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Automatic Enrollment Redux: The Final Regulations Have Arrived

The Pension Protection Act of 2006 created two new types of automatic enrollment features—the Eligible Automatic Contribution Arrangement ("EACA") and the Qualified Automatic Contribution Arrangement ("QACA"). Though these arrangements were initially available for plan years beginning in 2008, early adopters and their service providers have been operating in good-faith compliance with the proposed regulations issued in November 2007. That changed on February 24, 2009, when the Treasury Department issued the long-anticipated final regulations ("Final Regs"). Before delving into the content of the Final Regs, some background is in order.

What Is an Eligible Automatic Contribution Arrangement?

An EACA is a feature in a 401(k) plan that provides for the automatic enrollment of all covered employees who do not have an affirmative deferral election in effect. The default deferral rate generally must be uniform for all employees covered by the arrangement [Treas. Reg. §1.414(w)-1(b)(2)]. Subject to certain limitations, participants covered by the EACA can request a permissible withdrawal of the amounts automatically withheld during the first 90 days of participation, and sponsors of EACAs generally have an extended deadline of six months following the end of the plan year (instead of the regular 2 ½ months) to distribute excess contributions to avoid imposition of the 10% penalty [Treas. Reg. §§1.401(k)-2(b)(5)(iii) and 1.401(m)-2(b)(4)(iii)].

What Is a Qualified Automatic Contribution Arrangement?

A QACA is a new type of safe-harbor 401(k) plan that combines the automatic enrollment feature of the EACA with a provision requiring automatic escalation of the default percentage each year [Treas. Reg. §1.401(k)-3(j)]. During the Initial Period (the timeframe from the initial automatic enrollment through the end of the following plan year), the default deferral rate must be at least 3% of pay. The default rate automatically increases by one percentage point in each of the three subsequent years [Treas. Reg. §1.401(k)-3(j)(2)(ii)].

Example #1

Bright Side, Inc. sponsors a 401(k) plan that includes a QACA. Terry becomes eligible for the plan on September 1, 2009.

Year	Minimum Default Percentage
Initial Period (Sept. 1, 2009–Dec. 31, 2010)	3%
2011	4%
2012	5%
2013	6%

The default percentages can be higher and the escalation can continue beyond the fifth year as long it satisfies the minimums noted above and does not exceed 10% in any year [Treas. Reg. §1.401(k)-3(j)(2)(i)(B)]. Thus, Bright Side, Inc. could set the initial default deferral rate at 6% of pay and avoid the automatic escalation requirement altogether. Alternatively, it could set the default rate for the initial period at 5% of pay and continue the escalation until Terry reaches 10% in 2015.

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In addition to automatic enrollment and automatic escalation, a QACA includes a required employer contribution that can be either a match or a nonelective contribution. The match must be at least 100% of the first one percent deferred, plus 50% of the next five percent deferred [Treas. Reg. §1.401(k)-3(k)(2)]. Similar to the "traditional" safe harbor 401(k) plan, the nonelective contribution must be at least 3% of pay [Treas. Reg. §1.401(k)-3(b)]. Unlike the "traditional" safe-harbor, the employer contribution to a QACA must be fully vested on completion of two years of service [Treas. Reg. §1.401(k)-3(k)(3)].

Uniformity Requirement

Some of the more significant changes from the proposed regulations relate to the requirement that, subject to certain limited exceptions, the default deferral percentage must be applied uniformly to all employees eligible to make a cash-or-deferred election in the plan, e.g., existing employees and new hires. Several of the comment letters submitted to Treasury requested latitude to apply the default rate to a subset of eligible employees.

The Final Regs grant this flexibility by allowing employers to specify in their plan documents the employees that will and will not be covered by the EACA [Treas. Reg. §1.414(w)-1(e)(3)]. Therefore, for example, the plan could allow immediate eligibility to make salary deferrals but include an EACA that only covers those employees who have completed the statutory eligibility requirements, i.e., age 21 and one year of service. Upon satisfaction of the statutory eligibility requirements, any employee without an affirmative deferral election in effect would be automatically enrolled at the EACA's default rate. Plans that elect this limited application and do not cover all employees under the EACA provisions, however, are not permitted to take advantage of the extended six-month timeframe for avoiding the excise tax on excess contribution refunds.

The Final Regs also permit a single plan to include multiple EACAs with different default deferral percentages for certain groups of employees [Treas. Reg. §1.414(w)-1(b)(2)(iii)]. The additional flexibility brings with it some added complexity. The final regulations seek to limit excessive "creativity" by incorporating some of the disaggregation concepts from IRC §410(b). Only EACAs covering groups of employees that can be disaggregated under IRC §410(b), e.g., collectively-bargained employees, can be subject to a different default rate than other EACAs in the plan. All EACAs covering employees who cannot be disaggregated must be combined to determine whether the plan satisfies the uniformity requirement.

Example #2

> Lumberjacks, Inc. sponsors a 401(k) plan that includes two EACAs—one covering Division A with a default rate of 3% and the other covering Division B with a default rate of 5%. A is comprised exclusively of collectively-bargained employees, and B is comprised of noncollectively-bargained employees.
>
> Because collectively-bargained employees are disaggregated under IRC §410(b), both EACAs satisfy the uniformity requirement.
>
> Assume Division A hires a group of nonunion employees that cannot be disaggregated for any other reason. Because nondisaggregated employees are now being covered by two EACAs with nonuniform default rates, the plan no longer satisfies the uniformity requirement.

The QACA uniformity rule is modified with regard to the timing of the automatic deferral increases. The Final Regulations clarify that the scheduled increases are based on the date on which deferrals for a given participant are first withheld pursuant to the QACA without regard to whether he or she may have had an affirmative election in effect in the interim [Treas. Reg. §1.401(k)-3(j)(2)(iv)].

Example #3

> Assume the same facts from Example #1, above, except that Terry makes an affirmative deferral election on January 1, 2011, equal to 2% of compensation and then revokes the election on January 1, 2013.

Year	Minimum Default Percentage
Initial Period (Sept. 1, 2009–Dec. 31, 2010)	3%
2011	2%

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2012	2%
2013	6%

As Terry no longer has an affirmative election in effect, he is again subject to the default deferral percentage and automatic escalation. Applying the minimum required escalation schedule to his initial automatic withholding in September 2009, Terry's minimum required default rate in 2013 is 6% of pay.

The plan can "reset" an employee to the beginning of the schedule, e.g., the Initial Period, if he or she does not have any default deferrals withheld during the immediately preceding plan year [Treas. Reg. §1.401(k)-3(j)(2)(iv)]. This has practical application in determining the correct default percentage for rehired employees.

Example #4

Graham is automatically enrolled in a QACA on February 1, 2010, at a default rate of 3%. He terminates employment in December 2010 and is rehired in January 2012.

Year	Plan's Escalation Schedule	Graham's Deferral Schedule
2010 (part of Initial Period)	3%	3%
2011 (part of Initial Period)	3%	0%
2012	4%	3%
2013	5%	4%
2014	6%	5%

Under the minimum required QACA escalation schedule, Graham would normally be increased to 4% in 2012. As he did not make any default deferrals during the entire 2011 plan year, he may be treated as a newly enrolled QACA participant at the 3% default rate.

The plan is also permitted to apply automatic deferral increases based on portions of years instead of at year-end. This allows employers to coordinate the automatic increases with performance evaluations and/or salary increases that may take place mid-year. Any such mid-year increases must be applied on a uniform basis to all covered employees [Treas. Reg. §1.401(k)-3(j)(2)(iii)(A)].

Although there was nothing in previous guidance specifically precluding the practice, the Final Regs note that a plan may provide for the expiration of affirmative elections at a set time or at set intervals [Treas. Reg. §1.414(w)-1(e)(3)]. Participants who do not make subsequent affirmative elections are then automatically enrolled at the default rate.

Permissible Withdrawals

The final regulations clarify that in order to be eligible to take a permissible withdrawal, a participant in an EACA must request the withdrawal within 90 days of the first pay date on which default deferrals were withheld and not the date such amounts were deposited to the trust [Treas. Reg. §1.414(w)-1(c)(2)(ii)]. Plan sponsors may choose to further restrict the timeframe for requesting permissible withdrawals to a minimum of 30 days [Treas. Reg. §1.414(w)-1(c)(2)(i)]. All EACAs required to be aggregated for application of the uniformity rule (described above) must also be aggregated to determine whether a participant is within the specified window to request a permissible withdrawal [Treas. Reg. §1.414(w)-1(c)(2)(iv)(B)]. This prevents a plan from establishing multiple EACAs with staggered eligibility to allow a participant to move from EACA to EACA and extend the 90-day withdrawal period.

Similar to the above-described treatment of rehires, the permissible withdrawal clock is reset for employees who do not have any default deferrals withheld during the plan year immediately preceding their rehire. Any withdrawal request would be applicable only to newly withheld automatic deferrals and not to any deferrals that were contributed during the participant's prior employment [Treas. Reg. §1.414(w)-1(c)(3)].

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Another point of debate relates to the employer matching contribution associated with the permissibly withdrawn amount. The proposed regulations required the employer to deposit the related match even though it would be instantly forfeited. The Final Regs provide some relief. The plan may now provide that, as long as the employer is not otherwise required to allocate the match earlier, e.g., each pay period, it is no longer necessary to allocate and immediately forfeit matching contributions related to automatic deferrals that are permissibly withdrawn [Treas. Reg. §1.414(w)-1(d)(2)].

Default Investments

Under the proposed regulations, EACAs were required to comply with the Qualified Default Investment Alternative regulations under ERISA §404(c)(5). Because there was no parallel rule for the QACA, it was possible to have a QACA that was not also an EACA. As permissible withdrawals are only available in EACAs, a nonQDIA QACA would not be able to take advantage of this feature. The Worker, Retiree, and Employee Recovery Act ("WRERA"), which was signed into law at the end of 2008, removes the mandatory use of a QDIA in EACAs [WRERA §109(b)]. As a result of this change, all QACAs are now also EACAs even if the default investment is not a QDIA. (Now, try to read this paragraph aloud five times fast!)

Notice Requirement

There are several clarifications in the Final Regs on the timing of the required QACA/EACA notice. The notice is deemed timely if provided between 30 and 90 days prior to the start of a plan year. For a participant who becomes eligible during the year, the notice must be provided no earlier than 90 days prior to his or her eligibility date and no later than the eligibility date itself. If the notice cannot reasonably be provided in this timeframe, it may still be considered timely if provided prior to the pay date covering the pay period in which the employee became eligible. Furthermore, the employee must have sufficient time to make a deferral election after receiving the notice [Treas. Reg. §1.401(k)-3(j)(4)(iii)].

Although WRERA eliminated the requirement for EACAs to use QDIAs, the Final Regs specify that the notice must still inform participants how their automatic deferrals will be invested absent their direction [Treas. Reg. §§1.401(k)-3(j)(4)(ii)(C) and 1.414(w)-1(b)(3)(ii)(D)].

Unanswered Questions

The Final Regs do not provide relief or clarification on two key issues raised by several commentators. First, the Final Regs retain the prohibition on adding an EACA or a QACA to an existing 401(k) plan in the middle of a plan year [Treas. Reg. §§1.401(k)-3(e) and 1.414(w)-1(b)(3)(iii)]. The second item relates to the requirement that employer matching and nonelective contributions intended to satisfy the ADP and ACP tests in a QACA must be vested after no more than two years. There has been some confusion on whether/how the sponsor of a "traditional" safe-harbor 401(k) plan requiring immediate vesting can transition to the two-year vesting schedule if they implement a QACA. The Final Regs do not provide any further guidance on this question.

Effective Dates

The provisions in the Final Regs applicable to QACAs are effective retroactively for plan years beginning on or after January 1, 2008. The EACA provisions are effective for plan years beginning in 2010 or later [Treas. Reg. §1.414(w)-1(f)(2)]. The preamble to the Final Regs indicates they are not applicable to automatic enrollment arrangements established pursuant to guidance predating PPA.

While the final automatic contribution arrangement regulations provide some welcome relief and greater flexibility, both the EACA and QACA include many moving parts not found in a traditional 401(k) plan. Inadvertently delaying an eligible participant's automatic enrollment or automatic escalation is failure to follow the

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terms of the plan—an operational failure that must be corrected. The additional complexities inherent in these designs emphasize the need for careful coordination between all plan service providers.

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