Is There a Plan Design that Combines the Benefits of Automatic Enrollment & Safe Harbor?

Facts

My company sponsors a 401(k) plan, and we fail the annual ADP test pretty consistently. We really want to increase participation; not only to help our test results, but also to encourage our employees to save for retirement. Automatic enrollment would help with participation, but we would have to set the default rate too high in order for it to solve our testing problem.

Question

Is there a type of plan design similar to a safe harbor plan that combines automatic enrollment with other features that will ensure we pass testing?

Answer

What if we told you that you could have the best of both worlds - a safe harbor 401(k) plan that incorporates automatic enrollment to improve participation and guarantee that you pass the ADP test? Behold, the Qualified Automatic Contribution Arrangement or QACA. Yes, we know…another goofy acronym that sounds like a duck call, but this one will ensure the plan's highly compensated employees are not "sitting ducks" when it comes time to run the ADP test. In addition, the "flock" of plan participants will likely grow!

Although it is possible to take a regular automatic enrollment feature and tack it on to a regular safe harbor 401(k) plan, the QACA combines these features in a way that offers some additional advantages above and beyond passage of the ADP test. Let's walk through some of the key elements.

Automatic Enrollment - Default Rate

The QACA has minimum and maximum parameters on the default rates used to automatically enroll participants. The default deferral rate must start at a minimum of 3% of compensation and must automatically increase by at least one percentage point per year until it hits 6% of pay. The initial default rate can be set at a higher level and/or the scheduled escalations can continue beyond 6% of pay; however, the default rate can never exceed 10% of pay.

Plan sponsors who prefer to avoid the automatic increases can set the initial default rate anywhere from 6% to 10% and simply leave it there.

One word of caution: if the company chooses to make a matching contribution (more on this below), then the cost of the that match will increase as the deferral rate increases. Setting the initial default rate at 6% or higher might lessen the administrative burden of dealing the automatic escalations, but it could also wind up costing a whole lot more. If cost is in question, it would be worth preparing a projection ahead of time to make sure the higher default rate doesn't break the bank.

Required Company Contribution (Must Pick One or the Other)

Similar to traditional safe harbor 401(k) plans, the QACA also requires the company to make a contribution to non-HCEs each year. That contribution can be either a match or a nonelective contribution that is at least as generous as the following:

- Matching contribution: 100% on the first 1% of pay deferred by each employee plus 50% on the next 5% of pay deferred. That means any employee who defers at least 6% of pay must receive a minimum matching contribution of 3.5% of pay.
- Nonelective contribution: 3% of compensation for each participant who is eligible for the plan regardless of whether he or she chooses to defer.
- The "better" option will vary based on each company's situation. If the goal is to drive up participation, the match would likely be more effective. If cost is a concern and you are not expecting many employees to defer, the match might be more affordable. However, if you also want to layer in a profit sharing contribution, the 3% nonelective contribution option might provide greater flexibility.

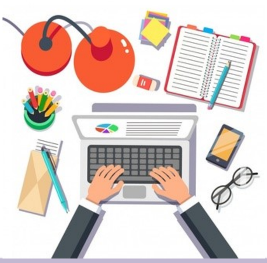
Vesting Requirements

This is one of those special QACA advantages we mentioned earlier. In a traditional safe harbor plan, the safe harbor contributions must be immediately vested from day one. In a QACA, the safe harbor contributions can have a vesting schedule of up to two years. For companies that have higher turnover in the earlier years, the ability to apply a vesting schedule can make the QACA a much more palatable design. Any participants who terminate with fewer than two years of service will forfeit the company contributions, which can then be used to fund contributions in future years.

We tried to think of a good bird analogy to wrap up this Question of the Week, but all the ones we thought of were pretty fowl. Sorry, we couldn't resist. If you think a QACA might be the right solution for you or if you'd like to discuss any other plan design options, give us a call.

Related Resources

- DWC Knowledge Center: Retirement Plan Design Resources



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