PLAN SPONSOR
Digest

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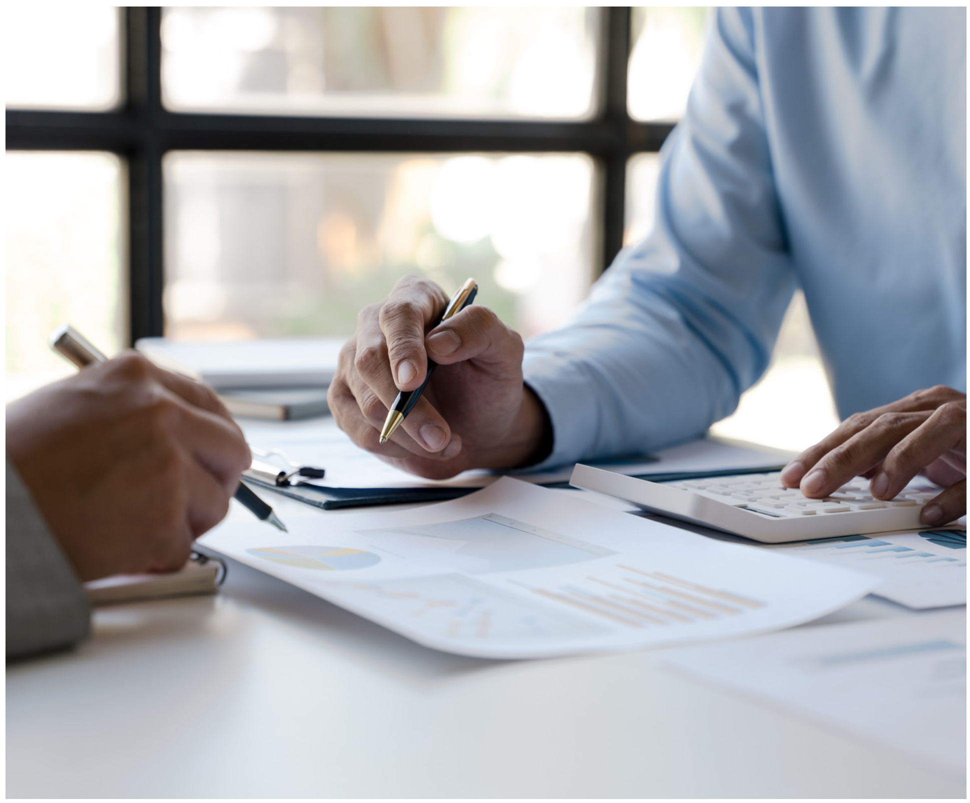
The ongoing evolution of plan automation



While various forms of retirement plan automation—such as auto enrollment and auto escalation—have become commonplace in recent years, it was not all that long ago that plan sponsors first begin testing the retirement plan automation waters, seeking guidance from the federal government as to what was permissible within 401(k) plans and other similar defined contribution savings arrangements. With the most recent retirement reform legislation (SECURE 2.0 Act) enshrining automatic enrollment as a mandatory feature for many newly established 401(k) plans beginning in 2025, now is a good time to step back and take a look at the evolution of plan automation over the past 25 years. While we are at it, we might as well pull out our proverbial crystal ball and speculate a bit on what the future might hold with regard to plan automation.

The early years

Some of the first official federal guidance concerning plan automation came in the form of two IRS Revenue Rulings issued in 1998 and 2000 (Rev. Rule 98-30 and Rev. Rule 2000-8). In these rulings, the IRS confirmed the basic viability of auto enrollment, both for new hires and for existing employees. As the

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concept of auto enrollment began to pick up momentum, Congress saw the opportunity to increase national savings rates by implementing laws that not only permitted—but actually promoted—auto enrollment. The Pension Protection Act of 2006 (PPA) ushered in a more uniform approach to automatic enrollment (Eligible Automatic Contribution Arrangements) and created a new safe harbor 401(k) plan design alternative allowing plan sponsors to sidestep some of the more cumbersome traditional nondiscrimination testing requirements by implementing what is known as a “Qualified Automatic Contribution Arrangement” or QACA.

Picking up steam

With auto enrollment now firmly established in federal law as a viable plan design alternative and mounting statistical evidence confirming the positive impact of plan automation on plan participation and overall national savings rates, the use of both auto enrollment and auto escalation has continued to grow, year over year. More recently, as part of the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019, Congress created new tax incentives promoting the use of automatic enrollment within the small business community. Likewise, auto enrollment plays a central role in many of the newly formed state-sponsored retirement savings programs, often in the form of an auto enrollment, payroll deduction IRA program.

From optional to mandatory

As mentioned at the beginning of this article, auto enrollment and auto escalation will actually become mandatory for many new plans established on or after January 1, 2025. While mandates such as this are frowned upon by many plan sponsors, some view the mandate as more form over substance given the widespread voluntary adoption of the plan design alternatives already taking place under current law.

What is next?

Even as auto enrollment, re-enrollment and escalation have taken center stage in recent years, other forms of plan automation have also been taking root. In addition to creating an auto enrollment mandate for many newly established plans, SECURE 2.0 Act also codifies a relatively nascent concept referred to as auto portability. While still in its infancy, auto portability holds the promise of reducing retirement savings “leakage” by facilitating a more friction-free transition of retirement savings from one employer plan to the next as workers move from one employer to another.

Another plan automation strategy that will likely be a topic of discussion in the coming years is auto annuitization. While not everyone agrees, there seems to be a growing consensus among financial industry professionals that annuitization can and should play a crucial role in the so-called “decumulation” phase of retirement for many Americans. Nonetheless, while considerable evidence points to potential advantages of annuitization, very few retirement savers voluntarily elect to annuitize a portion of their retirement savings at retirement. While the concept of mandatory annuitization is unlikely to gain traction in the U.S., the concept of auto annuitization—where the default form of payout under a plan is annuitization, but a participant may affirmatively elect an alternative form of distribution—may garner the attention of lawmakers in coming years as Congress continues to address the numerous challenges surrounding retirement security*.

Net benefit

As critics of plan automation will point out, the plan automaton evolution has not been without its share of hiccups. Part of the national learning curve has involved coming to grips with the fact that not all auto enrollment designs are equally effective at optimizing retirement savings. It was quite common in the early days of plan automation, for example, for plans to simply default new plan participants into participation at a relatively low savings rate (e.g., 3%) and then leave them at that initial default rate year after year. In time, it became clear that both higher initial default rates (at least in some cases) combined with automatic escalation (gradual default increases in deferral rate) are needed for the level of savings rates needed to achieve financial security in retirement.

As the concepts of auto enrollment, re-enrollment and escalation have continued to evolve, however, the cumulative effect of these relatively simple design techniques has been nothing short of staggering. Given that auto enrollment and escalation are now firmly entrenched in federal retirement savings policy, it seems likely that we will see further expansion and refinement of plan automation techniques in the coming years.

*Under the Retirement Equity Act of 1984 (REA), certain types of plans including defined benefit and money purchase pension plans are already required to offer annuitized payouts (Qualified Preretirement Survivor Annuities and Qualified Joint and Survivor Annuities) to participants as the default from of payout.

SECURE 2.0 Act update: IRS announces clarification on catch-up contributions.

In late August, the IRS issued Notice 2023-62 providing an additional two-year administrative transition period on Section 603(c) of the SECURE 2.0 Act. This section originally required that all catch-up contributions to defined contribution plans be designated as Roth contributions for participants with FICA wages greater than $145,000 starting in 2024.

Because the financial services industry had concerns with this provision, the IRS issued Notice 2023-62 in order to give plan sponsors more time to understand the rules regarding catch-up contributions and update their plan documents and payroll systems accordingly, as well as share additional guidance to determine the scope of Section 603(c) for sole proprietors.

What's changing?

Under Section 603(c) of the SECURE 2.0 Act, the provisions initially applied to taxable years that begin after December 31, 2023. However, as the IRS just noted, the first two taxable years that begin after December 31, 2023, will be regarded as an administrative transition period.

Specifically, until 2026, those catch-up contributions will be treated as satisfying the requirements of section 414(v)(7)(A) which describes the rules of catch-up contributions, even if the contributions are not designated as Roth contributions. Further, a plan that does not provide for designated Roth contributions will be treated as satisfying the requirements of section 414(v)(7)(B) in this transition period.

As you consider your current plan design and employees who are eligible for catch-up contributions, ensure you are addressing any questions with your advisor and recordkeeping partners.

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