

Retirement Planning Opportunities

Automatic Enrollment 401(k) Plans Would They Work for You?

What Is an Automatic Enrollment 401(k) Plan?

The Automatic Enrollment 401(k) Plan is a 401(k) plan where eligible employees are automatically enrolled if they don't elect otherwise.

Prior to the Pension Protection Act, business owners didn't want to set up these plans because they were worried about:

- **State garnishment laws and**
- **Fiduciary liability for investment choices**

The Pension Protection Act provided an ERISA exemption to garnishment. It also ended the fiduciary liability worries by setting up default provisions for the investments and provisions that would let the employees opt out of participation. Additionally it set up uniform rates for the automatic elective deferrals with specific maximums and minimums.

Safe Harbor Enrollment Percentages

In order to satisfy the rules for being a nondiscrimination safe harbor, the percentages of compensation for an employee's contribution to an automatic enrollment 401(k) plan must not exceed 10% and must be:

- **Initially – No less than 3%**
- **2nd yr. – No Less than 4%**
- **Third Yr. – No Less than 5%**
- **Any Following Yr. – No Less than 6%**

These percentages do not apply to those who are already participating.

Safe Harbor Employer Contributions

Additionally the business owner must make one of two "safe harbor" contributions in order to satisfy the requirements for the

nondiscrimination safe harbor for automatic enrollment 401(k) plan. If the employer makes one of these contributions, then the plan is deemed to satisfy the top heavy requirements and doesn't have to satisfy the ADP nondiscrimination test.

The safe harbor contributions are:

- **3% of pay to all eligible non highly compensated employees**
- or
- **A matching contribution of 100% of the first 1% of pay deferred & 50% of the next 5% of pay deferred**

Automatic Enrollment 401(k) Plans – Other Requirements

The distribution rules for automatic enrollment plans are the same as for all 401(k) plans. Obviously, the salary deferrals are 100% vested at all times. The employer contributions are 100% vested after 2 years of service.

Employee Deferrals Made in Error

If a salary deferral was made for an employee who decides that he or she does not want to make deferrals, then the amounts may be withdrawn within 90 days.

These amounts are:

- **Not subject to the 10% premature distribution tax**
- **Treated as compensation**
- **Not included in discrimination test**

Advantages of Automatic Enrollment Plans

One of the major advantages of the plan is that the business owners don't need

to worry about the ADP non discrimination test. They can defer as much as they want up to the full legal limit without worrying about how much their rank and file employees defer.

In an ordinary 401(k) plan the highly compensated employees would be limited to deferring no more than a small percentage above the average deferred by the non highly compensated employees.

Additionally no top heavy minimum contributions are required in the plan.

Disadvantages of Automatic Enrollment Plans

These same advantages are available in a safe harbor 401(k) Plan without automatic enrollment. In these plans the matching contribution is a little higher. It is 100% of the first 3% of pay deferred plus 50% of the next 2% of pay deferred so the maximum contribution is 4% of pay vs. the 3.5% of pay maximum in the automatic enrollment plans.

Although the matching contribution percentage is lower in the automatic enrollment plans, the total matching contribution may be higher because there will usually be more employees with deferrals in the automatic enrollment plan. Consequently, the cost for including the non highly compensated employees can be much higher in the automatic enrollment plans than in the safe harbor 401(k) plans without automatic enrollment.

It is possible that the percentage of employees participating in the automatic enrollment plan could be lowered by making sure that all the employees are aware that their salaries will be deferred if they do not elect out of the plan. The extra work involved in handling deferrals for more employees along with the extra cost of including more employees may make these plans less popular than other 401(k) plans.