



JENNINGS LAW FIRM

memorandum

June 2008

A U T O M A T I C E N R O L L M E N T I N 4 0 1 (k) P L A N S

Numerous studies show that many (if not most) employees who fail to enroll in their employer's 401(k) plan have not made an affirmative decision not to enroll. In most cases, they simply failed to complete and return the paperwork. Many employers are adding an automatic enrollment feature to their 401(k) plans to bring these recalcitrant employees into the plan. The Pension Protection Act of 2006 (PPA) made significant changes to the rules governing automatic enrollment. This firm memorandum describes how an automatic enrollment feature works and discusses some of the issues that an employer needs to consider in reviewing and implementing an automatic enrollment feature.

This memorandum was updated as of June 2008 and reflects PPA statutory changes as well as proposed regulations issued by the Internal Revenue Service in November 2007.

What is an automatic enrollment feature in a 401(k) plan?

Under an automatic enrollment feature, an employee will automatically have a specific dollar amount or percent of each paycheck deducted from his wages and contributed to the plan. An employee may file an election to have a different contribution amount paid to the plan, including no contribution at all.

Is an automatic enrollment feature permitted under the law?

McDonald's Corporation is believed to have received IRS approval in the mid-1990s to add an automatic enrollment feature to its 401(k) plan. The IRS issued a revenue ruling in 1998 (updated in 2000) expressing their view that an automatic enrollment feature did not violate the tax rules governing 401(k) plans. Final regulations under Section 401(k) that became effective in 2006 expressly permit automatic enrollment features. PPA made significant changes to the rules.

The PPA changes are effective in plan years beginning after December 31, 2007.

How does an automatic enrollment feature work?

That depends on whether the employer is electing to implement one of the automatic enrollment features permitted under PPA or whether the employer wants to implement an automatic enrollment feature under pre-PPA rules. At this point we believe that most employers who intend to implement automatic enrollment will want to elect one of the options permitted under PPA.

As of the date this memorandum was updated (June 2008), the IRS had issued proposed regulations on PPA changes governing automatic enrollment. The proposed regulations can be relied on by plan sponsors until final regulations are issued. We will update this memorandum on a periodic basis as changes occur. If you download this memorandum to your computer, periodically check our website at www.danaconsulting.com to see if an

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updated memorandum is available. We will always highlight the effective date of the most recent memorandum.

What are the advantages of adding an automatic enrollment feature?

There are many benefits to adding this feature to a 401(k) plan:

1. Employees start saving for their retirement as soon as they are eligible. America has one of the lowest savings rates in the industrialized world and automatic enrollment helps employees start saving for their eventual retirement.
2. Automatic enrollment enhances the visibility and perception of the plan to employees.
3. There are other benefits depending on which PPA automatic enrollment feature the employer implements (see below).

What are the disadvantages of automatic enrollment?

Automatic enrollment imposes new responsibilities on an employer to start payroll deductions when an eligible employee fails to return his enrollment form indicating no 401(k) contributions are to be made. Failure to commence payroll deductions would likely be considered an “operational defect” under the EPCRS rules. The IRS intends to update the EPCRS rules to specify how this failure is corrected. For example, the IRS could grant a grace period to start payroll deductions or could require the employer to make up the lost contributions with an employer contribution.

Comment: Employers will need to review their payroll internal control procedures to verify they can timely enroll newly eligible employees and start payroll deductions. Also, under the QACA rules described below, payroll deductions must automatically increase over time.

Why did Congress makes changes to automatic enrollment under PPA?

There are a number of reasons.

1. Under virtually all state wage laws an employer cannot deduct 401(k) contributions from an employee’s paycheck without the employee’s written consent. PPA makes it clear that ERISA preempts state law in this regard.

Comment: To our knowledge, the Illinois Department of Labor never challenged employers who implemented automatic enrollment.

2. ERISA 404(c) protection applies to the employee’s account in the plan even though the employee has not made an affirmative election regarding how monies in his account are invested.

Comment: We think this is a big benefit to the new rules.

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3. Employees have up to 90 days to change their mind and request a refund of their contributions.

Comment: The regular rules governing 401(k) do not permit a distribution of an employee's 401(k) contributions if he decides he does not want to contribute. One of the disadvantages of automatic enrollment under pre-PPA rules was that a plan could have a significant number of very small account balances that could not be paid out until the employees terminated. Where plan fees are based in part of average account balances, a significant number of small balances could increase plan fees.

What are the options available under the new PPA rules?

PPA creates two kinds of automatic enrollment features:

1. Eligible automatic contribution arrangement (EACA)
2. Qualified automatic contribution arrangement (QACA)

What is the benefit of an EACA?

There are several benefits to implementing an EACA:

1. The employer has six months to make refunds of excess 401(k) contributions if the ADP test is failed. Under normal rules, refunds must be made within 2-1/2 months.

Comment: Employees are taxed in the year that the refund was received and not in the year the 401(k) contribution was withheld. This is a significant benefit, particularly for fiscal year plans which must use a "FIFO" rule for attributing the taxable year of refunds.

2. The plan has 90 days to refund 401(k) contributions (and earnings) if the employee changes his mind and elects to make no contributions to the plan.

Comment: The normal 10% penalty on early withdrawals from a 401(k) plan does not apply.

3. The plan qualifies for ERISA 404(c) protection on amounts contributed under the automatic enrollment feature.

What does the employer have to do under an EACA?

1. The employer has to give an annual written notice to employees who have been automatically enrolled that (a) they can opt out of the automatic enrollment feature and (b) explains the investment fund their 401(k) contributions are invested in.
2. The employer has to invest the employee's 401(k) contributions (and any employer contributions) in what is called a "qualified default investment alternative (QDIA)."

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Comment: Virtually all of the fund platforms that service the 401(k) plan industry are offering these kinds of investments, so we do not view this as a problem. Examples of these investments are lifestyle funds and target-date funds.

Comment: We understand several of the fund companies have expressed their willingness to issue the written notice each year since they typically have the employees' addresses. However, if the employer has not created an account for a newly eligible participant, the fund company is unlikely to be able to send that participant a notice. In this case the notice will need to be given by alternative means.

What is the benefit of a QACA?

The benefit to implementing a QACA is that the plan automatically passes the ADP test (and sometimes the ACP test), and no additional employer contribution is required if the plan is "top-heavy."

Comment: This is why an employer would implement a QACA.

Similar to an EACA the plan has 90 days to refund 401(k) contributions (and earnings) if the employee changes his mind and elects to make no contributions to the plan.

What does the employer have to do under a QACA?

1. The employer has to give an annual written notice to employees similar to that required under an EACA but with additional disclosures.
2. The employer has to invest the employee's 401(k) contributions in what is called a "qualified default investment alternative." This is also similar to the requirement under an EACA.
3. The employee's default contribution rate increases each year as follows:

1 st & 2 nd year of participation	3% of pay
3 rd year of participation	4% of pay
4 th year of participation	5% of pay
5 th year of participation and later	6% of pay

Comment: This will be a challenge for employers to properly monitor and implement. Hopefully IRS guidance will provide some relief here for insignificant omissions.

Comment: This escalating contribution rate is the default rate, which means the employee can change it at any time and the escalation no longer applies.

Comment: One option to avoid having to escalate an employee's contribution rate is to impose a default rate of 6% of pay as soon as automatic enrollment starts. One potential downside, however, is that an employee may respond by opting out altogether.

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4. The employer is required to make a contribution equal to:
 - a. 3% of pay for all eligible employees, whether or not they actually contribute.
 - b. A matching contribution of:
 - i. 100% of 401(k) contributions that do not exceed 1% of pay, and
 - ii. 50% of 401(k) contributions that exceed 1% of pay but do not exceed 6% of pay.

Comment: This employer contribution is very similar to the contribution an employer has to make under a safe harbor arrangement. The QACA match is a little less than the safe harbor match.

Comment: The QACA employer contributions must become fully vested after two years of service, whereas the safe harbor contribution must be immediately vested.

Which employees have to be automatically enrolled in the initial year an EACA or QACA is implemented?

Every employee who is eligible to make a 401(k) contribution and has not already made an affirmative election to make a contribution (including no contribution) must be enrolled. We would expect this to mean that the plan sponsor must have a signed payroll deduction form on file in order to exclude an employee from automatic enrollment.

Does an employer's 401(k) plan document have to be amended to permit automatic enrollment?

Absolutely, and very careful drafting is necessary. For example, the IRS requires that the plan document expressly describe how the annual ADP and ACP tests are satisfied. If an employer implements a QACA to automatically pass these tests, the plan document must reflect that.

Comment: Unless IRS guidance prohibits it, we recommend the plan document provide that an employer will start payroll deductions as soon as administratively feasible once an employee becomes eligible. Hopefully this will provide a short grace period for employers who inadvertently do not timely sign up employees.

How does an automatic enrollment feature work in a safe harbor 401(k) plan?

Using a QACA means the annual ADP test (and sometimes the ACP test) is automatically passed, the same result with a safe harbor provision. Thus, an employer would likely need to repeal the safe harbor provision in the year the QACA becomes effective.

Using an EACA still requires the plan to pass the ADP test each year. Thus, an employer may likely want to retain the safe harbor provision even if it adopts an EACA. Remember, an EACA gives the employer up to six months to refund 401(k) contributions that exceed the ADP test limit for the year.

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Should I replace my existing safe harbor 401(k) provision with an automatic enrollment feature?

An employer would only eliminate an existing safe harbor 401(k) provision if it was implementing a QACA. The EACA does not eliminate the ADP test, so an employer would not replace a safe harbor provision with an EACA. An employer could certainly have both an EACA and a safe harbor 401(k) plan.

The QACA employer contribution can be subject to a two-year vesting schedule, while a safe harbor contribution is fully vested. Also, the QACA match is slightly less than the safe harbor match. So the QACA does favor the employer a little more than the safe harbor provisions.

Automatic enrollment requires the employer to be more careful about timely enrolling employees and starting payroll deductions if the employee fails to opt out. Moreover, the IRS could require an employer to make up any contributions that were not timely deducted from the employee's paycheck. IRS guidance has not yet been issued on this point yet (as of June 2008).

How does an employer decide whether to implement an automatic enrollment feature?

1. First and foremost, an employer needs to determine whether it can timely monitor an automatic enrollment program and enroll employees as they become eligible. If the employer cannot, then automatic enrollment is really not an option. We are somewhat certain the IRS is going to cause employers some level of "pain" for failing to properly administer an automatic enrollment feature.
2. Next, the employer needs to identify what it is trying to accomplish. Is the employer just trying to encourage employees to save for their retirement? Alternatively, is a failed ADP test the driving motive? Once this determination is made, the employer can decide whether to implement an EACA or QACA.
3. Which employees will be automatically enrolled? All employees who are eligible to make a 401(k) contribution and have not completed a payroll deduction form must be enrolled. The employer may want to re-enroll all of its eligible employees. This may be the preferable approach if the employer cannot readily identify which employees have actually filed a payroll deduction form.
4. Which investment option will be selected to accept contributions for employees who are automatically enrolled? The employer will want to select an investment option that constitutes a "qualified default investment option" under Labor Department regulations.
5. The contribution amount must be determined. Studies indicate an amount of 3% of an employee's paycheck is the most common amount. If the employer implements a QACA, a higher default contribution rate is required over time.

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6. The plan document has to be amended to add the automatic enrollment provisions. New enrollment materials need to be prepared.
7. Employee meetings should be conducted. This is a major change in the way a typical plan is administered and employees should understand how automatic enrollment will affect them.
8. The effective date of the change must be determined and communicated to employees. PPA-compliant automatic enrollment cannot be added until the first day of the following plan year.

Our Recommendations

We think automatic enrollment is a marvelous feature that overcomes employees' inertia over completing and returning their enrollment forms. Studies have shown that the vast majority of employees who are automatically enrolled do *not* stop their contributions later. They stay in the plan and continue making contributions (and receiving available matching contributions).

Adopting an EACA or QACA imposes new responsibilities on the employer that must be carefully considered. As indicated above, failure to timely start payroll deductions is likely to be considered an operational defect under the EPCRS rules. The IRS has announced that the EPCRS rules will be amended to address failures to properly administer an automatic enrollment feature.

In our view, proper education is the key to making automatic enrollment successful and popular with employees. This is another example where a dedicated investment advisor provides immeasurable benefits to employees and makes the plan a success. These advisors can explain the benefits of making contributions to the plan and can assist the employee with making informed investment decisions pertaining to their contributions.

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If you would like additional information about adding an automatic enrollment feature to your company's plan, please call Lee T. Jennings at (312) 332-7733.

Please visit our website at www.danaconsulting.com