

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is a darker shade of blue. The hourglass is centered on the page.

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February 2, 2009

Congressional Research Service

Report RS21954

Automatic Enrollment in Section 401(k) Plans

Patrick Purcell, Domestic Social Policy Division

Updated January 16, 2007

Abstract. The Internal Revenue Service (IRS) has issued rulings to inform employers that it is permissible under current law to enroll employees in these plans automatically, provided that the employee is notified in advance and is permitted to leave the plan if he or she chooses to do so. Automatic enrollment, in which a percentage of the employee's salary is placed in an individual account without requiring the worker to take any action, has been shown to increase worker participation in 401(k) plans and similar salary reduction retirement savings plans. In 2004, automatic enrollment had been adopted by an estimated 11% of 401(k) plans. About 1% of plans with fewer than 50 participants and 31% of plans with 5,000 or more participants had automatic enrollment in 2004. The Pension Protection Act of 2006 (P.L. 109-280) includes provisions to promote automatic enrollment in 401(k) plans.

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Automatic Enrollment in 401(k) Plans

Patrick Purcell

Specialist in Income Security

January 16, 2007

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Congressional Research Service

7-5700

www.crs.gov

RS21954

CRS Report for Congress

Prepared for Members and Committees of Congress

Summary

Most employers that sponsor retirement savings plans under §401(k) of the Internal Revenue Code (IRC) require employees to decide whether to enroll in the plan. The Internal Revenue Service (IRS) has issued rulings to inform employers that it is permissible under current law to enroll employees in these plans automatically, provided that the employee is notified in advance and is permitted to leave the plan if he or she chooses to do so. Automatic enrollment, in which a percentage of the employee's salary is placed in an individual account without requiring the worker to take any action, has been shown to increase worker participation in §401(k) plans and similar salary reduction retirement savings plans. In 2004, automatic enrollment had been adopted by an estimated 11% of §401(k) plans. About 1% of plans with fewer than 50 participants and 31% of plans with 5,000 or more participants had automatic enrollment in 2004. The Pension Protection Act of 2006 (P.L. 109-280) includes provisions to promote automatic enrollment in 401(k) plans.

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Types of Retirement Plans

About half of all workers in the United States participate in an employer-sponsored retirement plan, a figure that has remained relatively stable for the past quarter-century. Over the past 20 years, however, there has been a shift in coverage from traditional pensions, also called *defined benefit* plans, to *defined contribution* plans such as those authorized under §401(k) of the Internal Revenue Code (IRC). According to the Bureau of Labor Statistics, only 21% of workers in the private sector participated in a defined benefit plan in 2005, whereas 42% participated in a defined contribution plan. About 11% of private-sector workers were in both types of plan at their current job in 2005. Defined benefit (DB) plans typically are funded entirely by the employer, and they are required by law to offer the retiree the option to receive his or her benefit in the form of a guaranteed life-long annuity.¹ Defined contribution (DC) plans consist of individual accounts in which workers can accumulate savings for retirement. Prior to enactment of the Revenue Act of 1978 (P.L. 95-600), DC plans also were typically funded exclusively by employer contributions. This law added §401(k) to the IRC, allowing employees to make pre-tax contributions to employer-sponsored retirement savings plans.

In 2006, workers can defer taxes on up to \$15,000 of wage or salary income that is directed to an employer-sponsored retirement plan established under §401(k).² After 2006, the maximum annual deferral will be indexed to the Consumer Price Index.³ Employers also can contribute to §401(k) plans. Section 415(c) of the Internal Revenue Code defines the maximum allowable contribution to a §401(k) plan, including both employer and employee contributions. The maximum contribution is \$44,000 in 2006.

Enrollment Practices

In a traditional defined benefit plan, employees typically do not need to enroll in the plan to accrue benefits. Workers automatically earn benefits under a DB plan, provided that they are in a covered group of workers and work the required number of hours per year.⁴ In contrast, most employers who sponsor §401(k) plans require employees to enroll in these plans voluntarily. One reason for this difference is that DB plans in the private sector usually are funded entirely by the employer, whereas most DC plans (and all §401(k) plans) require the employee to contribute to the plan. Employers who require employees to enroll voluntarily in §401(k) plans do so for several reasons: (1) participants in most DC plans must decide *how much* to contribute (up to the legal limit or a lower limit established by the plan sponsor); (2) participants in many DC plans must decide *how to invest* their contributions; and (3) several states have laws that require employers to secure a worker's permission before making any payroll deductions other than those required by law, such as income tax withholding and the Social Security and Medicare payroll taxes.

¹ A DB plan also can offer to pay the worker his or her accrued benefit as a single lump-sum payment, but the employee *must* be offered the option of an annuity.

² The same limits also apply to §403(b) annuities and §457 deferred compensation arrangements.

³ Workers age 50 or older can make an additional contribution of \$5,000 in 2006. This amount will be indexed to inflation in years after 2006.

⁴ Employers can, if they choose, exclude employees with less than one year of service or who work fewer than 1,000 hours per year.

Because enrollment in most §401(k) plans is voluntary, not all workers whose employers offer a plan choose to participate. The Bureau of Labor Statistics reports that in 2005, 53% of workers in the private sector were employed at establishments that offered a DC plan, but just 42% of employees at private establishments participated in a plan. Consequently, the participation rate among employees whose employer offered a DC plan was 79%. In contrast, the BLS reports that 22% of workers in the private sector were employed at establishments that offered defined benefit plans and 21% participated in those plans, yielding a participation rate in these plans of 95.5%.

IRS Rulings

Employers who sponsor §401(k) plans often promote participation among their employees by providing them with information on the importance of saving for retirement and the tax savings that result from participating. One way to achieve high rates of plan participation is to enroll employees automatically. Rather than the default option being that the employee will not be included in the plan unless he or she actively enrolls, the default under automatic enrollment is that some of the employee's pay will be deducted and directed into a retirement account unless he or she instructs the employer not to do so. The IRS has issued several rulings in recent years to clarify for employers that they are permitted to enroll employees in §401(k) and §403(b) plans automatically through payroll deduction, provided that the employee is notified in advance and has the option to drop out of the plan. Unless the employee elects otherwise, he or she is presumed to be participating, and an amount set by the employer (such as 3% of pay) is deducted from the employee's (pre-tax) pay and contributed to the §401(k) plan.

In 1998, the IRS issued a ruling clarifying that automatic enrollment in §401(k) plans is permissible for *newly hired* employees (Revenue Ruling 98-30). The IRS issued a second ruling in 2000 stating that automatic enrollment also is permissible for *current employees* who have not already enrolled in the plan (Revenue Ruling 2000-8).⁵ In 2004, the IRS published a general information letter that clarified two previously ambiguous points. The letter stated that (1) the amount deducted from the employee's pay and contributed to the plan can be any amount that is permissible under the plan up to the annual contribution limits under IRC §402(g), and (2) the plan can automatically increase the employee's contribution over time, such as after each pay raise. Again, the IRS emphasized that employees must be fully informed of these plan provisions and they must have the option to change the amount of their contribution or to stop contributing to the plan altogether.

Plan Participation

The IRS has promoted automatic enrollment through these official announcements mainly to increase participation among moderate- and lower-income workers. The IRS has noted that "the rate of participation in elective retirement savings plans tends to be lowest among these workers."⁶ Evidence from surveys and case studies suggests that automatic enrollment results in higher rates of participation in §401(k) plans. In 2001, the Profit Sharing/401(k) Council of America (PSCA) surveyed 25 companies that had adopted automatic enrollment. Nine provided

⁵ Revenue Ruling 2000-35 states that automatic enrollment is permitted in 403(b) plans for employees of public schools, other educational and charitable organizations. Revenue Ruling 2000-33 states that automatic enrollment is permitted in 457(b) plans for state and local government employees. Announcement 2000-60 states that automatic enrollment is permitted in IRS-approved prototype 401(k) plans (standardized plans used largely by small businesses.)

⁶ Press release, Internal Revenue Service, July 18, 2000.

information on participation rates before and after the implementation of automatic enrollment. The average participation rate at these companies increased from 68% three months before automatic enrollment was implemented to 77% at the time of the survey. Studying the effect of automatic enrollment at three companies that adopted it between 1997 and 1998, economists James Choi, David Laibson, and Brigitte Madrian found that participation increased to between 86% and 96% after automatic enrollment took effect. After three years of service, the participation rate among employees hired under automatic enrollment was 30 percentage points higher than among employees hired before automatic enrollment was implemented.⁷

According to the PSCA, 11% of §401(k) and profit-sharing plans used automatic enrollment in 2004. Automatic enrollment was more common in large plans than in small plans. It had been adopted by 1% of §401(k) plans with fewer than 50 participants and by 31% of plans with 5,000 or more participants. In a survey of mainly large firms, the benefits consulting firm Hewitt Associates found that 24% used automatic enrollment in 2005, up from 14% in 2003. Deloitte Consulting recently reported that 23% of the 830 plan sponsors it surveyed in 2005 and 2006 had instituted automatic enrollment.

Policy Issues

Automatic enrollment has been shown to increase participation rates in §401(k) plans among eligible employees. There are, however, two other important decisions that participants in a §401(k) plan must make, or that must be made for them: *how much* to contribute to the plan and *how to invest* those contributions. Plan sponsors who have adopted automatic enrollment generally have been conservative in setting the contribution amount and in choosing investments for employees who have been enrolled automatically. Both the PSCA and Deloitte Consulting report that the most common contribution rate for employees who are enrolled in a plan automatically is 3% of pay. These contributions are typically invested in a stable value fund, money market fund, or target retirement date fund.⁸ Many plan sponsors are reluctant to set the default contribution rate for automatic enrollment higher than 3% of pay because that rate was used in examples of permissible automatic enrollment practices published by the IRS. Employers also tend to choose conservative investments—those with little risk of capital loss, such as money market funds and stable value funds—due to concerns about their liability as plan fiduciaries if the investments they have chosen decline in value. Financial analysts generally agree that a contribution equal to 3% of pay is too small, and that the rate of return on money market funds and stable value funds is too low for most workers to build an adequate retirement fund over the course of their careers.⁹ Life-cycle funds and target retirement date funds allocate contributions among investments based on generally agreed upon principles of diversification. They are more likely than money market funds or stable value funds to result in adequate retirement savings over a lifetime.

⁷ James J. Choi, David Laibson, and Brigitte C. Madrian, “Plan Design and 401(k) Savings Outcomes,” *National Tax Journal*, vol. 52(2), June 2004, pp. 275-298.

⁸ Stable value funds typically invest in bonds and achieve rates of return 2 to 3 percentage points higher than money market funds. Most include a *guaranteed investment contract* (GIC) with an insurance company. The insurance company invests the money and guarantees the investors a rate of return. It keeps any returns above the guaranteed rate.

⁹ Many employers also provide matching contributions. Common match rates are 50% of the first 6% of pay that the employee defers or 100% of the first 3% of salary the employee defers.

Low default contribution rates and conservative default investment funds typical in plans that have automatic enrollment would be of less concern to policy-makers if participants took an active role in managing their contribution amounts and investment choices. Unfortunately, many participants in retirement plans behave passively, and for them the default choices often become permanent. This is a concern not only for workers who would not otherwise have enrolled in the plan, but also for participants who would have elected voluntarily to participate in the plan and who—if not for the plan’s default contribution rate and default investment funds—would have chosen a higher contribution rate and more appropriate investments for their retirement accounts.

Researchers have found that there is a substantial amount of inertia among participants in §401(k) plans with respect to managing their accounts.¹⁰ A relatively small percentage take great interest in managing their retirement funds, regularly increasing their contributions and re-balancing their accounts. Many plan participants, however, seem to accept the default contribution percentages and investment choices associated with automatic enrollment as implicit investment advice, or as an endorsement by their employer that these are somehow the “right” choices for them.

To clarify its interpretation of federal law with respect to contribution rates under automatic enrollment, the IRS issued a general information letter on March 17, 2004, stating that the automatic contribution level may be more (or less) than the 3% that it had used in previously published examples of acceptable practices under automatic enrollment. If the employer offers matching contributions, for example, the automatic contribution rate can be higher or lower than the percentage that is matched by employer contributions. The letter also stated that the automatic contribution percentage can be increased (or decreased) over time under a specified schedule—one based on years of service, for example. The employer must describe the details of the change in the required notice to employees of their right to select another contribution rate. The IRS letter also stated that increases in the automatic contribution percentage can be triggered by future increases in an employee’s pay or by bonuses. Again, the required employee notice must describe exactly how this would affect participating employees.

The rulings and letters issued by the IRS may encourage more firms to adopt automatic enrollment, and to couple it with automatic increases in the contribution rate until the employee reaches some agreed-upon maximum contribution level. Analysts point out, however, that employers who adopt automatic enrollment should be sure to put the participant’s contributions into appropriate investment funds as he or she gets older. Life-cycle funds, for example, progressively invest more in bonds and less in stocks as the employee approaches retirement age, lessening the chance of large capital losses. Employees also should be reminded continually that they have the right to change their contribution amount or to choose alternative investment funds.

One successful model of automatic enrollment coupled with progressive increases in the employee contribution rate was developed by economists Richard Thaler of the University of Chicago and Shlomo Benartzi of UCLA. Called *Save More Tomorrow* (SMarT), it asks workers to contribute a portion of their future raises into their §401(k) plan. This way, workers can raise their future contribution rate without experiencing a drop in take-home pay. In a case study of the SMarT plan, Thaler and Benartzi found that most workers (78%) who were asked to participate agreed to do so and most who joined (80%) continued with scheduled increases through at least

¹⁰ See James Choi, David Laibson, Brigitte Madrian, and Andrew Metrick, “Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance,” Working Paper 2002-3, Pension Research Council, University of Pennsylvania, Nov. 2001.

the fourth pay raise. (Even those who eventually dropped out continued to contribute a higher percentage of pay than they were contributing before the program began). Those who participated raised their average contribution rate from 3.5% of pay to 13.6% of pay over a 40-month period.¹¹

The Pension Protection Act

The Pension Protection Act of 2006 (P.L. 109-280) amended ERISA §404(c) to extend to default investments under automatic enrollment plans the same protections that participant-directed investments receive, thus relieving employers of fiduciary liability for investment losses. The law provides that beginning in 2008, §401(k) plans with automatic enrollment that satisfy certain requirements will be deemed to meet the nondiscrimination requirements of the Internal Revenue Code.¹² It also provides that plans consisting solely of contributions made through automatic enrollment will not be subject to the top-heavy rules.¹³ To be deemed as satisfying the nondiscrimination rules, a plan with automatic enrollment must meet requirements with respect to (1) automatic deferral of pay; (2) matching or nonelective contributions; and (3) notice to employees.

The PPA provides that a plan may limit eligibility for automatic enrollment to employees who were not eligible for the plan prior to the date it began automatic enrollment. The plan must provide that, unless an eligible employee elects otherwise, the employee will defer a percentage of pay not to exceed 10%, but at least equal to 3% of pay for the first year; 4% during the second year; 5% during the third year; and 6% during the fourth year and thereafter. The percentage must be applied uniformly to all eligible employees. The employer also must either make (1) a matching contribution on behalf of each nonhighly compensated employee equal to 100% of the first 1% of pay the employee defers and 50% of the next 5% of pay the employee defers, or (2) a nonelective contribution equal to at least 3% of pay on behalf of each eligible nonhighly compensated employee. If the employer makes matching contributions, the match rate for a highly compensated employee cannot be greater than the match rate with respect to the same rate of deferral of a nonhighly compensated employee. Also, if the plan makes matching contributions, it must assure that matching contributions are not provided for elective deferrals in excess of 6% of pay, and that the match rate does not increase as the rate of an employee's elective deferrals increases. Plans with automatic enrollment must provide that employees with at least two years of service are 100% vested in employer contributions. (Employees are always 100% vested in their own contributions.)

Each employee eligible to participate in the plan must receive notice of his or her right to elect not to have automatic deferrals made on the employee's behalf or to elect to defer a different amount. The employee must be informed how contributions made under the automatic enrollment arrangement will be invested in the absence of any investment election by the employee.

¹¹ See Richard H. Thaler and Shlomo Benartzi, "Save More Tomorrow™: Using Behavioral Economics to Increase Employee Saving," *Journal of Political Economy*, vol. 112(1) Feb. 2004.

¹² The IRC prohibits plans from discriminating in favor of highly-compensated employees with respect to contributions or benefits. Plans are tested for discrimination by a mathematical formula that measures contributions for highly-compensated employees relative to other employees.

¹³ A "top heavy" plan is one in which the account values of the "key employees" exceed 60% of the total of the accounts of all employees under the plan. A "key employee" is defined as anyone who in any of the preceding four plan years was (1) a 5% owner of the employer, (2) a 1% owner of the employer having annual compensation from the employer of more than \$150,000, or (3) an officer of the company having an annual salary greater than \$140,000. Top-heavy plans are subject to minimum benefits and faster vesting of benefits for non-key employees.

Erroneous automatic deferrals may be distributed from the plan within 90 days after the date of the first deferral. The 10% early withdrawal tax will not apply to distributions of erroneous automatic deferrals. In addition, the excise tax on excess contributions will not apply if the excess contribution, and any income attributable to the contribution, is distributed within six months after the close of the plan year. The PPA also preempts any state law that would directly or indirectly prohibit or restrict the inclusion in a plan of an automatic contribution arrangement.

Author Contact Information

Patrick Purcell
Specialist in Income Security
ppurcell@crs.loc.gov, 7-7571

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