



What is Automatic Enrollment & How Does it Work?

Facts

Our company sponsors a 401(k) plan, but very few of our participants are contributing. We started the plan as an added benefit to help attract and retain employees, but we also truly want to encourage our employees to save for retirement. I've heard a lot about something called automatic enrollment and how it can be a great tool to get people to save, but I really don't know much more about it.

Question

What is automatic enrollment and how does it work?

Answer

Automatic enrollment is a provision that has grown quite a bit in popularity over the years, so much so that Congress and the IRS have gone out of their way to pass laws and issue regulations that make it easier for companies to add to their plans. There are three general types of automatic enrollment arrangements. We will provide an overview here and then get into more of the details about each type in future Question of the Week posts.

Overview

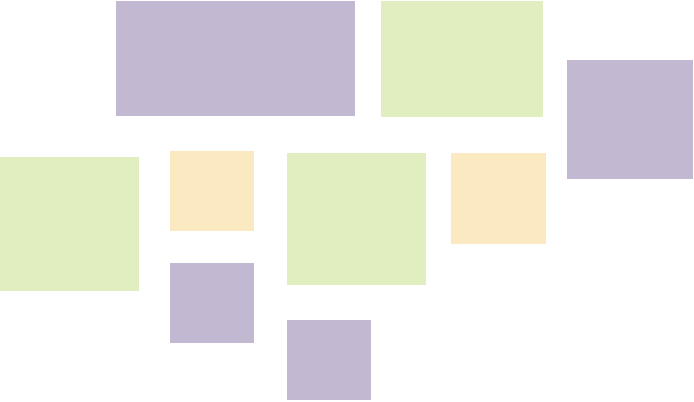
In a "regular" 401(k) plan, participants are given the opportunity to enroll at whatever contribution rate they choose. However, it is up to them to sign up. If they do not take affirmative steps to do so, they do not contribute. Sometimes, it is because they overtly choose not to contribute, but more often it is simply because they forget, are confused by all the choices, or think it will take too much time and effort. Either way, the result is the same - they do not take advantage of saving on a tax-favored basis, and they forego any company matching contributions you might make.

Automatic enrollment flips that script. In a nutshell, it provides that once an employee becomes eligible for the plan, he or she will be automatically signed up to make contributions at a specified rate unless he or she makes an affirmative decision to contribute at a different rate or opt out. In other words, it uses the power of inertia for good.

Types of Automatic Enrollment Features

Broadly speaking, there are three types of automatic enrollment features, each of which allows for different options and carries different pros and cons. We apologize in advance for the acronyms...we promise we didn't make them up.

Automatic Contribution Arrangement (ACA) This is the most basic type of automatic enrollment feature and essentially does just what we described above while offering a little more flexibility in when and how it is implemented.



Eligible Automatic Contribution Arrangement (EACA) The EACA carries some extra bells and whistles, including an extended deadline for correcting [nondiscrimination tests](#) and the ability for participants who forget to opt out in time to withdraw automatically withheld amounts within a short window. It is somewhat less flexible, however, requiring that all participants (new and existing) be treated uniformly.

Qualified Automatic Contribution Arrangement (QACA) This combines automatic enrollment with [safe harbor 401\(k\)](#) features to provide for guaranteed passage of the ADP test. In addition, the QACA has minimum and maximum parameters on the default rates used when participants are automatically enrolled, which may include automatically increasing the amounts withheld each year.

We will explore each of these in more detail in future QOTWs but wanted to provide you with a quick summary here.

Design Options and Requirements

Regardless of which type of automatic enrollment you choose, there are several design options and requirements to consider.

- **Default Deferral Rate:** This is the percentage of pay that is withheld from a participant's pay when he or she is automatically enrolled. In ACAs and EACAs this can be any percentage the sponsor prefers, but QACAs generally require a minimum of 3% (subject to annual increases) and a maximum of 10%.
- **Automatic Escalation:** This is an option that provides for increases in the default rate at set intervals, usually annually. For example, a plan might set the initial default rate at 2% and then increase by one percentage point each year, either with or without a cap. In a QACA, automatic escalation is required for any default rates of less than 6%.
- **Affected Participants:** ACAs and QACAs allow flexibility as to which participants are subject to the automatic enrollment provisions. Will you automatically enroll existing employees or just new participants? If existing employees, is it only those not presently deferring, or do you also pick up those who are deferring less than the default rate? EACAs carry a uniformity requirement that removes some of this flexibility.
- **Annual Notice:** All automatic enrollment plans require that a notice be provided to participants within a "reasonable" time (usually 30 to 90 days) before they are initially subject to the automatic enrollment feature, and before the start of each year thereafter. The notice describes the basics of what automatic enrollment is, communicates the default deferral rate, and instructs participants how to change their elections or opt out.

Factors to Consider

When thinking through the types of automatic enrollment features, as well as the options available within each one, there are a number of factors to consider. First and foremost is to understand what you are trying to accomplish. If your primary objective is to avoid failing your annual ADP test, automatic enrollment may certainly help but there is no guarantee unless paired with a safe harbor feature. If you want as many employees



as possible to save, perhaps starting with a lower default rate and increasing it over time will be less intimidating to your employees and result in fewer opt-outs. Those are just two of many possibilities.

Then there is your budget. Most would agree that it is a good thing for more employees to save at higher rates. There is also the inescapable reality that if you make a company matching contribution, increased participation rates will also mean an increase in the overall cost of the company match.

Automatic enrollment can absolutely be an effective part of any 401(k) plan. By taking the time to think through the various options, we can help you construct the design that is best for your situation.

Stay tuned for more information on ACAs, EACAs, and QACAs (oh, my) in future QOTWs.

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