Lincoln Financial Group®

# Open the roads

## Automatic Enrollment Overview

**U.S. workers' low participation in their company retirement plans has been a major concern for the last two decades.** Despite widespread availability of employer-sponsored 401(k), 403(b), governmental 457(b) plans, and various incentives, many workers simply don't sign up. Younger employees in particular, who could realize 30 or more years of tax-deferred gains, miss out when they don't take advantage of an employer-sponsored savings plan.

One of the most promising ways to move these younger workers into a retirement plan is by adding an automatic enrollment feature. Still, although it has been available to sponsors since the 1990s, many employers have shied away from automatic enrollment due to concerns about:

- Anti-garnishment rules imposed by many states
- Fiduciary responsibility surrounding the selection of investment options for participants and default savings rates as well as the ability to automatically increase such savings rates each year
- Restrictions on distributing small account balances for participants who enrolled in error

The Pension Protection Act of 2006 effectively removed these impediments. So, if you are now contemplating adding an automatic enrollment feature to your company's retirement plan, this brief guide provides an overview of how automatic enrollment works, some of the issues that employers may wish to consider, and how Lincoln can help you if you ultimately choose to update your retirement plan with this feature.

## What is automatic enrollment?

*Automatic enrollment is a feature designed to boost employee participation rates[1] that can be added to your organization's retirement plan. The essential features of automatic enrollment—which have been in place since the concept was first introduced nearly a decade ago—include the following:*

- Eligible employees are not required to sign up for the company savings plan because they are automatically enrolled.
- The employer sets a default contribution rate and selects a default investment.
- Employees may elect either not to participate (opt-out), or to make changes to their own contribution amount and investment selection.

[1]Revenue Rulings 98-30, 2000-8, and 2000-33 have provided valuable guidance from the Internal Revenue Service regarding automatic enrollment plan design.

# How does the new legislation affect automatic enrollment?

The Pension Protection Act leaves the basic features of automatic enrollment unchanged, but reduces the complexity around administering the feature in five key areas:

**Offers relief from anti-garnishment laws**

Some states restrict an employer's right to divert workers' wages from their paychecks without their consent. The new legislation allows plans governed by the Employee Retirement Income Security Act (ERISA) to implement the automatic enrollment feature without violating state anti-garnishment laws.

**Helps plan sponsors manage their fiduciary responsibilities regarding default investments**

Because of Department of Labor (DOL) guidance regarding appropriateness of investments designated as default investments, plan sponsors may no longer feel compelled to default participants into a money market fund or other preservation of principal fund. Instead, participants can be directed automatically into a balanced, managed, lifecycle or other similar fund that is better suited to their long-term financial needs.

**Allows employers to automatically increase the savings rate each year**

If a default savings rate is set at 4% or 5%, and plan participants never increase it, they may not be adequately preparing for retirement. By automatically increasing the initial savings rate by 1% or 2% each year (with a cap between 10% and 15%), plans with this feature will be better able to help participants realize a more secure retirement.

**Liberalizes treatment of distributing small account balances**

One reason plan sponsors have resisted offering automatic enrollment has been the restriction on how to return contributions made in error (e.g., employees who do not wish to participate but do not opt out of a plan in time before a default deferral is made). The Pension Protection Act relieves companies from having to wait for a "distributable event" (e.g., death or separation from service) before returning such contributions without penalty. Now these balances can be distributed directly to employees who request the withdrawal within 90 days after the first unintended deferral is made.

**Creates a Safe Harbor plan design**

If certain conditions are met, the plan may avoid the administrative burden of having nondiscrimination testing and top-heavy calculations prepared each year starting in 2008. The Safe Harbor design is further described later in this brochure.

# What are some important considerations?

Adding an automatic enrollment feature to your retirement plan can be a complex decision and may not be appropriate in all cases. Sponsors should consider the following:

**Potentially increased administrative costs**

There could be increased expenses to manage with an automatic enrollment plan. Some of the additional employer responsibilities include:

- Identifying newly eligible employees and employees not currently contributing at the default rate
- Notifying employees about the new plan feature
- Managing employees' opt-outs
- Working with payroll provider to apply default deferral and annual step-up contributions
- Approving the distribution of contributions made in error

Lincoln Financial Group is prepared to assist you with all of these administrative requirements. However, plan sponsors must recognize that certain aspects of automatic enrollment will increase the complexity of the plan's administration.

## Four reasons to consider adding automatic enrollment as a plan feature

1. **It immediately boosts plan participation**

   Although available statistics are based on only a small number of plans that adopted the feature in the late 1990's, automatic enrollment appears to significantly improve participation rates. Automatic enrollment is particularly useful for getting younger employees into the plan and encouraging them to save for the long term.

2. **It simplifies rules for nondiscrimination testing**

   Because all employees must opt out of a plan that offers an automatic enrollment feature, participation and the average saving rate of the non highly compensated employees (NHCEs) will increase when they are automatically enrolled. This may improve the plan's ability to boost contributions from highly compensated employees (HCEs). In addition, if the plan sponsor utilizes a safe harbor plan design, testing will not be required.

3. **It potentially increases employee satisfaction and retention**

   A retirement plan is widely considered by employees as one of the most desirable benefits a company can offer.

4. **It provides greater assurance that long-term employees will be able to retire with the dignity and security they deserve**

   No employer wants a loyal tenured employee to retire with little or no accumulated assets. Employers would prefer that older employees have the option to retire instead of feeling compelled to continue to work.

**Further reading**

Ian Tocher, "An Automatic Affair: Promoting Retirement Plan Participation," *Business and Compensation Solutions,* March 2006.

Sarah Holden and Jack VanDerhei, "The Influence of Automatic Enrollment, Catch-up, and IRA Contributions on 401(k) Accumulations at Retirement," *Investment Company Institute® Perspective, II*: 2, July 2005.

The SPARK Institute, "Statement of Position on Auto Pilot Plans," June 5, 2006.

### How to treat existing employees not already participating in the plan

While the process of automatically enrolling new employees is straightforward and permitted under current law, automatically enrolling existing employees not already participating in the plan may be a sensitive issue. However, most employers will auto enroll and auto increase both newly eligible and existing eligible nonparticipants so that all employees will be better prepared for their retirement.

### An increased budgetary commitment

With higher enrollment levels comes the responsibility for the plan sponsor to potentially contribute more to the plan than they are contributing today in the form of matching contributions. A plan sponsor may decide to lower the matching contribution rate to offset the additional outlays due to anticipated participation increases from automatic enrollment.

### A choice of plan design

The Pension Protection Act states that if the employer is willing to follow the "qualified automatic contribution arrangement" rules, the plan can be considered a "safe harbor plan" and thus automatically meets some of the applicable nondiscrimination testing and top-heavy calculation requirements. Plan sponsors who wish to follow the safe harbor provisions, which will be available with the 2008 plan year, will need to take the following steps:

- Introduce the automatic enrollment feature to new employees, and at a minimum, collect opt-out forms for all existing employees.
- Establish a default rate for deferrals that increases over time, with a minimum starting rate of 3% for the first year and increasing 1% per year until the defaulted deferral rate reaches 6% in year four for all participants who do not opt out or otherwise make an affirmative deferral rate. The employer may continue to increase the deferral rate past 6% in subsequent years but the rate may not exceed 10%.
- Commit to certain employer matching or nonelective contribution levels. The employer may match according to one of the following schedules:

**A.** An employer matching contribution

| | |
|---|---|
| 1% deferral | 100% match |
| 2%–6% | 50% match |
| Above 6% | no match |

*Alternative matching contributions are allowed as long as no matching above 6% deferral savings rate is made; the match does not accelerate as the deferral rate increases; the match is at least as great as the match would be based on the above schedule; and HCEs do not receive a match in excess of the NHCEs. For example, a match formula that provides a dollar for dollar match up to the first 3.5% deferred would be an eligible matching formula that would meet the safe harbor requirements.*

**B.** A 3% nonelective contribution

- Vest employees after two years of service.
- Provide employees an initial and annual notice. The notice must describe how employees are given the opportunity to select a different deferral rate and choose other investment options.
- Select a default fund consistent with the DOL Qualified Default Investment Alternative (QDIA) guidelines.

Organizations that are unable to meet all of these requirements may use the automatic enrollment feature, but certain plans would still be subject to nondiscrimination requirements.[1]

[1] 401(k) plans are subject to ADP, ACP, and top-heavy requirements; ERISA 403(b) plans with matching contributions are subject to ACP testing requirements; and Governmental 457(b) plans are not subject to these nondiscrimination testing requirements.

# 12 steps to implementing automatic enrollment

Although automatic enrollment has been an available feature for qualified plans since the 1990s, the Pension Protection Act of 2006 offers greater incentives for 401(k), 403(b) and governmental 457(b) plans to implement it. In particular, the law introduces a new safe harbor that, if followed, could eliminate certain nondiscrimination testing in 401(k) and ERISA 403(b) plans.[1] Whether you elect to follow the Safe Harbor guidelines for implementing automatic enrollment or use a more modified approach, the following steps must be taken:

| Steps | Action | Description/detail |
|---|---|---|
| 1 | Decide to follow the law regarding automatic default rates and increases in their entirety in order to meet ADP/ACP and top-heavy test. Effective for 2008 plan year and forward.<br><br>OR | Based on the new law, employers must make an initial automatic default salary deferral rate of at least 3%, increasing by 1% each year until rate is 6%. At the employer's option, the automatic increase can continue until the deferral rate is 10%.<br><br>Some employers may elect to use a 6% deferral rate to avoid yearly step-ups in the default rate. |
| | Make plan design decision to use modified automatic enrollment plan. | Skip to Step 5. |
| 2 | Decide how to treat existing employees either not deferring at default rate or not participating in the plan. | Regardless of age, service or entry dates, existing employees may begin deferring at new default rate in Year 1. Additionally, previously existing eligible employees must affirmatively elect to opt out or affirmatively elect to save at a specific savings rate in order for the employer to take advantage of the safe harbor provisions. Generally, employers will automatically enroll existing employees in order to meet this requirement. |
| 3 | Decide whether to make Safe Harbor matching or nonelective contributions. | Matching formula:<br>1% deferral — 100% match<br>2%–6% — 50% match<br>Above 6% — no match<br><br>OR<br><br>Non-elective formula: 3% of compensation |
| 4 | Adopt Safe Harbor vesting schedule. | 100% after two years of service<br><br>Skip to Step 6. |

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**Lincoln Financial Group can help**

*Lincoln Financial is committed to providing investment professionals and their clients with the investment and retirement planning resources to maximize the effectiveness of their 401(k), 403(b) and governmental 457(b) plans. To learn more about how Lincoln Financial can help you accommodate an automatic enrollment feature in your company's retirement plan, contact your financial professional.*

| Steps | Action | Description/detail |
| --- | --- | --- |
| 5 | Implement non-Safe Harbor plan design using modified automatic enrollment plan. | Any plan design elections that do not exactly follow Steps 1-4 above will not have Safe Harbor protection. **Note: Non-Safe Harbor plans will need to continue testing.** |
| 6 | Update plan document and summary plan description, or summary of material modification (applies to 401(k) and ERISA 403(b) plans whether or not Safe Harbor is followed). | Distribute new summary of plan description or summary of material modification to all current and eligible plan participants. |
| 7 | Select default investment from available investment menu. | Choose from DOL's Qualified Default Investment Alternative (QDIA) criteria. These may include balanced, managed or lifecycle (target maturity) funds. |
| 8 | Identify current employees who are not deferring at default rate. | Plan sponsors will need to keep up-to-date records of all eligible participants, including those who opt out of the auto enrollment process. |
| 9 | Send initial notification of automatic enrollment feature 30–90 days before implementation. | Collect opt-out forms from employees electing not to participate (during 30–90-day window). Also collect requests to defer at different amounts and with alternative investment elections. |
| 10 | Instruct payroll provider to update deferral rates in payroll system. | • Retain deferral rates for participants who are deferring at a greater rate than the new default rate.<br>• Update deferral rates for participants who do not "opt out" of auto enrollment.<br>• Make deferral rate 0% for those who opt out of auto enrollment feature. |
| 11 | Process/approve withdrawals. | • During 90-day window (from the time the first contribution is deposited) participant can make a request to withdrawal contribution(s) made in error.<br>• Refunded amounts are reported on Form 1099-R. |
| 12 | **Annual process (ongoing)**<br>Repeat Steps 7 through 11. | **To update payroll each year:**<br>• Leave rates the same for those deferring at a greater rate than the new year's default rate.<br>• Update deferral rates for employees who did not negatively elect out of participation (e.g., move from 3% to 4%).<br>• Keep deferral rate at 0% for those who had previously opted out.<br>• Make deferral rate 0% for new employees who opt out. |

# A century of integrity

At Lincoln Financial Group, we have over a 100-year-old heritage of helping companies find solutions to their funding and benefit needs — with the same honesty, integrity, and responsibility that you'd expect from our namesake. It's a legacy that we proudly and respectfully continue each day.

## The strength of Lincoln Financial today

Lincoln Financial is one of the largest financial services companies in the country. We believe our continued commitment to strength and stability is indispensable to who we are and critical to your confidence in us. We are a proven industry leader in identifying and delivering sophisticated financial strategies and product solutions for the creation, protection, and utilization of capital. We are committed to assist companies in helping their employees and their families redefine their retirement because we don't believe retirement is an end — it's an opportunity for everyone to start doing what they were meant for all along.

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