Automatic enrollment safe harbor 401(k) plan – how does it work?

Effective for plan years beginning on or after January 1, 2008

Although automatic enrollment plans have been around for years, the Pension Protection Act of 2006 (PPA 2006) provides new incentives for implementing automatic enrollment in 401(k) plans on or after January 1, 2008.

Automatic enrollment plans

In addition to the incentives provided in PPA 2006, automatic 401(k) enrollment is becoming popular because it encourages retirement saving among people who otherwise might not save, particularly young people and lower-income employees. Surveys suggest that considerably more workers will contribute to 401(k)s if companies set up accounts for them rather than if employees are left to enroll on their own. And because traditional pensions are becoming much less common, participating in a defined contribution plan, such as a 401(k), is more important than ever. In fact, for many people, it may be the easiest — if not the only — way to set aside pre-tax income for retirement.

It's important to note that employees can always choose to opt out of the 401(k) plan, provided they follow the rules for opting out of the plan. When designing the automatic enrollment plan, an employer has some flexibility in choosing how much of the employee's income to defer and where to invest it — although employees always have the opportunity to increase or decrease the percentage and change the manner in which the money is invested.

What is a QACA?

A new safe harbor automatic enrollment program for 401(k) plans, known as a "qualified automatic contribution arrangement" or "QACA," applies to plan years beginning on or after January 1, 2008. Among the advantages of a QACA is its exemption from nondiscrimination testing and top heavy testing. Please note further guidance from the IRS is expected on the operation of these plans.

Requirement for establishing a QACA

- **Minimum deferral percentages —** A QACA must have a minimum specified automatic contribution percentage. That percentage will increase in the second, third and fourth plan years of an employee's participation. The minimum deferral for the first full year of participation is at least 3% (but no more than 10%) of compensation. The minimum increases to 4% the second year, 5% the third year, and 6% the fourth year; the maximum automatic percentage cannot exceed 10%.
- **Eligibility exceptions —** The automatic enrollment rules apply to all eligible employees — with two exceptions. The first exception is for employees who are already deferring. The second exception is for those who have filed an election not to defer. However, the employer may choose to include eligible employees who defer less than the plan's minimum amount in the program.
- **Minimum contribution requirements —** The plan sponsor must make either a matching contribution of 100% of the first 1% of compensation deferred plus 50% of the next 5% deferred (for a maximum match of 3.5% of compensation on the first 6% deferred) or a nonelective contribution of at least 3% of compensation to all eligible non-highly compensated employees.
- **Vesting —** Employer contributions used to satisfy the safe harbor must be 100% vested after an employee has completed no more than two years of service. Note that this is another key advantage of a QACA. For example, in regular 401(k) safe harbor arrangements (i.e., those that are not QACAs) immediate and full vesting of safe harbor contributions is mandated.
- **What are the normal distributions?** The normal 401(k) plan in-service withdrawal restrictions apply to distributions before age 59½.

- **Notice requirements —** Within a reasonable time before the beginning of each plan year, employees eligible to participate in the QACA must receive written notice of their rights and obligations regarding automatic enrollment. The employee notice must also be provided when an employee is hired (if hire date is within 30 days of becoming eligible) or just before eligibility requirements are satisfied. The notice must explain the employee's right to decline automatic enrollment or to change his or her election amount, including the right to stop deferrals. Failure to provide adequate notice may result in rather severe civil penalties being levied for each violation of the notice requirement.

Key advantages

There are two key advantages to the new automatic enrollment safe harbor plan, or QACA, compared to a traditional 401(k) safe harbor plan:

- QACA matching contribution is less expensive than a 401(k) safe harbor plan's matching contribution (maximum is 3.5% versus 4% of compensation).
- Vesting is 100% after 2 years of service versus immediate vesting in a non-QACA safe harbor plan.

These features can help to reduce the cost of the increasing matching contributions required in the automatic enrollment safe harbor plan.

How we can help

We recognized the importance of selecting and designing an appropriate retirement plan for you and your employees. We know that not one product fits all and we work closely with you to find strategies and solutions to meet your company's unique needs. We offer a wide variety of wealth management services and non-proprietary retirement plan solutions from the top providers in the industry. We will work closely with you to help you design the appropriate retirement plan to meet your company's goals and objectives.