Defined Contribution
Institutional Investment
Association

Implementing Automatic Features in Defined Contribution Plans: Answers To Frequently Asked Questions (FAQs)

Implementing Automatic Features in Defined Contribution Plans

The Pension Protection Act of 2006 (PPA) introduced multiple safe harbors for implementing automatic enrollment in defined contribution (DC) plans: (1) a safe harbor for preemption of state anti-garnishment laws under the Employee Retirement Income Security Act (ERISA), (2) a safe harbor extending 404(c) protection under ERISA to auto features, and (3) nondiscrimination testing safe harbors. While helpful in providing comfort to plan sponsors seeking to implement automatic features such as automatic enrollment and automatic contribution escalation, the introduction of these safe harbors has also caused considerable confusion within the DC plan sponsor community. This confusion may prevent sponsors from taking full advantage of auto features and translate into sub-optimal implementation approaches that are unlikely to facilitate adequate income replacement by plan participants in retirement. Examples include:

- Low default contribution rates
- Small, if any, annual auto escalation increases
- Low caps on contribution escalation

This Frequently Asked Questions (FAQ) resource is the third in a series on best practices in implementing automatic features in DC plans and seeks to provide clarification on common regulatory questions that plan sponsors and their advisors may have when putting auto features into practice. This is not intended to constitute legal advice. Plan sponsors may want to consult with their own counsel on matters specific to their plans.

DCIIA's first paper on this topic, *"Raising the Bar: Pumping Up Retirement Savings"*, examined the results of our 2011 plan sponsor survey and found that the use of automatic features was directionally positive, but recommended more guidance on implementing them to further improve outcomes.

In 2013, our second paper in the series, *"Best Practices When Implementing Automatic Features in DC Plans"*, described how to implement auto features in DC plans in more robust ways to help achieve better outcomes for plan participants.

Please visit our website *www.dciia.org* to download these publications and learn more about our Auto Features Resource Center.

These FAQ's were developed by the Public Policy Committee of DCIIA, and the law firm of Morgan, Lewis & Bockius LLP.

Frequently Asked Regulatory Questions

1. **Are there any maximum limitations or requirements that plan sponsors should consider when implementing an automatic contribution escalation program?**

   As a general rule, plan sponsors are free to choose the appropriate maximum auto-escalation percentage for their plan, based on the plan design that the plan sponsor wishes to adopt to support the plan's retirement income replacement. For example, a plan could choose the plan's maximum deferral percentage or a lesser percentage such as 15 percent. In guidance previously issued by the Treasury Department (Revenue Ruling 2009 – 30) an example was provided of a plan using an 11 percent auto escalation cap — demonstrating that a 10-percent cap on auto escalation percentages is not required.

   Interaction with ERISA 404(c) and QDIA Safe Harbors: Plan sponsors seeking the protections of the ERISA 404(c) or QDIA (Qualified Default Investment Alternative) safe harbors can elect any contribution escalation percentage with no maximum, and are not restricted by a 10 percent maximum contribution escalation percentage. This means that when auto escalated contributions are defaulted into a Qualified Default Investment Alternative (QDIA) consistent with the QDIA safe harbor, auto escalation percentages that are higher than 10 percent will not jeopardize the plan's ability to rely on the ERISA 404(c) or QDIA safe harbor.

Interaction with QACA Safe Harbor: The only instance in which a 10-percent limit applies is if the plan sponsor wishes to adopt the Qualified Automatic Contribution Arrangement (QACA) safe harbor from nondiscrimination compliance testing included in the PPA. Some plan sponsors use the nondiscrimination safe harbor design option, which includes a 10 percent auto escalation limit, if they have trouble satisfying the nondiscrimination testing requirements of the Internal Revenue Code (IRC). However, not all plan sponsors need or use this safe harbor. For example, they may find that using higher auto escalation maximum limits for non-highly paid employees may make it easier for the plan to satisfy nondiscrimination testing.

2. Is there a required initial default contribution rate for automatic contribution escalation programs?

Plan sponsors are free to choose any initial default contribution rate for their automatic contribution escalation programs, based on the plan design that the plan sponsor wishes to adopt. While employers have traditionally set automatic enrollment percentages at 2 percent or 3 percent, there is no requirement to do so. For example, a plan could choose an initial default contribution rate of 5 percent or any other percentage that the plan sponsor feels is consistent with its plan design goals to support retirement adequacy. In guidance previously issued by the Treasury Department (Revenue Ruling 2009-30), an example was provided of a plan using a 4 percent initial default contribution rate — demonstrating that auto escalation percentages are not required to begin at lower percentages, such as 2 percent or 3 percent.

Interaction with ERISA 404(c) and QDIA Safe Harbors: Plan sponsors seeking the protections of the ERISA 404(c) or QDIA safe harbor are not limited to any minimum specified default contribution rate and can elect any percentage. Thus, when participants are initially defaulted at a percentage selected by the plan sponsor and are defaulted into a QDIA consistent with the QDIA safe harbor, the default contribution rate will not jeopardize the plan's ability to use the ERISA 404(c) or QDIA safe harbors.

Interaction with QACA Safe Harbor: The only instance in which a required minimum initial default contribution rate applies is if the plan sponsor wishes to adopt the QACA safe harbor from nondiscrimination compliance testing included in the PPA. Some plan sponsors use the nondiscrimination safe harbor design option, if they have trouble satisfying the nondiscrimination testing requirements of the IRC, which requires that the initial automatic enrollment percentage be at least 3 percent (meaning that a higher initial auto enrollment percentage is permitted up to the 10% cap noted above). However, plan sponsors may find that using a higher initial default contribution percentage coupled with auto escalation may make it easier for the plan to satisfy nondiscrimination testing without a need to rely on this safe harbor.

3. Must automatic contribution escalation programs have a 1 percent step-up auto escalation rate?

Plan sponsors may choose any auto escalation step-up rate, taking into consideration the plan sponsor's plan design goals. While a 1 percent annual increase is often used as the step-up rate, there is no requirement to do so. Plan sponsors are free to use a higher step-up percentage. Additionally, plans can be designed to provide for different auto escalation step-up rates based on different criteria. For example, a plan sponsor could provide for a semi-annual step-up rate of 1 percent or an annual step-up rate of 2 percent. The plan sponsor may determine whatever percentage and timing seems appropriate, given the composition of their workforce as well as the retirement income replacement goals for the plan.

In another example, in guidance previously issued by the Treasury Department (Revenue Ruling 2009-30), an example was provided of a plan that ties auto escalation rates to base pay increases. Specifically, the default contribution percentage example was increased each year on the first pay period after the employee's anniversary date. The increase was equal to the greater of (i) 1 percentage point, or (ii) a number of percentage points calculated as 30 percent of the percentage increase in the eligible employee's base pay over the eligible employee's base pay for the immediately preceding pay period. This example demonstrates that different auto escalation criteria can be applied to different groups in the plan.

Interaction with QACA Safe Harbor and EACA: The only instances in which a limit may apply are ones in which a plan is trying to satisfy either the (i) PPA QACA nondiscrimination safe harbor, or (ii) PPA "Eligible Automatic Contribution Arrangement" (EACA) (where the plan allows withdrawals of auto enrolled amounts within 90 days after the auto enrollment date). In those instances, auto increases must comply with "uniformity" requirements. The uniformity requirements would require auto escalation to apply uniformly across employee groups (excepting collectively bargained employees, which are treated separately). Additionally, plans that wish to satisfy the PPA QACA nondiscrimination safe harbor must auto escalate by at least 1 percent each year (up to a maximum of 10 percent).

4. Are plan sponsors required to tie the initial default contribution rate under an auto enrollment program to the plan's maximum matching contribution percentage?

Plan sponsors are permitted to select any initial default contribution rate and are not required to tie the rate to the plan's matching contribution formula in any way. The initial default contribution rate could be less than or more than the plan's maximum matching contribution percentage. For example, a plan may be designed to have a matching contribution formula of 50 percent of the first 4 percent of pay, but the plan could be designed to auto enroll participants at 5 percent of pay. Thus, the initial default contribution rate could be more than the maximum matching contribution percentage. The decision is up to the plan sponsor as part of plan design.

Some plan sponsors may also decide to "stretch" the matching contribution rate, such as up to 8 percent or 9 percent of pay, in order to encourage employees to save more for retirement. For example, a plan sponsor could provide a matching formula of 25 percent of the first 8 percent of pay, instead of 50 percent of the first 4 percent of pay. In both situations, the overall match is 2 percent of pay, but the higher matching contribution formula may encourage higher savings. In that case, providing a higher auto escalation percentage will also allow employees to take advantage of the matching contributions made at higher percentages.

Interaction with QACA Safe Harbor: The only instance in which a required minimum initial default contribution rate applies is if the plan sponsor wishes to use the QACA nondiscrimination safe harbor. Some plan sponsors may decide to use the QACA nondiscrimination safe harbor design option if they could have trouble satisfying the nondiscrimination testing requirements of the IRC without this safe harbor. The QACA nondiscrimination testing safe harbor design requires that the initial auto enrollment percentage be at least 3 percent (meaning that a higher initial auto enrollment percentage is permitted up to the 10 per cent cap noted above). In addition, plan sponsors may find that using a higher initial default contribution percentage coupled with auto escalation may make it easier for the plan to satisfy nondiscrimination testing without a need to rely on this safe harbor.

5. Are auto enrollment programs permitted to have different initial default contribution rates, auto escalation rates and/or auto escalation caps for different groups of employees?

Yes. Plan sponsors are free to design their plans with different initial default contribution rates, automatic contribution escalation rates, and/or auto escalation caps for different groups of employees. For example, a plan could be designed to auto enroll part-time employees at a rate of 2 percent, and full-time employees at a rate of 6 percent. A plan could also be designed to auto escalate different groups of employees at different rates. For example, one group of employees could be auto escalated annually at 2 percent, and another group of employees could be auto escalated annually at 4 percent.

Examples of various plan designs that could be adopted are described below. These are simply examples and plan sponsors should be encouraged to consider other designs that may be acceptable and work well for their plans. [1]

Design Requirements: If a plan sponsor decides to design a plan to provide for different auto escalation rates for different groups, the plan sponsor will need to ensure that the different auto escalation rates satisfy nondiscrimination requirements.

Plan Name	Auto Enrollment	Auto Escalation
Plan A Plan A auto enrolls existing employees and new hires at 2% of pay. The plan sponsor could decide to auto enroll at higher rates and add an auto escalation feature.	New Hires: 4% Existing Employees: 3%	2% increase at the beginning of each plan year up to 12% of pay
Plan B Plan B does not have an auto enrollment feature. The plan sponsor could decide to implement an auto enrollment and auto escalation plan design feature	New Hires: 5% Existing Employees: 5%	1% increase on each employee's anniversary date, up to 15% of pay
Plan C Plan C previously auto enrolled existing employees and new hires at 3% of pay. The plan sponsor decided to auto enroll newly hired employees at higher rates and add an auto escalation feature.	New Hires: 6% Existing Employees: 4%	2% increase at the beginning of each plan year, up to 14% of pay

[1] Before implementing one of these examples, the example should be evaluated for applicable nondiscrimination and uniformity requirements based on the plan's participant population and other relevant factors.

Interaction with QACA Safe Harbor and EACA: Additionally, if the plan is trying to satisfy either (i) the QACA nondiscrimination safe harbor or (ii) the PPA EACA requirements (where the plan allows withdrawals of auto enrolled amounts within 90 days after the auto enrollment date), the auto increases must comply with "uniformity" requirements based on the ERISA definition of "automatic contribution arrangement," which requires a default contribution election of a uniform percentage of contribution (other than those of collectively bargained employees, which are permitted to be created separately for purposes of satisfying the uniformity requirements).

6. Are automatic enrollment programs required to sweep in existing employees?

Plan sponsors are free to decide, as part of their plan design, whether or not to automatically enroll existing employees who have not elected to participate in the plan. While a plan could also be — and most frequently is — designed to only auto enroll new hires, an auto enrollment program could be designed to automatically enroll all existing employees and future hires. Plan sponsors may find that auto enrolling existing employees not participating in the plan may make it easier for the plan to satisfy nondiscrimination testing requirements.

Interaction with QACA Safe Harbor and EACA: Plans seeking to comply with the QACA nondiscrimination safe harbor must auto enroll all eligible employees except those who previously made an affirmative election to participate (or not to participate) in the plan. If a plan previously auto enrolled participants at a percentage that is higher than the QACA safe harbor default percentage, plan sponsors do not have to re-auto enroll those participants at a lower level and may allow them to continue to contribute at the higher percentage.

Plans that wish to satisfy the EACA requirements (where the plan allows withdrawals of auto enrolled amounts within 90 days after the auto enrollment date) are required to auto enroll all eligible employees who did not previously make an affirmative election to participate or not participate, if the plan sponsor wants to be able to take advantage of the 6-month Actual Deferral Percentage/Actual Contribution Percentage (ADP/ACP) correction period that is available under this type of program.

7. Are plan sponsors who previously implemented auto enrollment programs permitted to automatically re-enroll participants who previously opted out?

Plan sponsors are free to design their plans to auto enroll existing employees — including employees who opted out of auto enrollment when it was previously implemented. There is no limit on how many times a plan sponsor can reinstitute an automatic enrollment program.

8. Are automatic contribution escalation programs required to sweep in existing employees?

Similar to the answer to Question 6, above, plan sponsors are free to decide, as part of their plan design, whether or not to auto-escalate existing employees. An automatic escalation program could be designed to auto escalate all existing employees and future hires. However, a plan could also be designed to only auto escalate those who were auto enrolled, whether new hires or existing employees who had not otherwise elected to participate. Plan sponsors may find that having an automatic escalation feature apply to all employees may make it easier for the plan to satisfy nondiscrimination testing requirements.

Interaction with QACA Safe Harbor and EACA: The only instance in which existing employees must be auto escalated is one in which plan sponsors wish to adopt the QACA safe harbor from nondiscrimination compliance testing. Some plan sponsors use the nondiscrimination safe harbor design option, which requires that the initial auto enrollment percentage be at least 3 percent during the first plan year, at least 4 percent during the second plan year, at least 5 percent during the third plan year, and at least 6 percent during the fourth plan year (and thereafter), but not to exceed 10 percent of compensation. However, plan sponsors may find that using a higher auto escalation limit may make it easier for the plan to satisfy nondiscrimination testing requirements, and that this safe harbor is not necessary.

Plan sponsors who wish to comply with EACA requirements (where the plan allows withdrawals of auto enrolled amounts within 90 days after the auto enrollment date) may auto escalate at any rate so long as the auto escalation percentage is uniform for all eligible employees (other than collectively bargained employees, which are permitted to be treated separately for purposes of satisfying the uniformity requirement).

About DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a nonprofit association dedicated to enhancing the retirement security of American workers. Toward this end, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution plan design. DCIIA members include investment managers, consultants, law firms, record keepers, insurance companies, plan sponsors and others committed to the best interests of plan participants. For more information, visit www.dciia.org.