge fan of George Carlin and he had a great comedy routine on euphemisms, he didn't understand when toilet paper became bathroom tissue. His point

participation for plans without this feature. The PPA eliminated many liability headaches by amending the Employee Retirement Income Security Act (ERISA) to provide a safe harbor for plan sponsors who invest participant assets in certain types of default investment alternatives when participants do not give investment direction through automatic enrollment. To assist employers in selecting QDIAs that met employees' long-term retirement needs, the Department of Labor (DOL) issued a final regulation detailing the characteristics of

these investments. The PPA paved the way for three types of automatic enrollment features: Automatic Contribution Arrangement, Eligible Automatic Contribution Arrangement, and Qualified Automatic Contribution Arrangement.

Automatic Contribution Arrangement (ACA)

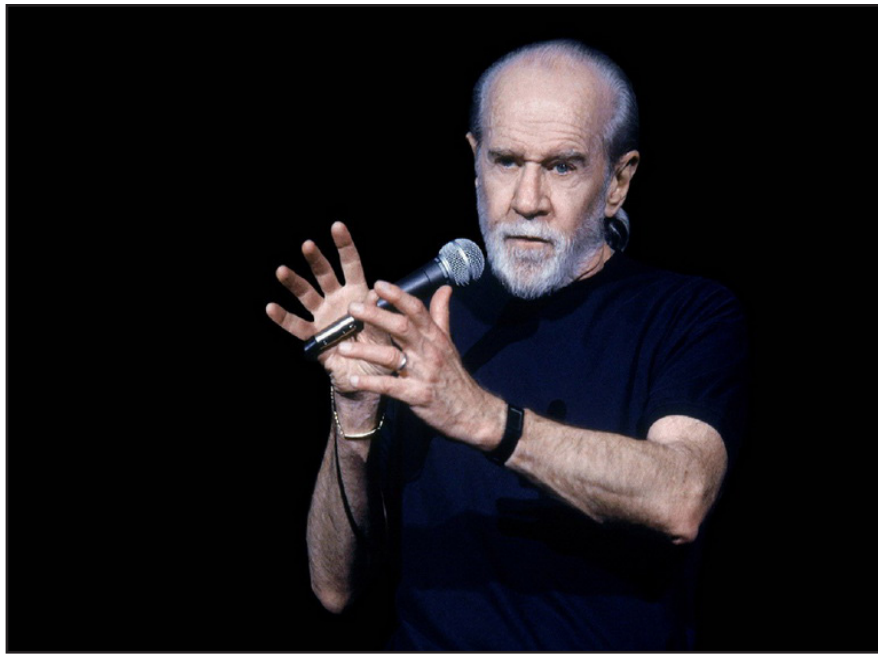
ACA is a plan feature that allows employees, who are eligible to participate in a 401(k) plan but fail to make a salary deferral election, to be automatically enrolled in the plan and have a predetermined percentage of their compensation deferred. Upfront and annual notices are required to let employees know they will be automatically enrolled in the plan, the percentage of pay, and to which investment options the contributions will be directed in the absence of an investment election. These notices also advise employees of their right not to defer or to defer at a different percentage of pay.

Eligible Automatic Contribution Arrangement (EACA)

An EACA is like the basic automatic contribution arrangement, with a few additional requirements related to the content of the initial and annual participant notices and default contribution rate. There are two potential advantages to meeting the EACA requirements. First, the plan has the option to extend the window to correct failed Average Deferral Percentage (ADP) or Average Contribution Percentage (ACP) tests from two-and-a-half to six months after the close of the plan year, while still avoiding the 10% employer excise tax. Also, a plan can (but is not required to) allow for automatically enrolled participants to withdraw their contributions within the time stated in the plan (within 90 days of the first contribution).

Qualified Automatic Contribution Arrangement (QACA)

A QACA allows a plan to satisfy the ADP test, as well as to potentially satisfy the Actual Contribution Percentage test (ACP) for matching contributions and the top-heavy test. The QACA design is essentially a variation of the traditional safe har-



bor 401(k) or 403(b) plan, which requires an annual contribution. The plan must include certain features—such as minimum automatic deferral percentages and increases, mandatory minimum employer contributions, and a special vesting schedule. Unlike regular safe harbor matching contributions, plan sponsors can use a two-year vesting schedule instead of automatically vesting the participant. The initial and annual notices for QACA contain the same information as the EACA notice, along with the general requirements of a traditional 401(k)/403(b) safe harbor notice.

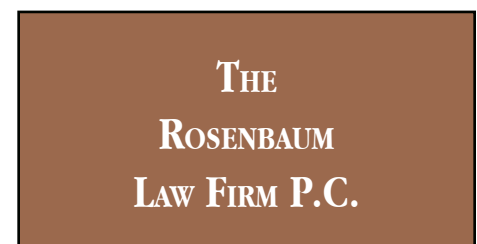
Secure 2.0 and Automatic Enrollment

PPA made Automatic Enrollment a huge success, far greater if it remained Negative Election with zero liability protection from plan sponsors on plan investments. It's a huge success because most employees are passive, they're too lazy to affirmatively opt out of a 401(k) plan or ask for their money back. It also helped that most plan providers saw the opportunity behind it and supported it. Approximately 62% of businesses that offer 401(k) plans, now have automatic enrollment policies. SECURE 2.0 has now further strengthened Automatic Enrollment by foisting it on new plan sponsors. SECURE Act 2.0 which was signed into law on December 29, 2022, will require plan sponsors that establish new 401(k) plans to automatically enroll newly hired employees, when eligible, in the plan at a pretax contribution level of 3 percent of the employee's pay. This level would increase annually by 1 percentage point up to at least 10 percent but not more than

15 percent of the employee's pay. Employees could affirmatively elect a different contribution. These provisions apply in 2025 to new 401(k) and 403(b) plans established after December 29, 2022, as current plans would be grandfathered. There is also an exception for small businesses with 10 or fewer employees, those in business for less than three years, church plans, and governmental plans.

Is it for you?

If you established a new 401(k) plan in 2023 and you don't meet an exception, the choice for Automatic Enrollment has been made for you in 2025. If not, you need to determine if it's something you need and/or want, mainly depending on the deferral percentage rate of your employees and non-highly compensated employees. If you are failing your ADP test or close to it, Automatic Enrollment is a great "gimmick" to boost your chances of passing. If your plan participants aren't deferring much and you want them to save for retirement, then Automatic Enrollment is right for you. Automatic Enrollment is a great tool, but like with any retirement plan feature, it might not be the right fit for everyone, including you.



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