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Automatic Enrollment Is a Good Thing—or Is It?

Some Unintended Plan Sponsor Consequences

BY JIM FARLEY

Getting individuals to save more sounds great. Similarly, how about 401(k) participants having larger account balances when they retire? Few would argue against it because, as a matter of public policy, it plays well and, to quote Martha Stewart, "It's a good thing." However, public policy concerns aside, are we prepared to address the requirements that accompany automatic enrollment? Is it "plug and play," or do we need to read the instructions?

Before going further, let's define what we mean by *automatic enrollment*. It is an optional provision in a 401(k), 403(b) or governmental 457(b) plan, whereby an employee becomes a deferring (that is, money taken out of paycheck) plan participant, at a specific (uniform) pay percentage, even though the employee made no affirmative election to have withholding occur. Prior to the Pension Protection Act [PPA] of 2006, many states (e.g., New York and California) prohibited the inclusion of any automatic contribution arrangement, as any wage reduction required affirmative consent. PPA's Section 902(f) added ERISA [Employee Retirement Income Security Act] §514(e)(1), which preempted state law on this issue, and so universal automatic enrollment was born.

The most basic decision a plan sponsor should consider is, what will this plan enhancement cost? But before we arrive at the appropriate conclusion, there are several onion layers to peel away.

For example, does the plan offer (or consider offering, in the case of a new plan) a matching contribution? Let's say the answer is "yes" and that the match is $0.50 for every $1.00 saved on the first 6 percent of pay. Suppose, then, a hypothetical 401(k) plan sponsor sets the auto-enrollment saving threshold at a minimum 3 percent of pay per individual, unless the employee elects a different percentage, including the option not to contribute. Doing the math, the matching contribution on the first 3 percent of pay will cost 1.5 percent of pay. If the affected payroll (that is, those who would not have participated but for this provision) is $500,000, auto-enrollment would cost this hypothetical employer $7,500. Yes, it's a tax-deductible contribution, but if this were a real-world situation, it's real money also. Clearly, this hypothetical sponsor should complete some basic cost/benefit analysis to determine whether the program should be implemented.

Is there an upside in this scenario? The potential employee satisfaction that saving and being matched money may well be worth the expense. In addition, if the employer offers a default investment that meets the Department of Labor's standards, called a Qualified Default Investment Alternative (QDIA),[1] and also allows newly participating employees who were automatically enrolled to withdraw their savings within 90 days of enrollment, the plan gets an added bonus. This is called an Eligible Automatic Contribution Arrangement (EACA).[2]

Traditional 401(k) plans must prepare a discrimination test within two and a half months of the plan year-end. If the disparity between highly compensated employee (HCE) savings (as a percentage of compensation) and nonhighly compensated employee (NHCE) savings exceeds regulatory thresholds (usually 2 percent), action must be taken. If automatic enrollment is elected, the disparity gap could be smaller as more NHCEs participate. Assuming a disparity still exists, to balance the scale, then either the plan refunds savings to the affected HCEs or the employer contributes more money on behalf of NHCEs. If the refund option is elected, the overage must be returned to the HCEs and is considered income for the tax year in which the plan year began, unless it was a Roth 401(k) contribution, in which case it would just be refunded.[3]

HERE ARE TWO HYPOTHETICAL EXAMPLES:

1. Hypothetical participant A is the only HCE in calendar year plan Q, and A elected to save pretax, not Roth after-tax. It is determined that A has contributed $2,000 more during 2008

than the regulations allow. A must receive a taxable refund on or before March 15, 2009, and this refund is income for 2008.

2. If we assume the same facts as in example 1, except that plan Q is an EACA, A can receive the $2,000 refund on or before June 30, 2009, and it is 2009 income instead of being income for 2008. This allows A to file a timely tax return without waiting on plan test results.

In order to add automatic enrollment to an existing plan, an amendment must be adopted. Such an amendment will rarely be free. A typical amendment may cost a plan sponsor several hundred dollars, but in some instances, more, depending on what goes into the amendment's construction, including such potential cost items as a feasibility study, meetings (employee and employer), and written employee disclosure.

According to proposed Treasury regulations,[4] although apparently not supported by statute, automatic-enrollment provisions can be added only at the beginning of a plan year. Since most businesses operate on the calendar, there are generally major planning activities concentrated during one portion of the year. Is the business able to focus on making this change at a time when budgets are being created, employee reviews are being conducted, and other employee benefits, such as medical, may be undergoing scrutiny? It seems that it would be a difficult task to implement an automatic-enrollment program unless preparations were made earlier in a year.

Will the administrative cost of the plan increase as a result of adding auto-enrollment? Someone has to provide all newly eligible participants a notice to "opt out" and add them to the 401(k) roster. Will the pension servicing firm (frequently called a third-party administrator or TPA, accounting office, or payroll provider) remind the sponsor to add employees A, B, C, D, et al.? If yes, it stands to reason that there would be additional administrative charges, as these types of firms do not perform these services for every plan they service. If not the TPA, is the sponsor equipped to handle this responsibility? That could be an alarming scenario, as many businesses, especially smaller ones, do not maintain the infrastructure to track any number of nonbottom line-related activities. As we will see, failure to handle auto-enrollment properly can be costly.

If the "opt out" notice is not delivered in a timely manner (i.e., between 30 and 90 days before the beginning of the plan year to which it applies and every year thereafter), the penalty for not providing the notice is $1,100 per day for each day it is late.[5] A notice delivered on December 15 that was due by December 1 could cost a sponsor $15,400 in penalties, and that's if only one person is affected. If two people don't receive the notice (as in this example), the fine could double.

Failing to automatically enroll someone in a timely manner can result in retroactively adding them to the plan, with sponsor dollars funding the "missed savings" plus any possible earnings those "missed savings" did not generate. If the error is not discovered within two years or affects a significant number of participants, a filing with the IRS under its Employee Plans Correction Resolution System (EPCRS) may be needed to ensure continued compliance. This action comes with a filing fee that starts at $750 if the plan has fewer than 21 participants, $1,000 if there are 21–50 participants, $2,500 if there are 51–100 participants, and $5,000 if there are 101–500 participants. In addition, a pension professional (e.g., attorney, accountant, consultant) would need to prepare the submission, and they would surely charge something. For readers unfamiliar with EPCRS, it is an IRS-run compliance assistance program designed to aid retirement programs having form or operational defects that can be corrected without jeopardizing plan qualification.

Another facet of auto-enrollment plans, called Qualified Automatic Contribution Arrangements (QACAs),[6] requires an annual auto-increase, whereby the savings rate of auto-enrolled employees begins at a threshold amount, say 3 percent, and increases by a percentage, typically 1 percent, each year thereafter, but not to exceed 10 percent. However, the initial threshold (here 3 percent) must be maintained through the end of the plan year following the plan year it was first effective. For example, if a hypothetical QACA started on January 1, 2009, with a 3 percent automatic-enrollment threshold, the 3 percent level, unless the participant opts out or changes contributions on his/her own, would continue through 2010 and not become 4 percent until 2011. Increasing savings levels need to be maintained on a participant-by-participant basis, as not everyone steps up at the same time. This is a form of safe harbor 401(k) plan, exempt from the discrimination testing previously described, when the employer provides either a matching contribution equal to $1.00 per $1.00 saved on the first 1 percent of pay and $0.50 for every $1.00 saved on the next 5 percent of pay or a 3 percent non-elective contribution for all eligible employees, even if they "opt out." Being a watchdog over this feature could also be expensive.

It is difficult to deny that Americans need to save more. Participants in a 401(k) had an average account balance of nearly $76,000, but a median balance of just about $26,000 at year-end 2006, while one-third of participants had a

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balance of less than $10,000.[7] The participation rate in plans with auto-enrollment was 28 percent higher than in plans without the feature,[8] which seems quite indicative that employee inertia can be overcome. So, while broader participation and concurrent saving is welcome, it should not, as we have outlined, be undertaken with a blind eye. ■

[1] Department of Labor Regulation 2550.404(c)-5(e). In addition, see our white paper, "Qualified Default Investment Alternatives," accessible on our Website, www.lordabbett.com. A participant in a participant-directed individual account plan will be deemed to have exercised control over assets in his or her account if, in the absence of investment directions from the participant, the plan invests the assets in a qualified default investment alternative (QDIA). A plan fiduciary that complies with the QDIA regulations will not be liable for any loss, or by reason of any breach, that results from investments in a QDIA. The QDIA regulations became effective on December 24, 2007.

[2] Proposed Treasury Regulation 1.414(w)-1(a).

[3] 401(k) plans must describe how discrimination testing will be satisfied under the Internal Revenue Code and Treasury Regulation 1.401(k)-1(e)(7).

[4] Proposed Treasury Regulation 1.414(w)-1(b)(1).

[5] Section 902 of PPA amended Section 502(c)(4) of the Employee Retirement Income Security Act of 1974, as amended, (ERISA) to provide that the Secretary of Labor may assess a civil penalty against any person of up to $1,100 a day for each violation by any person of Section 302(b)(7)(F)(vi) or Section 514(e)(3) of ERISA.

[6] Proposed Treasury Regulation 1.401(k)-3.

[7] Vanguard, "How America Saves 2007."

[8] *Building Futures,* vol. VIII, Fidelity Investments Institutional Services Company, Inc., as of December 31, 2006.

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